CODE OF FEDERAL REGULATIONS

Title 26

Internal Revenue

Part 1 (§§ 1.140 to 1.169)

Revised as of April 1, 2022

Containing a codification of documents
of general applicability and future effect

As of April 1, 2022

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

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

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OLIVER A. POTTS,
Director,
Office of the Federal Register
April 1, 2022

THIS TITLE

Title 26—INTERNAL REVENUE is composed of twenty-two volumes. The contents of these volumes represent all current regulations codified under this title by the Internal Revenue Service, Department of the Treasury, as of April 1, 2022. The first fifteen volumes comprise part 1 (Subchapter A—Income Tax) and are arranged by sections as follows: §§ 1.0–1.60; §§ 1.61–1.139; §§ 1.140–1.169; §§ 1.170–1.300; §§ 1.301–1.400; §§ 1.401–1.409; §§ 1.410–1.440; §§ 1.441–1.500; §§ 1.501–1.640; §§ 1.641–1.850; §§ 1.851–1.907; §§ 1.908–1.1000; §§ 1.1001–1.1400; §§ 1.1401–1.1550; and § 1.1551 to end of part 1. The sixteenth volume containing parts 2–29, includes the remainder of subchapter A and all of Subchapter B—Estate and Gift Taxes. The last six volumes contain parts 30–39 (Subchapter C—Employment Taxes and Collection of Income Tax at Source); parts 40–49; parts 50–299 (Subchapter D—Miscellaneous Excise Taxes); parts 300–499 (Subchapter F—Procedure and Administration); parts 500–599 (Subchapter G—Regulations under Tax Conventions); and part 600 to end (Subchapter H—Internal Revenue Practice).

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

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

Title 26—Internal Revenue

(This book contains part 1, §§ 1.140 to 1.169)

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

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

SUBCHAPTER A—INCOME TAX (CONTINUED)

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

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

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

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

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

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

SUBCHAPTER A—INCOME TAX (CONTINUED)

PART 1—INCOME TAXES (CONTINUED)

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

Section 1.148–0 through 1.148–11 also issued under 26 U.S.C. 148(i).

Section 1.148–6 also issued under 26 U.S.C. 148 (f), (g), and (i).

Section 1.149(b)–1 also issued under 26 U.S.C. 149(b)(3)(B) (v).

Section 1.149(d)–1 also issued under 26 U.S.C. 149(d)(7).

Section 1.149(e)–1 also issued under 26 U.S.C. 149(e).

Section 1.149(g)–1 also issued under 26 U.S.C. 149(g)(5).

Section 1.150–4 also issued under 26 U.S.C. 150 (c)(5).

Section 1.152–4 also issued under 26 U.S.C. 152(e).

Section 1.162–24 also issued under 26 U.S.C. 162(h).

Section 1.162(k)–1 is also issued under section 26 U.S.C. 162(k).

Section 1.163–8T also issued under 26 U.S.C. 469(k)(4).

Section 1.163–9T also issued under 26 U.S.C. 163(h)(3)(D).

Section 1.163(j)–1 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–2 also issued under 26 U.S.C. 1502.

Section 1.163(j)–3 also issued under 26 U.S.C. 1502.

Section 1.163(j)–4 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–5 also issued under 26 U.S.C. 1502.

Section 1.163(j)–6 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–7 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–8 also issued under 26 U.S.C. 163(j)(8)(B).

Section 1.163(j)–9 also issued under 26 U.S.C. 163(j)(7)(B) and (C) and 26 U.S.C. 1502.

Section 1.163(j)–10 also issued under 26 U.S.C. 163(j)(8)(B) and 26 U.S.C. 1502.

Section 1.163(j)–11 also issued under 26 U.S.C. 1502.

Section 1.165–12 also issued under 26 U.S.C. 165(j)(3).

Section 1.166–10 also issued under 26 U.S.C. 166(f).

Section 1.168(d)–1 also issued under 26 U.S.C. 168(d)(3).

Section 1.168(f)(8)–1T also added under sec. 112(c), Black Lung Benefits Revenue Act of 1981 (Pub. L. 97–119).

Section 1.168(h)–1 also issued under 26 U.S.C. 168.

Section 1.168(i)–1 also issued under 26 U.S.C. 168(i)(4).

Section 1.168(i)–1T also issued under 26 U.S.C. 168(i)(4).

Section 1.168(i)–2 also issued under 26 U.S.C. 168.

Section 1.168(i)–4 also issued under 26 U.S.C. 168(i)(5).

Section 1.168(j)–1T also added under 26 U.S.C. 168(j)(10).

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

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[T.D. 8712, 62 FR 2283, Jan. 16, 1997, as amended by T.D. 8757, 63 FR 3259, Jan. 22, 1998; T.D. 8941, 66 FR 4664, Jan. 18, 2001; T.D. 9016, 67 FR 59759, Sept. 23, 2002; T.D. 9085, 68 FR 45775, Aug. 4, 2003; T.D. 9150, 69 FR 50066, Aug. 13, 2004; T.D. 9234, 70 FR 75031, Dec. 19, 2005; T.D. 9429, 73 FR 63374, Oct. 24, 2008; T.D. 9741, 80 FR 65642, Oct. 27, 2015; T.D. 9777, 81 FR 46591, July 18, 2016]

Tax Exemption Requirements for State and Local Bonds

§ 1.141–1 Definitions and rules of general application.

(a) *In general.* For purposes of §§ 1.141–0 through 1.141–16, the following definitions and rules apply: The definitions in this section, the definitions in § 1.150–1, the definition of placed in service in § 1.150–2(c), the definition of reasonably required reserve or replacement fund in § 1.148–2(f), and the definitions in § 1.148–1 of bond year, commingled fund, fixed yield issue, higher yielding investments, investment, investment proceeds, issue price, issuer, nonpurpose investment, purpose investment, qualified guarantee, qualified hedge, reasonable expectations or reasonableness, rebate amount, replacement proceeds, sale proceeds, variable yield issue and yield.

(b) *Certain general definitions.*

Common areas means portions of a facility that are equally available to all users of a facility on the same basis for uses that are incidental to the primary use of the facility. For example, hallways and elevators generally are treated as common areas if they are used by the different lessees of a facility in connection with the primary use of that facility.

Consistently applied means applied uniformly to account for proceeds and other amounts.

Deliberate action is defined in § 1.141–2(d)(3).

Discrete portion means a portion of a facility that consists of any separate and discrete portion of a facility to which use is limited, other than common areas. A floor of a building and a portion of a building separated by walls, partitions, or other physical barriers are examples of a discrete portion.

Disposition is defined in § 1.141–12(c)(1).

Disposition proceeds is defined in § 1.141–12(c)(1).

Essential governmental function is defined in § 1.141–5(d)(4)(ii).

Financed means constructed, reconstructed, or acquired with proceeds of an issue.

Governmental bond has the same meaning as in § 1.150–1(b), except that, for purposes of § 1.141–13, governmental bond is defined in § 1.141–13(b)(2)(iv).

Governmental person means a state or local governmental unit as defined in § 1.103–1 or any instrumentality thereof. It does not include the United States or any agency or instrumentality thereof.

Hazardous waste remediation bonds is defined in § 1.141–4(f)(1).

Measurement period is defined in § 1.141–3(g)(2).

Nongovernmental person means a person other than a governmental person.

Output facility means electric and gas generation, transmission, distribution, and related facilities, and water collection, storage, and distribution facilities.

Private business tests means the private business use test and the private security or payment test of section 141(b).

Proceeds means the sale proceeds of an issue (other than those sale proceeds used to retire bonds of the issue that are not deposited in a reasonably required reserve or replacement fund). Proceeds also include any investment proceeds from investments that accrue during the project period (net of rebate amounts attributable to the project period). Disposition proceeds of an issue are treated as proceeds to the extent provided in § 1.141–12. The Commissioner may treat any replaced amounts as proceeds.

Project period means the period beginning on the issue date and ending on the date that the project is placed in service. In the case of a multipurpose issue, the issuer may elect to treat the project period for the entire issue as ending on either the expiration of the temporary period described in § 1.148–2(e)(2) or the end of the fifth bond year after the issue date.

Public utility property means public utility property as defined in section 168(i)(10).

Qualified bond means a qualified bond as defined in section 141(e).

Renewal option means a provision under which either party has a legally enforceable right to renew the contract. Thus, for example, a provision under which a contract is automatically renewed for 1-year periods absent cancellation by either party is not a renewal option (even if it is expected to be renewed).

Replaced amounts means replacement proceeds other than amounts that are treated as replacement proceeds solely because they are sinking funds or pledged funds.

Weighted average maturity is determined under section 147(b).

Weighted average reasonably expected economic life is determined under section 147(b). The reasonably expected economic life of property may be determined by reference to the class life of the property under section 168.

(c) *Elections.* Elections must be made in writing on or before the issue date and retained as part of the bond documents, and, once made, may not be revoked without the permission of the Commissioner.

(d) *Related parties.* Except as otherwise provided, all related parties are treated as one person and any reference to ''person'' includes any related party.

(e) *Partnerships.* A partnership (as defined in section 7701(a)(2)) is treated as an aggregate of its partners, rather than as an entity.

[T.D. 8712, 62 FR 2284, Jan. 16, 1997, as amended by T.D. 9234, 70 FR 75032, Dec. 19, 2005; T.D. 9741, 80 FR 65643, Oct. 27, 2015; T.D. 9777, 81 FR 46592, July 18, 2016]

§ 1.141–2 Private activity bond tests.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. The purpose of the private activity bond tests of section 141 is to limit the volume of tax-exempt bonds that finance the activities of nongovernmental persons, without regard to whether a financing actually transfers benefits of tax-exempt financing to a nongovernmental person. The private activity bond tests serve to identify arrangements that have the potential to transfer the benefits of tax-exempt financing, as well as arrangements that actually transfer these benefits. The regulations under section 141 may not be applied in a manner that is inconsistent with these purposes.

(b) *Scope.* Sections 1.141–0 through 1.141–16 apply generally for purposes of the private activity bond limitations under section 141.

(c) *General definition of private activity bond.* Under section 141, bonds are private activity bonds if they meet either the private business use test and private security or payment test of section 141(b) or the private loan financing test of section 141(c). The private business use and private security or payment tests are described in §§ 1.141–3 and 1.141–4. The private loan financing test is described in § 1.141–5.

(d) *Reasonable expectations and deliberate actions*—(1) *In general.* An issue is an issue of private activity bonds if the issuer reasonably expects, as of the issue date, that the issue will meet either the private business tests or the private loan financing test. An issue is also an issue of private activity bonds if the issuer takes a deliberate action, subsequent to the issue date, that causes the conditions of either the private business tests or the private loan financing test to be met.

(2) *Reasonable expectations test*—(i) *In general.* In general, the reasonable expectations test must take into account reasonable expectations about events and actions over the entire stated term of an issue.

(ii) *Special rule for issues with mandatory redemption provisions.* An action that is reasonably expected, as of the issue date, to occur after the issue date and to cause either the private business tests or the private loan financing test to be met may be disregarded for purposes of those tests if—

(A) The issuer reasonably expects, as of the issue date, that the financed property will be used for a governmental purpose for a substantial period before the action;

(B) The issuer is required to redeem all nonqualifying bonds (regardless of the amount of disposition proceeds actually received) within 6 months of the date of the action;

(C) The issuer does not enter into any arrangement with a nongovernmental person, as of the issue date, with respect to that specific action; and

(D) The mandatory redemption of bonds meets all of the conditions for remedial action under §1.141–12(a).

(3) *Deliberate action defined*—(i) *In general.* Except as otherwise provided in this paragraph (d)(3), a deliberate action is any action taken by the issuer that is within its control. An intent to violate the requirements of section 141 is not necessary for an action to be deliberate.

(ii) *Safe harbor exceptions.* An action is not treated as a deliberate action if—

(A) It would be treated as an involuntary or compulsory conversion under section 1033; or

(B) It is taken in response to a regulatory directive made by the federal government. See §1.141–7(g)(4).

(4) *Special rule for dispositions of personal property in the ordinary course of an established governmental program*—(i) *In general.* Dispositions of personal property in the ordinary course of an established governmental program are not treated as deliberate actions if—

(A) The weighted average maturity of the bonds financing that personal property is not greater than 120 percent of the reasonably expected actual use of that property for governmental purposes;

(B) The issuer reasonably expects on the issue date that the fair market value of that property on the date of disposition will be not greater than 25 percent of its cost; and

(C) The property is no longer suitable for its governmental purposes on the date of disposition.

(ii) *Reasonable expectations test.* The reasonable expectation that a disposition described in paragraph (d)(4)(i) of this section may occur in the ordinary course while the bonds are outstanding will not cause the issue to meet the private activity bond tests if the issuer is required to deposit amounts received from the disposition in a commingled fund with substantial tax or other governmental revenues and the issuer reasonably expects to spend the amounts on governmental programs within 6 months from the date of commingling.

(iii) *Separate issue treatment.* An issuer may treat the bonds properly allocable to the personal property eligible for this exception as a separate issue under §1.150–1(c)(3).

(5) *Special rule for general obligation bond programs that finance a large number of separate purposes.* The determination of whether bonds of an issue are private activity bonds may be based solely on the issuer's reasonable expectations as of the issue date if all of the requirements of paragraphs (d)(5)(i) through (vii) of this section are met.

(i) The issue is an issue of general obligation bonds of a general purpose governmental unit that finances at least 25 separate purposes (as defined in §1.150–1(c)(3)) and does not predominantly finance fewer than 4 separate purposes.

(ii) The issuer has adopted a fund method of accounting for its general governmental purposes that makes tracing the bond proceeds to specific expenditures unreasonably burdensome.

(iii) The issuer reasonably expects on the issue date to allocate all of the net proceeds of the issue to capital expenditures within 6 months of the issue date and adopts reasonable procedures to verify that net proceeds are in fact so expended. A program to randomly spot check that 10 percent of the net proceeds were so expended generally is a reasonable verification procedure for this purpose.

(iv) The issuer reasonably expects on the issue date to expend all of the net proceeds of the issue before expending proceeds of a subsequent issue of similar general obligation bonds.

(v) The issuer reasonably expects on the issue date that it will not make any loans to nongovernmental persons with the proceeds of the issue.

(vi) The issuer reasonably expects on the issue date that the capital expenditures that it could make during the 6-month period beginning on the issue date with the net proceeds of the issue that would not meet the private business tests are not less than 125 percent of the capital expenditures to be financed with the net proceeds of the issue.

(vii) The issuer reasonably expects on the issue date that the weighted average maturity of the issue is not greater than 120 percent of the weighted average reasonably expected economic life of the capital expenditures financed with the issue. To determine reasonably expected economic life for this purpose an issuer may use reasonable estimates based on the type of expenditures made from a fund.

(e) *When a deliberate action occurs.* A deliberate action occurs on the date the issuer enters into a binding contract with a nongovernmental person for use of the financed property that is not subject to any material contingencies.

(f) *Certain remedial actions.* See §1.141–12 for certain remedial actions that prevent a deliberate action with respect to property financed by an issue from causing that issue to meet the private business use test or the private loan financing test.

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

Example 1 Involuntary action. City B issues bonds to finance the purchase of land. On the issue date, B reasonably expects that it will be the sole user of the land for the entire term of the bonds. Subsequently, the federal government acquires the land in a condemnation action. B sets aside the condemnation proceeds to pay debt service on the bonds but does not redeem them on their first call date. The bonds are not private activity bonds because B has not taken a deliberate action after the issue date. See, however, §1.141–14(b), *Example 2.*

Example 2 Reasonable expectations test—involuntary action. The facts are the same as in *Example 1*, except that, on the issue date, B reasonably expects that the federal government will acquire the land in a condemnation action during the term of the bonds. On the issue date, the present value of the amount that B reasonably expects to receive from the federal government is greater than 10 percent of the present value of the debt service on the bonds. The terms of the bonds do not require that the bonds be redeemed within 6 months of the acquisition by the federal government. The bonds are private activity bonds because the issuer expects as of the issue date that the private business tests will be met.

Example 3 Reasonable expectations test—mandatory redemption. City C issues bonds to rehabilitate an existing hospital that it currently owns. On the issue date of the bonds, C reasonably expects that the hospital will be used for a governmental purpose for a substantial period. On the issue date, C also plans to construct a new hospital, but the placed in service date of that new hospital is uncertain. C reasonably expects that, when the new hospital is placed in service, it will sell or lease the rehabilitated hospital to a private hospital corporation. The bond documents require that the bonds must be redeemed within 6 months of the sale or lease of the rehabilitated hospital (regardless of the amount actually received from the sale). The bonds meet the reasonable expectations requirement of the private activity bond tests if the mandatory redemption of bonds meets all of the conditions for a remedial action under §1.141–12(a).

Example 4 Dispositions in the ordinary course of an established governmental program. City D issues bonds with a weighted average maturity of 6 years for the acquisition of police cars. D reasonably expects on the issue date that the police cars will be used solely by its police department, except that, in the ordinary course of its police operations, D sells its police cars to a taxicab corporation after 5 years of use because they are no longer suitable for police use. Further, D reasonably expects that the value of the police cars when they are no longer suitable for police use will be no more than 25 percent of cost. D subsequently sells 20 percent of the police cars after only 3 years of actual use. At that time, D deposits the proceeds from the sale of the police cars in a commingled fund with substantial tax revenues and reasonably expects to spend the proceeds on governmental programs within 6 months of the date of deposit. D does not trace the actual use of these commingled amounts. The sale of the police cars does not cause the private activity bond tests to be met because the requirements of paragraph (d)(4) of this section are met.

[T.D. 8712, 62 FR 2284, Jan. 16, 1997, as amended by T.D. 8757, 63 FR 3260, Jan. 22, 1998; T.D. 9016, 67 FR 59759, Sept. 23, 2002]

§ 1.141–3 Definition of private business use.

(a) *General rule*—(1) *In general.* The private business use test relates to the use of the proceeds of an issue. The 10 percent private business use test of section 141(b)(1) is met if more than 10 percent of the proceeds of an issue is used in a trade or business of a nongovernmental person. For this purpose, the use of financed property is treated as the direct use of proceeds. Any activity carried on by a person other than a natural person is treated as a trade or business. Unless the context or a provision clearly requires otherwise, this section also applies to the private business use test under sections 141(b)(3) (unrelated or disproportionate use), 141(b)(4) ($15 million limitation for certain output facilities), and 141(b)(5) (the coordination with the volume cap where the nonqualified amount exceeds $15 million).

(2) *Indirect use.* In determining whether an issue meets the private business use test, it is necessary to look to both the indirect and direct uses of proceeds. For example, a facility is treated as being used for a private business use if it is leased to a nongovernmental person and subleased to a governmental person or if it is leased to a governmental person and then subleased to a nongovernmental person, provided that in each case the nongovernmental person's use is in a trade or business. Similarly, the issuer's use of the proceeds to engage in a series of financing transactions for property to be used by nongovernmental persons in their trades or businesses may cause the private business use test to be met. In addition, proceeds are treated as used in the trade or business of a nongovernmental person if a nongovernmental person, as a result of a single transaction or a series of related transactions, uses property acquired with the proceeds of an issue.

(3) *Aggregation of private business use.* The use of proceeds by all nongovernmental persons is aggregated to determine whether the private business use test is met.

(b) *Types of private business use arrangements*—(1) *In general.* Both actual and beneficial use by a nongovernmental person may be treated as private business use. In most cases, the private business use test is met only if a nongovernmental person has special legal entitlements to use the financed property under an arrangement with the issuer. In general, a nongovernmental person is treated as a private business user of proceeds and financed property as a result of ownership; actual or beneficial use of property pursuant to a lease, or a management or incentive payment contract; or certain other arrangements such as a take or pay or other output-type contract.

(2) *Ownership.* Except as provided in paragraph (d)(1) or (d)(2) of this section, ownership by a nongovernmental person of financed property is private business use of that property. For this purpose, ownership refers to ownership for federal income tax purposes.

(3) *Leases.* Except as provided in paragraph (d) of this section, the lease of financed property to a nongovernmental person is private business use of that property. For this purpose, any arrangement that is properly characterized as a lease for federal income tax purposes is treated as a lease. In determining whether a management contract is properly characterized as a lease, it is necessary to consider all of the facts and circumstances, including the following factors—

(i) The degree of control over the property that is exercised by a nongovernmental person; and

(ii) Whether a nongovernmental person bears risk of loss of the financed property.

(4) *Management contracts*—(i) *Facts and circumstances test*. Except as provided in paragraph (d) of this section, a management contract (within the meaning of paragraph (b)(4)(ii) of this section) with respect to financed property may result in private business use of that property, based on all of the facts and circumstances. A management contract with respect to financed property generally results in private business use of that property if the contract provides for compensation for services rendered with compensation based, in whole or in part, on a share of net profits from the operation of the facility.

(ii) *Management contract defined*. For purposes of this section, a management contract is a management, service, or incentive payment contract between a governmental person and a service provider under which the service provider provides services involving all, a portion of, or any function of, a facility. For example, a contract for the provision of management services for an entire hospital, a contract for management services for a specific department of a hospital, and an incentive payment contract for physician services to patients of a hospital are each treated as a management contract.

(iii) *Arrangements generally not treated as management contracts*. The arrangements described in paragraphs (b)(4)(iii)(A) through (D) of this section generally are not treated as management contracts that give rise to private business use.

(A) Contracts for services that are solely incidental to the primary governmental function or functions of a financed facility (for example, contracts for janitorial, office equipment repair, hospital billing, or similar services).

(B) The mere granting of admitting privileges by a hospital to a doctor, even if those privileges are conditioned on the provision of de minimis services, if those privileges are available to all qualified physicians in the area, consistent with the size and nature of its facilities.

(C) A contract to provide for the operation of a facility or system of facilities that consists predominantly of public utility property, if the only compensation is the reimbursement of actual and direct expenses of the service provider and reasonable administrative overhead expenses of the service provider.

(D) A contract to provide for services, if the only compensation is the reimbursement of the service provider for actual and direct expenses paid by the service provider to unrelated parties.

(iv) *Management contracts that are properly treated as other types of private business use*. A management contract with respect to financed property results in private business use of that property if the service provider is treated as the lessee or owner of financed property for federal income tax purposes, unless an exception under paragraph (d) of this section applies to the arrangement.

(5) *Output contracts*. See §1.141–7 for special rules for contracts for the purchase of output of output facilities.

(6) *Research agreements*—(i) *Facts and circumstances test*. Except as provided in paragraph (d) of this section, an agreement by a nongovernmental person to sponsor research performed by a governmental person may result in private business use of the property used for the research, based on all of the facts and circumstances.

(ii) *Research agreements that are properly treated as other types of private business use*. A research agreement with respect to financed property results in private business use of that property if the sponsor is treated as the lessee or owner of financed property for federal income tax purposes, unless an exception under paragraph (d) of this section applies to the arrangement.

(7) *Other actual or beneficial use*—(i) *In general*. Any other arrangement that conveys special legal entitlements for beneficial use of bond proceeds or of financed property that are comparable to special legal entitlements described in paragraphs (b)(2), (3), (4), (5), or (6) of this section results in private business use. For example, an arrangement that conveys priority rights to the use or capacity of a facility generally results in private business use.

(ii) *Special rule for facilities not used by the general public.* In the case of financed property that is not available for use by the general public (within the meaning of paragraph (c) of this section), private business use may be established solely on the basis of a special economic benefit to one or more nongovernmental persons, even if those nongovernmental persons have no special legal entitlements to use of the property. In determining whether special economic benefit gives rise to private business use it is necessary to consider all of the facts and circumstances, including one or more of the following factors—

(A) Whether the financed property is functionally related or physically proximate to property used in the trade or business of a nongovernmental person;

(B) Whether only a small number of nongovernmental persons receive the special economic benefit; and

(C) Whether the cost of the financed property is treated as depreciable by any nongovernmental person.

(c) *Exception for general public use*—(1) *In general.* Use as a member of the general public (general public use) is not private business use. Use of financed property by nongovernmental persons in their trades or businesses is treated as general public use only if the property is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business.

(2) *Use on the same basis.* In general, use under an arrangement that conveys priority rights or other preferential benefits is not use on the same basis as the general public. Arrangements providing for use that is available to the general public at no charge or on the basis of rates that are generally applicable and uniformly applied do not convey priority rights or other preferential benefits. For this purpose, rates may be treated as generally applicable and uniformly applied even if—

(i) Different rates apply to different classes of users, such as volume purchasers, if the differences in rates are customary and reasonable; or

(ii) A specially negotiated rate arrangement is entered into, but only if the user is prohibited by federal law from paying the generally applicable rates, and the rates established are as comparable as reasonably possible to the generally applicable rates.

(3) *Long-term arrangements not treated as general public use.* An arrangement is not treated as general public use if the term of the use under the arrangement, including all renewal options, is greater than 200 days. For this purpose, a right of first refusal to renew use under the arrangement is not treated as a renewal option if—

(i) The compensation for the use under the arrangement is redetermined at generally applicable, fair market value rates that are in effect at the time of renewal; and

(ii) The use of the financed property under the same or similar arrangements is predominantly by natural persons who are not engaged in a trade or business.

(4) *Relation to other use.* Use of financed property by the general public does not prevent the proceeds from being used for a private business use because of other use under this section.

(d) *Other exceptions*—(1) *Agents.* Use of proceeds by nongovernmental persons solely in their capacity as agents of a governmental person is not private business use. For example, use by a nongovernmental person that issues obligations on behalf of a governmental person is not private business use to the extent the nongovernmental person's use of proceeds is in its capacity as an agent of the governmental person.

(2) *Use incidental to financing arrangements.* Use by a nongovernmental person that is solely incidental to a financing arrangement is not private business use. A use is solely incidental to a financing arrangement only if the nongovernmental person has no substantial rights to use bond proceeds or financed property other than as an agent of the bondholders. For example, a nongovernmental person that acts solely as an owner of title in a sale and leaseback financing transaction with a city generally is not a private business user of the property leased to the city, provided that the nongovernmental person has assigned all of its rights to use the leased facility to the trustee for the bondholders upon default by the

city. Similarly, bond trustees, servicers, and guarantors are generally not treated as private business users.

(3) *Exceptions for arrangements other than arrangements resulting in ownership of financed property by a nongovernmental person*—(i) *Arrangements not available for use on the same basis by natural persons not engaged in a trade or business.* Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if—

(A) The term of the use under the arrangement, including all renewal options, is not longer than 100 days;

(B) The arrangement would be treated as general public use, except that it is not available for use on the same basis by natural persons not engaged in a trade or business because generally applicable and uniformly applied rates are not reasonably available to natural persons not engaged in a trade or business; and

(C) The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

(ii) *Negotiated arm's-length arrangements.* Use by a nongovernmental person pursuant to an arrangement, other than an arrangement resulting in ownership of financed property by a nongovernmental person, is not private business use if—

(A) The term of the use under the arrangement, including all renewal options, is not longer than 50 days;

(B) The arrangement is a negotiated arm's-length arrangement, and compensation under the arrangement is at fair market value; and

(C) The property is not financed for a principal purpose of providing that property for use by that nongovernmental person.

(4) *Temporary use by developers.* Use during an initial development period by a developer of an improvement that carries out an essential governmental function is not private business use if the issuer and the developer reasonably expect on the issue date to proceed with all reasonable speed to develop the improvement and property benefited by that improvement and to transfer the improvement to a governmental person, and if the improvement is in fact transferred to a governmental person promptly after the property benefited by the improvement is developed.

(5) *Incidental use*—(i) *General rule.* Incidental uses of a financed facility are disregarded, to the extent that those uses do not exceed 2.5 percent of the proceeds of the issue used to finance the facility. A use of a facility by a nongovernmental person is incidental if—

(A) Except for vending machines, pay telephones, kiosks, and similar uses, the use does not involve the transfer to the nongovernmental person of possession and control of space that is separated from other areas of the facility by walls, partitions, or other physical barriers, such as a night gate affixed to a structural component of a building (a nonpossessory use);

(B) The nonpossessory use is not functionally related to any other use of the facility by the same person (other than a different nonpossessory use); and

(C) All nonpossessory uses of the facility do not, in the aggregate, involve the use of more than 2.5 percent of the facility.

(ii) *Illustrations.* Incidental uses may include pay telephones, vending machines, advertising displays, and use for television cameras, but incidental uses may not include output purchases.

(6) *Qualified improvements.* Proceeds that provide a governmentally owned improvement to a governmentally owned building (including its structural components and land functionally related and subordinate to the building) are not used for a private business use if—

(i) The building was placed in service more than 1 year before the construction or acquisition of the improvement is begun;

(ii) The improvement is not an enlargement of the building or an improvement of interior space occupied exclusively for any private business use;

(iii) No portion of the improved building or any payments in respect of the improved building are taken into account under section 141(b)(2)(A) (the private security test); and

(iv) No more than 15 percent of the improved building is used for a private business use.

(e) *Special rule for tax assessment bonds.* In the case of a tax assessment bond that satisfies the requirements of §1.141–5(d), the loan (or deemed loan) of the proceeds to the borrower paying the assessment is disregarded in determining whether the private business use test is met. However, the use of the loan proceeds is not disregarded in determining whether the private business use test is met.

(f) *Examples.* The following examples illustrate the application of paragraphs (a) through (e) of this section. In each example, assume that the arrangements described are the only arrangements with nongovernmental persons for use of the financed property.

Example 1. Nongovernmental ownership. State A issues 20-year bonds to purchase land and equip and construct a factory. A then enters into an arrangement with Corporation X to sell the factory to X on an installment basis while the bonds are outstanding. The issue meets the private business use test because a nongovernmental person owns the financed facility. See also §1.141–2 (relating to the private activity bond tests), and §1.141–5 (relating to the private loan financing test).

Example 2 Lease to a nongovernmental person. (i) The facts are the same as in *Example 1*, except that A enters into an arrangement with X to lease the factory to X for 3 years rather than to sell it to X. The lease payments will be made annually and will be based on the tax-exempt interest rate on the bonds. The issue meets the private business use test because a nongovernmental person leases the financed facility. See also §1.141–14 (relating to anti-abuse rules).

(ii) The facts are the same as in *Example 2(i)*, except that the annual payments made by X will equal fair rental value of the facility and exceed the amount necessary to pay debt service on the bonds for the 3 years of the lease. The issue meets the private business use test because a nongovernmental person leases the financed facility and the test does not require that the benefits of tax-exempt financing be passed through to the nongovernmental person.

Example 3. Management contract in substance a lease. City L issues 30-year bonds to finance the construction of a city hospital. L enters into a 15-year contract with M, a nongovernmental person that operates a health maintenance organization relating to the treatment of M's members at L's hospital. The contract provides for reasonable fixed compensation to M for services rendered with no compensation based, in whole or in part, on a share of net profits from the operation of the hospital. However, the contract also provides that 30 percent of the capacity of the hospital will be exclusively available to M's members and M will bear the risk of loss of that portion of the capacity of the hospital so that, under all of the facts and circumstances, the contract is properly characterized as a lease for federal income tax purposes. The issue meets the private business use test because a nongovernmental person leases the financed facility.

Example 4. Ownership of title in substance a leasehold interest. Nonprofit Corporation R issues bonds on behalf of City P to finance the construction of a hospital. R will own legal title to the hospital. In addition, R will operate the hospital, but R is not treated as an agent of P in its capacity as operator of the hospital. P has certain rights to the hospital that establish that it is properly treated as the owner of the property for federal income tax purposes. P does not have rights, however, to directly control operation of the hospital while R owns legal title to it and operates it. The issue meets the private business use test because the arrangement provides a nongovernmental person an interest in the financed facility that is comparable to a leasehold interest. See paragraphs (a)(2) and (b)(7)(i) of this section.

Example 5. Rights to control use of property treated as private business use—parking lot. Corporation C and City D enter into a plan to finance the construction of a parking lot adjacent to C's factory. Pursuant to the plan, C conveys the site for the parking lot to D for a nominal amount, subject to a covenant running with the land that the property be used only for a parking lot. In addition, D agrees that C will have the right to approve rates charged by D for use of the parking lot. D issues bonds to finance construction of the parking lot on the site. The parking lot will be available for use by the general public on the basis of rates that are generally applicable and uniformly applied. The issue meets the private business use test because a nongovernmental person has special legal entitlements for beneficial use of the financed facility that are comparable to an ownership interest. See paragraph (b)(7)(i) of this section.

Example 6. Other actual or beneficial use—hydroelectric enhancements. J, a political subdivision, owns and operates a hydroelectric generation plant and related facilities. Pursuant to a take or pay contract, J sells 15 percent of the output of the plant to Corporation K, an investor-owned utility. K is treated as a private business user of the plant. Under the license issued to J for operation of the plant, J is required by federal regulations to construct and operate various facilities for the preservation of fish and for public recreation. J issues its obligations to finance the fish preservation and public recreation facilities. K has no special legal entitlements for beneficial use of the financed facilities. The fish preservation facilities are functionally related to the operation of the plant. The recreation facilities are available to natural persons on a short-term basis according to generally applicable and uniformly applied rates. Under paragraph (c) of this section, the recreation facilities are treated as used by the general public. Under paragraph (b)(7) of this section, K's use is not treated as private business use of the recreation facilities because K has no special legal entitlements for beneficial use of the recreation facilities. The fish preservation facilities are not of a type reasonably available for use on the same basis by natural persons not engaged in a trade or business. Under all of the facts and circumstances (including the functional relationship of the fish preservation facilities to property used in K's trade or business) under paragraph (b)(7)(ii) of this section, K derives a special economic benefit from the fish preservation facilities. Therefore, K's private business use may be established solely on the basis of that special economic benefit, and K's use of the fish preservation facilities is treated as private business use.

Example 7. Other actual or beneficial use—pollution control facilities. City B issues obligations to finance construction of a specialized pollution control facility on land that it owns adjacent to a factory owned by Corporation N. B will own and operate the pollution control facility, and N will have no special legal entitlements to use the facility. B, however, reasonably expects that N will be the only user of the facility. The facility will not be reasonably available for use on the same basis by natural persons not engaged in a trade or business. Under paragraph (b)(7)(ii) of this section, because under all of the facts and circumstances the facility is functionally related and is physically proximate to property used in N's trade or business, N derives a special economic benefit from the facility. Therefore, N's private business use may be established solely on the basis of that special economic benefit, and N's use is treated as private business use of the facility. See paragraph (b)(7)(ii) of this section.

Example 8. General public use—airport runway. (i) City I issues bonds and uses all of the proceeds to finance construction of a runway at a new city-owned airport. The runway will be available for take-off and landing by any operator of an aircraft desiring to use the airport, including general aviation operators who are natural persons not engaged in a trade or business. It is reasonably expected that most of the actual use of the runway will be by private air carriers (both charter airlines and commercial airlines) in connection with their use of the airport terminals leased by those carriers. These leases for the use of terminal space provide no priority rights or other preferential benefits to the air carriers for use of the runway. Moreover, under the leases the lease payments are determined without taking into account the revenues generated by runway landing fees (that is, the lease payments are not determined on a ''residual'' basis). Although the lessee air carriers receive a special economic benefit from the use of the runway, this economic benefit is not sufficient to cause the air carriers to be private business users, because the runway is available for general public use. The issue does not meet the private business use test. See paragraphs (b)(7)(ii) and (c) of this section.

(ii) The facts are the same as in *Example 8(i)*, except that the runway will be available for use only by private air carriers. The use by these private air carriers is not for general public use, because the runway is not reasonably available for use on the same basis by natural persons not engaged in a trade or business. Depending on all of the facts and circumstances, including whether there are only a small number of lessee private air carriers, the issue may meet the private business use test solely because the private air carriers receive a special economic benefit from the runway. See paragraph (b)(7)(ii) of this section.

(iii) The facts are the same as in *Example 8(i)*, except that the lease payments under the leases with the private air carriers are determined on a residual basis by taking into account the net revenues generated by runway landing fees. These leases cause the private business use test to be met with respect to the runway because they are arrangements that convey special legal entitlements to the financed facility to nongovernmental persons. See paragraph (b)(7)(i) of this section.

Example 9. General public use—airport parking garage. City S issues bonds and uses all of the proceeds to finance construction of a city-owned parking garage at the city-owned airport. S reasonably expects that more than 10 percent of the actual use of the parking garage will be by employees of private air carriers (both charter airlines and commercial airlines) in connection with their use of the airport terminals leased by those carriers. The air carriers' use of the parking garage, however, will be on the same basis as passengers and other members of the general public using the airport. The leases for the use of the terminal space provide no priority rights to the air carriers for use of the parking garage, and the lease payments are determined without taking into account the revenues generated by the parking garage.

Although the lessee air carriers receive a special economic benefit from the use of the parking garage, this economic benefit is not sufficient to cause the air carriers to be private business users, because the parking garage is available for general public use. The issue does not meet the private business use test. See paragraphs (b)(7)(ii) and (c) of this section.

Example 10. Long-term arrangements not treated as general public use—insurance fund. Authority T deposits all of the proceeds of its bonds in its insurance fund and invests all of those proceeds in tax-exempt bonds. The insurance fund provides insurance to a large number of businesses and natural persons not engaged in a trade or business. Each participant receives insurance for a term of 1 year. The use by the participants, other than participants that are natural persons not engaged in a trade or business, is treated as private business use of the proceeds of the bonds because the participants have special legal entitlements to the use of bond proceeds, even though the contractual rights are not necessarily properly characterized as ownership, leasehold, or similar interests listed in paragraph (b) of this section. Use of the bond proceeds is not treated as general public use because the term of the insurance is greater than 200 days. See paragraphs (b)(7)(i) and (c)(3) of this section.

Example 11. General public use—port road. Highway Authority W uses all of the proceeds of its bonds to construct a 25-mile road to connect an industrial port owned by Corporation Y with existing roads owned and operated by W. Other than the port, the nearest residential or commercial development to the new road is 12 miles away. There is no reasonable expectation that development will occur in the area surrounding the new road. W and Y enter into no arrangement (either by contract or ordinance) that conveys special legal entitlements to Y for the use of the road. Use of the road will be available without restriction to all users, including natural persons who are not engaged in a trade or business. The issue does not meet the private business use test because the road is treated as used only by the general public.

Example 12. General public use of governmentally owned hotel. State Q issues bonds to purchase land and construct a hotel for use by the general public (that is, tourists, visitors, and business travelers). The bond documents provide that Q will own and operate the project for the term of the bonds. Q will not enter into a lease or license with any user for use of rooms for a period longer than 200 days (although users may actually use rooms for consecutive periods in excess of 200 days). Use of the hotel by hotel guests who are travelling in connection with trades or businesses of nongovernmental persons is not a private business use of the hotel by these persons because the hotel is intended to be available and in fact is reasonably available for use on the same basis by natural persons not engaged in a trade or business. See paragraph (c)(1) of this section.

Example 13. General public use with rights of first refusal. Authority V uses all of the proceeds of its bonds to construct a parking garage. At least 90 percent of the spaces in the garage will be available to the general public on a monthly first-come, first-served basis. V reasonably expects that the spaces will be predominantly leased to natural persons not engaged in a trade or business who have priority rights to renew their spaces at then current fair market value rates. More than 10 percent of the spaces will be leased to nongovernmental persons acting in a trade or business. These leases are not treated as arrangements with a term of use greater than 200 days. The rights to renew are not treated as renewal options because the compensation for the spaces is redetermined at generally applicable, fair market value rates that will be in effect at the time of renewal and the use of the spaces under similar arrangements is predominantly by natural persons who are not engaged in a trade or business. The issue does not meet the private business use test because at least 90 percent of the use of the parking garage is general public use. See paragraph (c)(3) of this section.

Example 14. General public use with a specially negotiated rate agreement with agency of United States. G, a sewage collection and treatment district, operates facilities that were financed with its bonds. F, an agency of the United States, has a base located within G. Approximately 20 percent of G's facilities are used to treat sewage produced by F under a specially negotiated rate agreement. Under the specially negotiated rate agreement, G uses its best efforts to charge F as closely as possible the same amount for its use of G's services as its other customers pay for the same amount of services, although those other customers pay for services based on standard district charges and tax levies. F is prohibited by federal law from paying for the services based on those standard district charges and tax levies. The use of G's facilities by F is on the same basis as the general public. See paragraph (c)(2)(ii) of this section.

Example 15. Arrangements not available for use by natural persons not engaged in a trade or business—federal use of prisons. Authority E uses all of the proceeds of its bonds to construct a prison. E contracts with federal agency F to house federal prisoners on a space-available, first-come, first-served basis, pursuant to which F will be charged approximately the same amount for each prisoner as other persons that enter into similar transfer agreements. It is reasonably expected that other persons will enter into similar agreements. The term of the use under the contract is not longer than 100 days, and F has no right to renew, although E reasonably expects to renew the contract indefinitely. The prison is not financed for a principal purpose of providing the prison for use by F. It is reasonably expected that during the term of the bonds, more than 10 percent of the prisoners at the prison will be federal prisoners. F's use of the facility is not general public use because this type of use (leasing space for prisoners) is not available for use on the same basis by natural persons not engaged in a trade or business. The issue does not meet the private business use test, however, because the leases satisfy the exception of paragraph (d)(3)(i) of this section.

Example 16. Negotiated arm's-length arrangements—auditorium reserved in advance. (i) City Z issues obligations to finance the construction of a municipal auditorium that it will own and operate. The use of the auditorium will be open to anyone who wishes to use it for a short period of time on a rate-scale basis. Z reasonably expects that the auditorium will be used by schools, church groups, sororities, and numerous commercial organizations. Corporation H, a nongovernmental person, enters into an arm's-length arrangement with Z to use the auditorium for 1 week for each year for a 10-year period (a total of 70 days), pursuant to which H will be charged a specific price reflecting fair market value. On the date the contract is entered into, Z has not established generally applicable rates for future years. Even though the auditorium is not financed for a principal purpose of providing use of the auditorium to H, H is not treated as using the auditorium as a member of the general public because its use is not on the same basis as the general public. Because the term of H's use of the auditorium is longer than 50 days, the arrangement does not meet the exception under paragraph (d)(3)(ii) of this section.

(ii) The facts are the same as in *Example 16(i),* except that H will enter into an arm's-length arrangement with Z to use the auditorium for 1 week for each year for a 4-year period (a total of 28 days), pursuant to which H will be charged a specific price reflecting fair market value. H is not treated as a private business user of the auditorium because its contract satisfies the exception of paragraph (d)(3)(ii) of this section for negotiated arm's-length arrangements.

(g) *Measurement of private business use*—(1) *In general.* In general, the private business use of proceeds is allocated to property under §1.141–6. The amount of private business use of that property is determined according to the average percentage of private business use of that property during the measurement period.

(2) *Measurement period*—(i) *General rule.* Except as provided in this paragraph (g)(2), the measurement period of property financed by an issue begins on the later of the issue date of that issue or the date the property is placed in service and ends on the earlier of the last date of the reasonably expected economic life of the property or the latest maturity date of any bond of the issue financing the property (determined without regard to any optional redemption dates). In general, the period of reasonably expected economic life of the property for this purpose is based on reasonable expectations as of the issue date.

(ii) *Special rule for refundings of short-term obligations.* For an issue of short-term obligations that the issuer reasonably expects to refund with a long-term financing (such as bond anticipation notes), the measurement period is based on the latest maturity date of any bond of the last refunding issue with respect to the financed property (determined without regard to any optional redemption dates).

(iii) *Special rule for reasonably expected mandatory redemptions.* If an issuer reasonably expects on the issue date that an action will occur during the term of the bonds to cause either the private business tests or the private loan financing test to be met and is required to redeem bonds to meet the reasonable expectations test of §1.141–2(d)(2), the measurement period ends on the reasonably expected redemption date.

(iv) *Special rule for ownership by a nongovernmental person.* The amount of private business use resulting from ownership by a nongovernmental person is the greatest percentage of private business use in any 1-year period.

(v) *Special rule for partners that are nongovernmental persons*—(A) The amount of private business use by a nongovernmental person resulting from the use of property by a partnership in which that nongovernmental person is a partner is that nongovernmental partner's share of the amount of use of the property by the partnership. For this purpose, except as otherwise provided in paragraph (g)(2)(v)(B) of this section, a nongovernmental partner's share of the partnership's use of the property is the nongovernmental partner's greatest percentage share under section 704(b) of any partnership item of income, gain, loss, deduction, or credit attributable to the period that the partnership uses the property during the measurement period. For example, if a partnership has a nongovernmental partner and that partner's share of partnership items varies, with the greatest share being 25 percent, then that nongovernmental partner's share of the partnership's use of property is 25 percent.

(B) An issuer may determine a nongovernmental partner's share of the partnership's use of the property under guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter).

(vi) *Anti-abuse rule.* If an issuer establishes the term of an issue for a period that is longer than is reasonably necessary for the governmental purposes of the issue for a principal purpose of increasing the permitted amount of private business use, the Commissioner may determine the amount of private business use according to the greatest percentage of private business use in any 1-year period.

(3) *Determining average percentage of private business use.* The average percentage of private business use is the average of the percentages of private business use during the 1-year periods within the measurement period. Appropriate adjustments must be made for beginning and ending periods of less than 1 year.

(4) *Determining the average amount of private business use for a 1-year period*—(i) *In general.* The percentage of private business use of property for any 1-year period is the average private business use during that year. This average is determined by comparing the amount of private business use during the year to the total amount of private business use and use that is not private business use (government use) during that year. Paragraphs (g)(4) (ii) through (v) of this section apply to determine the average amount of private business use for a 1-year period.

(ii) *Uses at different times.* For a facility in which actual government use and private business use occur at different times (for example, different days), the average amount of private business use generally is based on the amount of time that the facility is used for private business use as a percentage of the total time for all actual use. In determining the total amount of actual use, periods during which the facility is not in use are disregarded.

(iii) *Simultaneous use.* In general, for a facility in which government use and private business use occur simultaneously, the entire facility is treated as having private business use. For example, a governmentally owned facility that is leased or managed by a nongovernmental person in a manner that results in private business use is treated as entirely used for a private business use. If, however, there is also private business use and actual government use on the same basis, the average amount of private business use may be determined on a reasonable basis that properly reflects the proportionate benefit to be derived by the various users of the facility (for example, reasonably expected fair market value of use). For example, the average amount of private business use of a garage with unassigned spaces that is used for government use and private business use is generally based on the number of spaces used for private business use as a percentage of the total number of spaces.

(iv) *Discrete portion.* For purposes of this paragraph (g), measurement of the use of proceeds allocated to a discrete portion of a facility is determined by treating that discrete portion as a separate facility.

(v) *Relationship to fair market value.* For purposes of paragraphs (g)(4) (ii) through (iv) of this section, if private business use is reasonably expected as of the issue date to have a significantly greater fair market value than government use, the average amount of private business use must be determined according to the relative reasonably expected fair market values of use rather than another measure, such as average time of use. This determination of relative fair market value may be made as of the date the property is acquired or placed in service if making this determination as of the issue date is not reasonably possible (for example, if the financed property is not identified on the issue date). In general, the relative reasonably expected fair market value for a period must be determined by taking into account the amount of reasonably expected payments for private business use for the period in a manner that properly reflects the proportionate benefit to be derived from the private business use.

(5) *Common areas*. The amount of private business use of common areas within a facility is based on a reasonable method that properly reflects the proportionate benefit to be derived by the users of the facility. For example, in general, a method that is based on the average amount of private business use of the remainder of the entire facility reflects proportionate benefit.

(6) *Allocation of neutral costs*. Proceeds that are used to pay costs of issuance, invested in a reserve or replacement fund, or paid as fees for a qualified guarantee or a qualified hedge must be allocated ratably among the other purposes for which the proceeds are used.

(7) *Commencement of measurement of private business use*. Generally, private business use commences on the first date on which there is a right to actual use by the nongovernmental person. However, if an issuer enters into an arrangement for private business use a substantial period before the right to actual private business use commences and the arrangement transfers ownership or is an arrangement for other long-term use (such as a lease for a significant portion of the remaining economic life of financed property), private business use commences on the date the arrangement is entered into, even if the right to actual use commences after the measurement period. For this purpose, 10 percent of the measurement period is generally treated as a substantial period.

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

Example 1. Research facility. University U, a state owned and operated university, owns and operates a research facility. U proposes to finance general improvements to the facility with the proceeds of an issue of bonds. U enters into sponsored research agreements with nongovernmental persons that result in private business use because the sponsors will own title to any patents resulting from the research. The governmental research conducted by U and the research U conducts for the sponsors take place simultaneously in all laboratories within the research facility. All laboratory equipment is available continuously for use by workers who perform both types of research. Because it is not possible to predict which research projects will be successful, it is not reasonably practicable to estimate the relative revenues expected to result from the governmental and nongovernmental research. U contributed 90 percent of the cost of the facility and the nongovernmental persons contributed 10 percent of the cost. Under this section, the nongovernmental persons are using the facility for a private business use on the same basis as the government use of the facility. The portions of the costs contributed by the various users of the facility provide a reasonable basis that properly reflects the proportionate benefit to be derived by the users of the facility. The nongovernmental persons are treated as using 10 percent of the proceeds of the issue.

Example 2. Stadium. (i) City L issues bonds and uses all of the proceeds to construct a stadium. L enters into a long-term contract with a professional sports team T under which T will use the stadium 20 times during each year. These uses will occur on nights and weekends. L reasonably expects that the stadium will be used more than 180 other times each year, none of which will give rise to private business use. This expectation is based on a feasibility study and historical use of the old stadium that is being replaced by the new stadium. There is no significant difference in the value of T's uses when compared to the other uses of the stadium, taking into account the payments that T is reasonably expected to make for its use. Assuming no other private business use, the issue does not meet the private business use test because not more than 10 percent of the use of the facility is for a private business use.

(ii) The facts are the same as in *Example 2(i)*, except that L reasonably expects that the stadium will be used not more than 60 other times each year, none of which will give rise to private business use. The issue meets the private business use test because 25 percent of the proceeds are used for a private business use.

Example 3. Airport terminal areas treated as common areas. City N issues bonds to finance the construction of an airport terminal. Eighty percent of the leasable space of the terminal will be leased to private air carriers. The remaining 20 percent of the leasable space will be used for the term of the bonds by N for its administrative purposes. The common areas of the terminal, including waiting areas, lobbies, and hallways are treated as 80 percent used by the air carriers for purposes of the private business use test.

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§ 1.141–4 Private security or payment test.

(a) *General rule*—(1) *Private security or payment*. The private security or payment test relates to the nature of the security for, and the source of, the payment of debt service on an issue. The private payment portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly to be derived from payments (whether or not to the issuer or any related party) in respect of property, or borrowed money, used or to be used for a private business use. The private security portion of the test takes into account the payment of the debt service on the issue that is directly or indirectly secured by any interest in property used or to be used for a private business use or payments in respect of property used or to be used for a private business use. For additional rules for output facilities, see §1.141–7.

(2) *Aggregation of private payments and security*. For purposes of the private security or payment test, payments taken into account as private payments and payments or property taken into account as private security are aggregated. However, the same payments are not taken into account as both private security and private payments.

(3) *Underlying arrangement*. The security for, and payment of debt service on, an issue is determined from both the terms of the bond documents and on the basis of any underlying arrangement. An underlying arrangement may result from separate agreements between the parties or may be determined on the basis of all of the facts and circumstances surrounding the issuance of the bonds. For example, if the payment of debt service on an issue is secured by both a pledge of the full faith and credit of a state or local governmental unit and any interest in property used or to be used in a private business use, the issue meets the private security or payment test.

(b) *Measurement of private payments and security*—(1) *Scope*. This paragraph (b) contains rules that apply to both private security and private payments.

(2) *Present value measurement*—(i) *Use of present value*. In determining whether an issue meets the private security or payment test, the present value of the payments or property taken into account is compared to the present value of the debt service to be paid over the term of the issue.

(ii) *Debt service*—(A) *Debt service paid from proceeds*. Debt service does not include any amount paid or to be paid from sale proceeds or investment proceeds. For example, debt service does not include payments of capitalized interest funded with proceeds.

(B) *Adjustments to debt service*. Debt service is adjusted to take into account payments and receipts that adjust the yield on an issue for purposes of section 148(f). For example, debt service includes fees paid for qualified guarantees under §1.148–4(f) and is adjusted to take into account payments and receipts on qualified hedges under §1.148–4(h).

(iii) *Computation of present value*—(A) *In general*. Present values are determined by using the yield on the issue as the discount rate and by discounting all amounts to the issue date. See, however, §1.141–13 for special rules for refunding bonds.

(B) *Fixed yield issues*. For a fixed yield issue, yield is determined on the issue date and is not adjusted to take into account subsequent events.

(C) *Variable yield issues*. The yield on a variable yield issue is determined over the term of the issue. To determine the reasonably expected yield as of any date, the issuer may assume that the future interest rate on a variable yield bond will be the then-current interest rate on the bonds determined under the formula prescribed in the bond documents. A deliberate action requires a recomputation of the yield on the variable yield issue to determine the present value of payments under that arrangement. In that case, the issuer must use the yield determined as of the date of the deliberate action for purposes of determining the present value of payments under the arrangement causing the deliberate action. See paragraph (g) of this section, *Example 3*.

(iv) *Application to private security*. For purposes of determining the present value of debt service that is secured by property, the property is valued at fair market value as of the first date on which the property secures bonds of the issue.

(c) *Private payments*—(1) *In general*. This paragraph (c) contains rules that apply to private payments.

(2) *Payments taken into account*—(i) *Payments for use*—(A) *In general*. Both direct and indirect payments made by any nongovernmental person that is treated as using proceeds of the issue are taken into account as private payments to the extent allocable to the proceeds used by that person. Payments are taken into account as private payments only to the extent that they are made for the period of time that proceeds are used for a private business use. Payments for a use of proceeds include payments (whether or not to the issuer) in respect of property financed (directly or indirectly) with those proceeds, even if not made by a private business user. Payments are not made in respect of financed property if those payments are directly allocable to other property being directly used by the person making the payment and those payments represent fair market value compensation for that other use. See paragraph (g) of this section, *Example 4* and *Example 5*. See also paragraph (c)(3) of this section for rules relating to allocation of payments to the source or sources of funding of property.

(B) *Payments not to exceed use*. Payments with respect to proceeds that are used for a private business use are not taken into account to the extent that the present value of those payments exceeds the present value of debt service on those proceeds. Payments need not be directly derived from a private business user, however, to be taken into account. Thus, if 7 percent of the proceeds of an issue is used by a person over the measurement period, payments with respect to the property financed with those proceeds are taken into account as private payments only to the extent that the present value of those payments does not exceed the present value of 7 percent of the debt service on the issue.

(C) *Payments for operating expenses*. Payments by a person for a use of proceeds do not include the portion of any payment that is properly allocable to the payment of ordinary and necessary expenses (as defined under section 162) directly attributable to the operation and maintenance of the financed property used by that person. For this purpose, general overhead and administrative expenses are not directly attributable to those operations and maintenance. For example, if an issuer receives $5,000 rent during the year for use of space in a financed facility and during the year pays $500 for ordinary and necessary expenses properly allocable to the operation and maintenance of that space and $400 for general overhead and general administrative expenses properly allocable to that space, $500 of the $5,000 received would not be considered a payment for the use of the proceeds allocable to that space (regardless of the manner in which that $500 is actually used).

(ii) *Refinanced debt service*. Payments of debt service on an issue to be made from proceeds of a refunding issue are taken into account as private payments in the same proportion that the present value of the payments taken into account as private payments for the refunding issue bears to the present value of the debt service to be paid on the refunding issue. For example, if all the debt service on a note is paid with proceeds of a refunding issue, the note meets the private security or payment test if (and to the same extent that) the refunding issue meets the private security or payment test. This paragraph (c)(2)(ii) does not apply to payments that arise from deliberate actions that occur more than 3 years after the retirement of the prior issue that are not reasonably expected on the issue date of the refunding issue. For purposes of this paragraph (c)(2)(ii), whether an issue is a refunding issue is determined without regard to §1.150–1(d)(2)(i) (relating to certain payments of interest).

(3) *Allocation of payments*—(i) *In general*. Private payments for the use of property are allocated to the source or

different sources of funding of property. The allocation to the source or different sources of funding is based on all of the facts and circumstances, including whether an allocation is consistent with the purposes of section 141. In general, a private payment for the use of property is allocated to a source of funding based upon the nexus between the payment and both the financed property and the source of funding. For this purpose, different sources of funding may include different tax-exempt issues, taxable issues, and amounts that are not derived from a borrowing, such as revenues of an issuer (equity).

(ii) *Payments for use of discrete property.* Payments for the use of a discrete facility (or a discrete portion of a facility) are allocated to the source or different sources of funding of that discrete property.

(iii) *Allocations among two or more sources of funding.* In general, except as provided in paragraphs (c)(3)(iv) and (v) of this section, if a payment is made for the use of property financed with two or more sources of funding (for example, equity and a tax-exempt issue), that payment must be allocated to those sources of funding in a manner that reasonably corresponds to the relative amounts of those sources of funding that are expended on that property. If an issuer has not retained records of amounts expended on the property (for example, records of costs of a building that was built 30 years before the allocation), an issuer may use reasonable estimates of those expenditures. For this purpose, costs of issuance and other similar neutral costs are allocated ratably among expenditures in the same manner as in §1.141–3(g)(6). A payment for the use of property may be allocated to two or more issues that finance property according to the relative amounts of debt service (both paid and accrued) on the issues during the annual period for which the payment is made, if that allocation reasonably reflects the economic substance of the arrangement. In general, allocations of payments according to relative debt service reasonably reflect the economic substance of the arrangement if the maturity of the bonds reasonably corresponds to the reasonably expected economic life of the property and debt service payments on the bonds are approximately level from year to year.

(iv) *Payments made under an arrangement entered into in connection with issuance of bonds.* A private payment for the use of property made under an arrangement that is entered into in connection with the issuance of the issue that finances that property generally is allocated to that issue. Whether an arrangement is entered into in connection with the issuance of an issue is determined on the basis of all of the facts and circumstances. An arrangement is ordinarily treated as entered into in connection with the issuance of an issue if—

(A) The issuer enters into the arrangement during the 3-year period beginning 18 months before the issue date; and

(B) The amount of payments reflects all or a portion of debt service on the issue.

(v) *Allocations to equity.* A private payment for the use of property may be allocated to equity before payments are allocated to an issue only if—

(A) Not later than 60 days after the date of the expenditure of those amounts, the issuer adopts an official intent (in a manner comparable to §1.150–2(e)) indicating that the issuer reasonably expects to be repaid for the expenditure from a specific arrangement; and

(B) The private payment is made not later than 18 months after the later of the date the expenditure is made or the date the project is placed in service.

(d) *Private security*—(1) *In general.* This paragraph (d) contains rules that relate to private security.

(2) *Security taken into account.* The property that is the security for, or the source of, the payment of debt service on an issue need not be property financed with proceeds. For example, unimproved land or investment securities used, directly or indirectly, in a private business use that secures an issue provides private security. Private security (other than financed property and private payments) for an issue is taken into account under section 141(b), however, only to the extent it is provided,

directly or indirectly, by a user of proceeds of the issue.

(3) *Pledge of unexpended proceeds.* Proceeds qualifying for an initial temporary period under §1.148–2(e)(2) or (3) or deposited in a reasonably required reserve or replacement fund (as defined in §1.148–2(f)(2)(i)) are not taken into account under this paragraph (d) before the date on which those amounts are either expended or loaned by the issuer to an unrelated party.

(4) *Secured by any interest in property or payments.* Property used or to be used for a private business use and payments in respect of that property are treated as private security if any interest in that property or payments secures the payment of debt service on the bonds. For this purpose, the phrase any interest in is to be interpreted broadly and includes, for example, any right, claim, title, or legal share in property or payments.

(5) *Payments in respect of property.* The payments taken into account as private security are payments in respect of property used or to be used for a private business use. Except as otherwise provided in this paragraph (d)(5) and paragraph (d)(6) of this section, the rules in paragraphs (c)(2)(i)(A) and (B) and (c)(2)(ii) of this section apply to determine the amount of payments treated as payments in respect of property used or to be used for a private business use. Thus, payments made by members of the general public for use of a facility used for a private business use (for example, a facility that is the subject of a management contract that results in private business use) are taken into account as private security to the extent that they are made for the period of time that property is used by a private business user.

(6) *Allocation of security among issues.* In general, property or payments from the disposition of that property that are taken into account as private security are allocated to each issue secured by the property or payments on a reasonable basis that takes into account bondholders' rights to the payments or property upon default.

(e) *Generally applicable taxes*—(1) *General rule.* For purposes of the private security or payment test, generally applicable taxes are not taken into account (that is, are not payments from a nongovernmental person and are not payments in respect of property used for a private business use).

(2) *Definition of generally applicable taxes.* A generally applicable tax is an enforced contribution exacted pursuant to legislative authority in the exercise of the taxing power that is imposed and collected for the purpose of raising revenue to be used for governmental or public purposes. A generally applicable tax must have a uniform tax rate that is applied to all persons of the same classification in the appropriate jurisdiction and a generally applicable manner of determination and collection.

(3) *Special charges.* A special charge (as defined in this paragraph (e)(3)) is not a generally applicable tax. For this purpose, a special charge means a payment for a special privilege granted or regulatory function (for example, a license fee), a service rendered (for example, a sanitation services fee), a use of property (for example, rent), or a payment in the nature of a special assessment to finance capital improvements that is imposed on a limited class of persons based on benefits received from the capital improvements financed with the assessment. Thus, a special assessment to finance infrastructure improvements in a new industrial park (such as sidewalks, streets, streetlights, and utility infrastructure improvements) that is imposed on a limited class of persons composed of property owners within the industrial park who benefit from those improvements is a special charge. By contrast, an otherwise qualified generally applicable tax (such as a generally applicable ad valorem tax on all real property within a governmental taxing jurisdiction) or an eligible PILOT under paragraph (e)(5) of this section that is based on such a generally applicable tax is not treated as a special charge merely because the taxes or PILOTs received are used for governmental or public purposes in a manner which benefits particular property owners.

(4) *Manner of determination and collection*—(i) *In general.* A tax does not have a generally applicable manner of determination and collection to the extent that one or more taxpayers make any

impermissible agreements relating to payment of those taxes. An impermissible agreement relating to the payment of a tax is taken into account whether or not it is reasonably expected to result in any payments that would not otherwise have been made. For example, if an issuer uses proceeds to make a grant to a taxpayer to improve property, agreements that impose reasonable conditions on the use of the grant do not cause a tax on that property to fail to be a generally applicable tax. If an agreement by a taxpayer causes the tax imposed on that taxpayer not to be treated as a generally applicable tax, the entire tax paid by that taxpayer is treated as a special charge, unless the agreement is limited to a specific portion of the tax.

(ii) *Impermissible agreements.* The following are examples of agreements that cause a tax to fail to have a generally applicable manner of determination and collection: an agreement to be personally liable on a tax that does not generally impose personal liability, to provide additional credit support such as a third party guarantee, or to pay unanticipated shortfalls; an agreement regarding the minimum market value of property subject to property tax; and an agreement not to challenge or seek deferral of the tax.

(iii) *Permissible agreements.* The following are examples of agreements that do not cause a tax to fail to have a generally applicable manner of determination and collection: an agreement to use a grant for specified purposes (whether or not that agreement is secured); a representation regarding the expected value of the property following the improvement; an agreement to insure the property and, if damaged, to restore the property; a right of a grantor to rescind the grant if property taxes are not paid; and an agreement to reduce or limit the amount of taxes collected to further a bona fide governmental purpose. For example, an agreement to abate taxes to encourage a property owner to rehabilitate property in a distressed area is a permissible agreement.

(5) *Payments in lieu of taxes.* A tax equivalency payment or other payment in lieu of a tax (''PILOT'') is treated as a generally applicable tax if it meets the requirements of paragraphs (e)(5)(i) through (iv) of this section—

(i) *Maximum amount limited by underlying generally applicable tax.* The PILOT is not greater than the amount imposed by a statute for a generally applicable tax in each year.

(ii) *Commensurate with a generally applicable tax.* The PILOT is commensurate with the amount imposed by a statute for a generally applicable tax in each year under the commensurate standard set forth in this paragraph (e)(5)(ii). For this purpose, except as otherwise provided in this paragraph (e)(5)(ii), a PILOT is commensurate with a generally applicable tax only if it is equal to a fixed percentage of the generally applicable tax that would otherwise apply in each year or it reflects a fixed adjustment to the generally applicable tax that would otherwise apply in each year. A PILOT based on a property tax does not fail to be commensurate with the property tax as a result of changes in the level of the percentage of or adjustment to that property tax for a reasonable phase-in period ending when the subject property is placed in service (as defined in §1.150–2(c)). A PILOT based on a property tax must take into account the current assessed value of the property for property tax purposes for each year in which the PILOT is paid and that assessed value must be determined in the same manner and with the same frequency as property subject to the property tax. A PILOT is not commensurate with a generally applicable tax, however, if the PILOT is set at a fixed dollar amount (for example, fixed debt service on a bond issue) that cannot vary with changes in the level of the generally applicable tax on which it is based.

(iii) *Use of PILOTs for governmental or public purposes.* The PILOT is to be used for governmental or public purposes for which the generally applicable tax on which it is based may be used.

(iv) *No special charges.* The PILOT is not a special charge under paragraph (e)(3) of this section.

(f) *Certain waste remediation bonds*—(1) *Scope.* This paragraph (f) applies to bonds issued to finance hazardous waste clean-up activities on privately owned land (hazardous waste remediation bonds).

(2) *Persons that are not private users.* Payments from nongovernmental persons who are not (other than coincidentally) either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site are not taken into account as private security. This paragraph (f)(2) applies to payments that secure (directly or indirectly) the payment of principal of, or interest on, the bonds under the terms of the bonds. This paragraph (f)(2) applies only if the payments are made pursuant to either a generally applicable state or local taxing statute or a state or local statute that regulates or restrains activities on an industry-wide basis of persons who are engaged in generating or handling hazardous waste, or in refining, producing, or transporting petroleum, provided that those payments do not represent, in substance, payment for the use of proceeds. For this purpose, a state or local statute that imposes payments that have substantially the same character as those described in Chapter 38 of the Code are treated as generally applicable taxes.

(3) *Persons that are private users.* If payments from nongovernmental persons who are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site do not secure (directly or indirectly) the payment of principal of, or interest on, the bonds under the terms of the bonds, the payments are not taken into account as private payments. This paragraph (f)(3) applies only if at the time the bonds are issued the payments from those nongovernmental persons are not material to the security for the bonds. For this purpose, payments are not material to the security for the bonds if—

(i) The payments are not required for the payment of debt service on the bonds;

(ii) The amount and timing of the payments are not structured or designed to reflect the payment of debt service on the bonds;

(iii) The receipt or the amount of the payment is uncertain (for example, as of the issue date, no final judgment has been entered into against the nongovernmental person);

(iv) The payments from those nongovernmental persons, when and if received, are used either to redeem bonds of the issuer or to pay for costs of any hazardous waste remediation project; and

(v) In the case when a judgment (but not a final judgment) has been entered by the issue date against a nongovernmental person, there are, as of the issue date, costs of hazardous waste remediation other than those financed with the bonds that may be financed with the payments.

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

Example 1. Aggregation of payments. State B issues bonds with proceeds of $10 million. B uses $9.7 million of the proceeds to construct a 10-story office building. B uses the remaining $300,000 of proceeds to make a loan to Corporation Y. In addition, Corporation X leases 1 floor of the building for the term of the bonds. Under all of the facts and circumstances, it is reasonable to allocate 10 percent of the proceeds to that 1 floor. As a percentage of the present value of the debt service on the bonds, the present value of Y's loan repayments is 3 percent and the present value of X's lease payments is 8 percent. The bonds meet the private security or payment test because the private payments taken into account are more than 10 percent of the present value of the debt service on the bonds.

Example 2. Indirect private payments. J, a political subdivision of a state, will issue several series of bonds from time to time and will use the proceeds to rehabilitate urban areas. Under all of the facts and circumstances, the private business use test will be met with respect to each issue that will be used for the rehabilitation and construction of buildings that will be leased or sold to nongovernmental persons for use in their trades or businesses. Nongovernmental persons will make payments for these sales and leases. There is no limitation either on the number of issues or the aggregate amount of bonds that may be outstanding. No group of bondholders has any legal claim prior to any other bondholders or creditors with respect to specific revenues of J, and there is no arrangement whereby revenues from a particular project are paid into a trust or constructive trust, or sinking fund, or are otherwise segregated or restricted for the benefit of any group of bondholders. There is, however, an unconditional obligation by J to pay the principal of, and the interest on, each issue. Although not directly pledged under the terms of the bond documents, the leases and sales are underlying arrangements. The payments relating to these leases and sales are taken into account as private payments to determine whether each issue of bonds meets the private security or payment test.

Example 3. Computation of payment in variable yield issues. (i) City M issues general obligation bonds with proceeds of $10 million to finance a 5-story office building. The bonds bear interest at a variable rate that is recomputed monthly according to an index that reflects current market yields. The yield that the interest index would produce on the issue date is 6 percent. M leases 1 floor of the office building to Corporation T, a nongovernmental person, for the term of the bonds. Under all of the facts and circumstances, T is treated as using more than 10 percent of the proceeds. Using the 6 percent yield as the discount rate, M reasonably expects on the issue date that the present value of lease payments to be made by T will be 8 percent of the present value of the total debt service on the bonds. After the issue date of the bonds, interest rates decline significantly, so that the yield on the bonds over their entire term is 4 percent. Using this actual 4 percent yield as the discount rate, the present value of lease payments made by T is 12 percent of the present value of the actual total debt service on the bonds. The bonds are not private activity bonds because M reasonably expected on the issue date that the bonds would not meet the private security or payment test and because M did not take any subsequent deliberate action to meet the private security or payment test.

(ii) The facts are the same as *Example 3(i)*, except that 5 years after the issue date M leases a second floor to Corporation S, a nongovernmental person, under a long-term lease. Because M has taken a deliberate action, the present value of the lease payments must be computed. On the date this lease is entered into, M reasonably expects that the yield on the bonds over their entire term will be 5.5 percent, based on actual interest rates to date and the then-current rate on the variable yield bonds. M uses this 5.5 percent yield as the discount rate. Using this 5.5 percent yield as the discount rate, as a percentage of the present value of the debt service on the bonds, the present value of the lease payments made by S is 3 percent. The bonds are private activity bonds because the present value of the aggregate private payments is greater than 10 percent of the present value of debt service.

Example 4. Payments not in respect of financed property. In order to further public safety, City Y issues tax assessment bonds the proceeds of which are used to move existing electric utility lines underground. Although the utility lines are owned by a nongovernmental utility company, that company is under no obligation to move the lines. The debt service on the bonds will be paid using assessments levied by City Y on the customers of the utility. Although the utility lines are privately owned and the utility customers make payments to the utility company for the use of those lines, the assessments are payments in respect of the cost of relocating the utility line. Thus, the assessment payments are not made in respect of property used for a private business use. Any direct or indirect payments to Y by the utility company for the undergrounding are, however, taken into account as private payments.

Example 5. Payments from users of proceeds that are not private business users taken into account. City P issues general obligation bonds to finance the renovation of a hospital that it owns. The hospital is operated for P by D, a nongovernmental person, under a management contract that results in private business use under §1.141–3. P will use the revenues from the hospital (after the required payments to D and the payment of operation and maintenance expenses) to pay the debt service on the bonds. The bonds meet the private security or payment test because the revenues from the hospital are payments in respect of property used for a private business use.

Example 6. Limitation of amount of payments to amount of private business use not determined annually. City Q issues bonds with a term of 15 years and uses the proceeds to construct an office building. The debt service on the bonds is level throughout the 15-year term. Q enters into a 5-year lease with Corporation R under which R is treated as a user of 11 percent of the proceeds. R will make lease payments equal to 20 percent of the annual debt service on the bonds for each year of the lease. The present value of R's lease payments is equal to 12 percent of the present value of the debt service over the entire 15-year term of the bonds. If, however, the lease payments taken into account as private payments were limited to 11 percent of debt service paid in each year of the lease, the present value of these payments would be only 8 percent of the debt service on the bonds over the entire term of the bonds. The bonds meet the private security or payment test, because R's lease payments are taken into account as private payments in an amount not to exceed 11 percent of the debt service of the bonds.

Example 7. Allocation of payments to funds not derived from a borrowing. City Z purchases property for $1,250,000 using $1,000,000 of proceeds of its tax increment bonds and $250,000 of other revenues that are in its redevelopment fund. Within 60 days of the date of purchase, Z declared its intent to sell the property pursuant to a redevelopment plan and to use that amount to reimburse its redevelopment fund. The bonds are secured only by the incremental property taxes attributable to the increase in value of the property from the planned redevelopment of the property. Within 18 months after the issue date, Z sells the financed property to Developer M for $250,000, which Z uses to reimburse the redevelopment fund. The property that M uses is financed both with the proceeds of the bonds and Z's redevelopment fund. The payments by M are properly allocable to the costs of property financed with the amounts in Z's redevelopment fund. See paragraphs (c)(3) (i) and (v) of this section.

Example 8. Allocation of payments to different sources of funding—improvements. In 1997, City L issues bonds with proceeds of $8 million to finance the acquisition of a building. In 2002, L spends $2 million of its general revenues to improve the heating system and roof of the building. At that time, L enters into a 10-year lease with Corporation M for the building providing for annual payments of $1 million to L. The lease payments are at fair market value, and the lease payments do not otherwise have a significant nexus to either the issue or to the expenditure of general revenues. Eighty percent of each lease payment is allocated to the issue and is taken into account under the private payment test because each lease payment is properly allocated to the sources of funding in a manner that reasonably corresponds to the relative amounts of the sources of funding that are expended on the building.

Example 9. Security not provided by users of proceeds not taken into account. County W issues certificates of participation in a lease of a building that W owns and covenants to appropriate annual payments for the lease. A portion of each payment is specified as interest. More than 10 percent of the building is used for private business use. None of the proceeds of the obligations are used with respect to the building. W uses the proceeds of the obligations to make a grant to Corporation Y for the construction of a factory that Y will own. Y makes no payments to W, directly or indirectly, for its use of proceeds, and Y has no relationship to the users of the leased building. If W defaults under the lease, the trustee for the holders of the certificates of participation has a limited right of repossession under which the trustee may not foreclose but may lease the property to a new tenant at fair market value. The obligations are secured by an interest in property used for a private business use. However, because the property is not provided by a private business user and is not financed property, the obligations do not meet the private security or payment test.

Example 10. Allocation of payments among issues. University L, a political subdivision, issued three separate series of revenue bonds during 1989, 1991, and 1993 under the same bond resolution. L used the proceeds to construct facilities exclusively for its own use. Bonds issued under the resolution are equally and ratably secured and payable solely from the income derived by L from rates, fees, and charges imposed by L for the use of the facilities. The bonds issued in 1989, 1991, and 1993 are not private activity bonds. In 1997, L issues another series of bonds under the resolution to finance additional facilities. L leases 20 percent of the new facilities for the term of the 1997 bonds to nongovernmental persons who will use the facilities in their trades or businesses. The present value of the lease payments from the nongovernmental users will equal 15 percent of the present value of the debt service on the 1997 bonds. L will commingle all of the revenues from all its bond-financed facilities in its revenue fund. The present value of the portion of the lease payments from nongovernmental lessees of the new facilities allocable to the 1997 bonds under paragraph (d) of this section is less than 10 percent of the present value of the debt service on the 1997 bonds because the bond documents provide that the bonds are equally and ratably secured. Accordingly, the 1997 bonds do not meet the private security test. The 1997 bonds meet the private payment test, however, because the private lease payments for the new facility are properly allocated to those bonds (that is, because none of the proceeds of the prior issues were used for the new facilities). See paragraph (c) of this section.

Example 11. Generally applicable tax. (i) Authority N issues bonds to finance the construction of a stadium. Under a long-term lease, Corporation X, a professional sports team, will use more than 10 percent of the stadium. X will not, however, make any payments for this private business use. The security for the bonds will be a ticket tax imposed on each person purchasing a ticket for an event at the stadium. The portion of the ticket tax attributable to tickets purchased by persons attending X's events will, on a present value basis, exceed 10 percent of the present value of the debt service on N's bonds. The bonds meet the private security or payment test. The ticket tax is not a generally applicable tax and, to the extent that the tax receipts relate to X's events, the taxes are payments in respect of property used for a private business use.

(ii) The facts are the same as *Example 11(i)*, except that the ticket tax is imposed by N on tickets purchased for events at a number of large entertainment facilities within the N's jurisdiction (for example, other stadiums, arenas, and concert halls), some of which were not financed with tax-exempt bonds. The ticket tax is a generally applicable tax and therefore the revenues from this tax are not payments in respect of property used for a private business use. The receipt of the ticket tax does not cause the bonds to meet the private security or payment test.

[T.D. 8712, 62 FR 2291, Jan. 16, 1997, as amended by T.D. 9429, 73 FR 63374, Oct. 24, 2008]

§ 1.141–5 Private loan financing test.

(a) *In general.* Bonds of an issue are private activity bonds if more than the lesser of 5 percent or $5 million of the proceeds of the issue is to be used (directly or indirectly) to make or finance loans to persons other than governmental persons. Section 1.141–2(d) applies in determining whether the private loan financing test is met. In determining whether the proceeds of an issue are used to make or finance loans, indirect, as well as direct, use of the proceeds is taken into account.

(b) *Measurement of test.* In determining whether the private loan financing test is met, the amount actually loaned to a nongovernmental person is not discounted to reflect the present value of the loan repayments.

(c) *Definition of private loan*—(1) *In general.* Any transaction that is generally characterized as a loan for federal income tax purposes is a loan for purposes of this section. In addition, a loan may arise from the direct lending of bond proceeds or may arise from transactions in which indirect benefits that are the economic equivalent of a loan are conveyed. Thus, the determination of whether a loan is made depends on the substance of a transaction rather than its form. For example, a lease or other contractual arrangement (for example, a management contract or an output contract) may in substance constitute a loan if the arrangement transfers tax ownership of the facility to a nongovernmental person. Similarly, an output contract or a management contract with respect to a financed facility generally is not treated as a loan of proceeds unless the agreement in substance shifts significant burdens and benefits of ownership to the nongovernmental purchaser or manager of the facility.

(2) *Application only to purpose investments*—(i) *In general.* A loan may be either a purpose investment or a nonpurpose investment. A loan that is a nonpurpose investment does not cause the private loan financing test to be met. For example, proceeds invested in loans, such as obligations of the United States, during a temporary period, as part of a reasonably required reserve or replacement fund, as part of a refunding escrow, or as part of a minor portion (as each of those terms are defined in §1.148–1 or §1.148–2) are generally not treated as loans under the private loan financing test.

(ii) *Certain prepayments treated as loans.* Except as otherwise provided, a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, is treated as a loan for purposes of the private loan financing test if a principal purpose for prepaying is to provide a benefit of tax-exempt financing to the seller. A prepayment is not treated as a loan for purposes of the private loan financing test if—

(A) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(B) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(C) The prepayment meets the requirements of §1.148–1(e)(2)(iii)(A) or (B) (relating to certain prepayments to acquire a supply of natural gas or electricity).

(iii) *Customary prepayments.* The determination of whether a prepayment satisfies paragraph (c)(2)(ii)(A) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (c)(2)(ii)(A) of this section if—

(A) The prepayment is made for—

(*1*) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(*2*) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(iv) *Additional prepayments as permitted by the Commissioner.* The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment is not treated as a loan for purposes of the private loan financing test.

(3) *Grants*—(i) *In general.* A grant of proceeds is not a loan. Whether a transaction may be treated as a grant or a loan depends on all of the facts and circumstances.

(ii) *Tax increment financing*—(A) *In general.* Generally, a grant using proceeds of an issue that is secured by generally applicable taxes attributable to the improvements to be made with the grant is not treated as a loan, unless the grantee makes any impermissible agreements relating to the payment that results in the taxes imposed on that taxpayer not to be treated as generally applicable taxes under §1.141–4(e).

(B) *Amount of loan.* If a grant is treated as a loan under this paragraph (c)(3), the entire grant is treated as a loan unless the impermissible agreement is limited to a specific portion of the tax. For this purpose, an arrangement with each unrelated grantee is treated as a separate grant.

(4) *Hazardous waste remediation bonds.* In the case of an issue of hazardous waste remediation bonds, payments from nongovernmental persons that are either users of the site being remediated or persons potentially responsible for disposing of hazardous waste on that site do not establish that the transaction is a loan for purposes of this section. This paragraph (c)(4) applies only if those payments do not secure the payment of principal of, or interest on, the bonds (directly or indirectly), under the terms of the bonds and those payments are not taken into account under the private payment test pursuant to §1.141–4(f)(3).

(d) *Tax assessment loan exception*—(1) *General rule.* For purposes of this section, a tax assessment loan that satisfies the requirements of this paragraph (d) is not a loan for purposes of the private loan financing test.

(2) *Tax assessment loan defined.* A tax assessment loan is a loan that arises when a governmental person permits or requires property owners to finance any governmental tax or assessment of general application for an essential governmental function that satisfies each of the requirements of paragraphs (d) (3) through (5) of this section.

(3) *Mandatory tax or other assessment.* The tax or assessment must be an enforced contribution that is imposed and collected for the purpose of raising revenue to be used for a specific purpose (that is, to defray the capital cost of an improvement). Taxes and assessments do not include fees for services. The tax or assessment must be imposed pursuant to a state law of general application that can be applied equally to natural persons not acting in a trade or business and persons acting in a trade or business. For this purpose, taxes and assessments that are imposed subject to protest procedures are treated as enforced contributions.

(4) *Specific essential governmental function*—(i) *In general.* A mandatory tax or assessment that gives rise to a tax assessment loan must be imposed for one or more specific, essential governmental functions.

(ii) *Essential governmental functions.* For purposes of paragraph (d) of this section, improvements to utilities and systems that are owned by a governmental person and that are available for use by the general public (such as sidewalks, streets and street-lights; electric, telephone, and cable television systems; sewage treatment and disposal systems; and municipal water facilities) serve essential governmental functions. For other types of facilities, the extent to which the service provided by the facility is customarily performed (and financed with governmental bonds) by governments with general taxing powers is a primary factor in determining whether the facility serves an essential governmental function. For example, parks that are owned by a governmental person and that are available for use by the general public serve an essential governmental function. Except as otherwise provided in this paragraph (d)(4)(ii), commercial or industrial facilities and improvements to property owned by a nongovernmental person do not serve an essential governmental function. Permitting installment payments of property taxes or other taxes is not an essential governmental function.

(5) *Equal basis requirement*—(i) *In general.* Owners of both business and nonbusiness property benefiting from the financed improvements must be eligible, or required, to make deferred payments of the tax or assessment giving rise to a tax assessment loan on an equal basis (the equal basis requirement). A tax or assessment does not satisfy the equal basis requirement if the terms for payment of the tax or assessment are not the same for all taxed or assessed persons. For example, the equal basis requirement is not met if certain property owners are permitted to pay the tax or assessment over a period of years while others must pay the entire tax or assessment immediately or if only certain property owners are required to prepay the tax or assessment when the property is sold.

(ii) *General rule for guarantees.* A guarantee of debt service on bonds, or of taxes or assessments, by a person that is treated as a borrower of bond proceeds violates the equal basis requirement if it is reasonable to expect on the date the guarantee is entered into that payments will be made under the guarantee.

(6) *Coordination with private business tests.* See §§ 1.141–3 and 1.141–4 for rules for determining whether tax assessment loans cause the bonds financing those loans to be private activity bonds under the private business use and the private security or payment tests.

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

Example 1. Turnkey contract not treated as a loan. State agency Z and federal agency H will each contribute to rehabilitate a project owned by Z. H can only provide its funds through a contribution to Z to be used to acquire the rehabilitated project on a turnkey basis from an approved developer. Under H's turnkey program, the developer must own the project while it is rehabilitated. Z issues its notes to provide funds for construction. A portion of the notes will be retired using the H contribution, and the balance of the notes will be retired through the issuance by Z of long-term bonds. Z lends the proceeds of its notes to Developer B as construction financing and transfers title to B for a nominal amount. The conveyance is made on condition that B rehabilitate the property and reconvey it upon completion, with Z retaining the right to force reconveyance if these conditions are not satisfied. B must name Z as an additional insured on all insurance. Upon completion, B must transfer title to the project back to Z at a set price, which price reflects B's costs and profit, not fair market value. Further, this price is adjusted downward to reflect any cost-underruns. For purposes of section 141(c), this transaction does not involve a private loan.

Example 2. Essential government function requirement not met. City D creates a special taxing district consisting of property owned by nongovernmental persons that requires environmental clean-up. D imposes a special tax on each parcel within the district in an amount that is related to the expected environmental clean-up costs of that parcel. The payment of the tax over a 20-year period is treated as a loan by the property owners for purposes of the private loan financing test. The special district issues bonds, acting on behalf of D, that are payable from the special tax levied within the district, and uses the proceeds to pay for the costs of environmental clean-up on the property within the district. The bonds meet the private loan financing test because more than 5 percent of the proceeds of the issue are loaned to nongovernmental persons. The issue does not meet the tax assessment loan exception because the improvements to property owned by a nongovernmental person are not an essential governmental function under section 141(c)(2). The issue also meets the private business tests of section 141(b).

[T.D. 8712, 62 FR 2296, Jan. 16, 1997, as amended by T.D. 9085, 68 FR 45775, Aug. 4, 2003]

§ 1.141–6 Allocation and accounting rules.

(a) *Allocations of proceeds to expenditures, projects, and uses in general*—(1) *Allocations to expenditures.* The allocations of proceeds and other sources of funds to expenditures under § 1.148–6(d) apply for purposes of §§ 1.141–1 through 1.141–15.

(2) *Allocations of sources to a project and its uses.* Except as provided in paragraph (b) of this section (regarding an eligible mixed-use project), if two or more sources of funding (including two

or more tax-exempt issues) are allocated to capital expenditures (as defined in §1.150–1(b)) for a project (as defined in paragraph (a)(3) of this section), those sources are allocated throughout that project to the governmental use and private business use of the project in proportion to the relative amounts of those sources of funding spent on the project.

(3) *Definition of project*—(i) *In general.* For purposes of this section, *project* means one or more facilities or capital projects, including land, buildings, equipment, or other property, financed in whole or in part with proceeds of the issue.

(ii) *Output facilities.* If an output facility has multiple undivided ownership interests (respectively owned by governmental persons or by both governmental and nongovernmental persons), each owner's interest in the facility is treated as a separate facility for purposes of this section, provided that all owners of the undivided ownership interests share the ownership and output in proportion to their contributions to the capital costs of the output facility.

(b) *Special allocation rules for eligible mixed-use projects*—(1) *In general.* The sources of funding allocated to capital expenditures for an eligible mixed-use project (as defined in paragraph (b)(2) of this section) are allocated to undivided portions of the eligible mixed-use project and the governmental use and private business use of the eligible mixed-use project in accordance with this paragraph (b). Qualified equity (as defined in paragraph (b)(3) of this section) is allocated first to the private business use of the eligible mixed-use project and then to governmental use, and proceeds are allocated first to the governmental use and then to private business use, using the percentages of the eligible mixed-use project financed with the respective sources and the percentages of the respective uses. Thus, if the percentage of the eligible mixed-use project financed with qualified equity is less than the percentage of private business use of the project, all of the qualified equity is allocated to the private business use. Proceeds are allocated to the balance of the private business use of the project. Similarly, if the percentage of the eligible mixed-use project financed with proceeds is less than the percentage of governmental use of the project, all of the proceeds are allocated to the governmental use, and qualified equity is allocated to the balance of the governmental use of the project. Further, if proceeds of more than one issue finance the eligible mixed-use project, proceeds of each issue are allocated ratably to the uses to which proceeds are allocated in proportion to the relative amounts of the proceeds of such issues allocated to the eligible mixed-use project. For private business use measured under §1.141–3(g), qualified equity and proceeds are allocated to the uses of the eligible mixed-use project in each one-year period under §1.141–3(g)(4). *See Example 1* of paragraph (f) of this section.

(2) *Definition of eligible mixed-use project. Eligible mixed-use project* means a project (as defined in paragraph (a)(3) of this section) that is financed with proceeds of bonds that, when issued, purported to be governmental bonds (as defined in §1.150–1(b)) (the applicable bonds) and with qualified equity pursuant to the same plan of financing (within the meaning of §1.150–1(c)(1)(ii)). An eligible mixed-use project must be wholly owned by one or more governmental persons or by a partnership in which at least one governmental person is a partner.

(3) *Definition of qualified equity.* For purposes of this section, *qualified equity* means proceeds of bonds that are not tax-advantaged bonds and funds that are not derived from proceeds of a borrowing that are spent on the same eligible mixed-use project as the proceeds of the applicable bonds. Qualified equity does not include equity interests in real property or tangible personal property. Further, qualified equity does not include funds used to redeem or repay governmental bonds. *See* §§1.141–2(d)(2)(ii) and 1.141–12(i) (regarding the effects of certain redemptions as remedial actions).

(4) *Same plan of financing.* Qualified equity finances a project under the same plan of financing that includes the applicable bonds if the qualified equity pays for capital expenditures of the project on a date that is no earlier

than a date on which such expenditures would be eligible for reimbursement by proceeds of the applicable bonds under §1.150–2(d)(2) (regardless of whether the applicable bonds are reimbursement bonds) and, except for a reasonable retainage (within the meaning of §1.148–7(h)), no later than the date on which the measurement period begins.

(c) *Allocations of private payments.* Except as provided in this paragraph (c), private payments for a project are allocated in accordance with §1.141–4. Payments under an output contract that result in private business use of an eligible mixed-use project are allocated to the same source of funding (notwithstanding §1.141–4(c)(3)(v) (regarding certain allocations of private payments to equity)) allocated to the private business use from such contract under paragraph (b) of this section.

(d) *Allocations of proceeds to common costs of an issue.* Proceeds used for expenditures for common costs (for example, issuance costs, qualified guarantee fees, or reasonably required reserve or replacement funds) are allocated in accordance with §1.141–3(g)(6). Proceeds, as allocated under §1.141–3(g)(6) to an eligible mixed-use project, are allocated to the uses of the project in the same proportions as the proceeds allocated to the uses under paragraph (b) of this section.

(e) *Allocations of proceeds to bonds.* In general, proceeds are allocated to bonds in accordance with the rules for allocations of proceeds to bonds for separate purposes of multipurpose issues in §1.141–13(d). For an issue that is not a multipurpose issue (or is a multipurpose issue for which the issuer has not made a multipurpose allocation), proceeds are allocated to bonds ratably in a manner similar to the allocation of proceeds to projects under paragraph (a)(2) of this section.

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

Example 1. Mixed-use project. City A issues $70x of bonds (the Bonds) and finances the construction of a 10-story office building costing $100x (the Project) with proceeds of the Bonds and $30x of qualified equity (the Qualified Equity). To the extent that the private business use of the Project does not exceed 30 percent in any particular year, the Qualified Equity is allocated to the private business use. If private business use of the Project were, for example, 44 percent in a year, the Qualified Equity would be allocated to 30 percent ($30x) private business use and proceeds of the Bonds would be allocated to the excess (that is, 14 percent or $14x), resulting in private business use of the Bonds in that year of 20 percent ($14x/$70x). Conversely, if private business use of the Project were 20 percent, Qualified Equity would be allocated to that 20 percent. The remaining Qualified Equity (that is, 10 percent or $10x) would be allocated to the governmental use in excess of the 70 percent to which the proceeds of the Bonds would be allocated.

Example 2. Mixed-use output facility. Authority A is a governmental person that owns and operates an electric transmission facility. Several years ago, Authority A used its equity to pay capital expenditures of $1000x for the facility. Authority A wants to make capital improvements to the facility in the amount of $100x (the Project). Authority A reasonably expects that, after completion of the Project, it will sell 46 percent of the available output of the facility, as determined under §1.141–7, under output contracts that result in private business use and it will sell 54 percent of the available output of the facility for governmental use. On January 1, 2017, Authority A issues $60x of bonds (the Bonds) and uses the proceeds of the Bonds and $40x of qualified equity (the Qualified Equity) to finance the Project. The Qualified Equity is allocated to 40 of the 46 percent private business use resulting from the output contracts. Proceeds of the Bonds are allocated to the 54 percent governmental use and thereafter to the remaining 6 percent private business use.

Example 3. Subsequent improvements and replacements. County A owns a hospital, which opened in 2001, that it financed entirely with proceeds of bonds it issued in 1998 (the 1998 Bonds). In 2017, County A finances the cost of an addition to the hospital with proceeds of bonds (the 2017 Bonds) and qualified equity (the 2017 Qualified Equity). The original hospital is a project (the 1998 Project) and the addition is a project (the 2017 Project). Proceeds of the 2017 Bonds and the 2017 Qualified Equity are allocated to the 2017 Project. The 2017 Qualified Equity is allocated first to the private business use of the 2017 Project and then to the governmental use of the 2017 Project. Proceeds of the 2017 Bonds are allocated first to the governmental use of the 2017 Project and then to the private business use of that project. Neither proceeds of the 2017 Bonds nor 2017 Qualified Equity is allocated to the uses of the 1998 Project. Proceeds of the 1998 Bonds are not allocated to uses of the 2017 Project.

[T.D. 9741, 80 FR 65643, Oct. 27, 2015]

§ 1.141–7 Special rules for output facilities.

(a) *Overview.* This section provides special rules to determine whether arrangements for the purchase of output from an output facility cause an issue of bonds to meet the private business tests. For this purpose, unless otherwise stated, water facilities are treated as output facilities. Sections 1.141–3 and 1.141–4 generally apply to determine whether other types of arrangements for use of an output facility cause an issue to meet the private business tests.

(b) *Definitions.* For purposes of this section and § 1.141–8, the following definitions and rules apply:

(1) *Available output.* The available output of a facility financed by an issue is determined by multiplying the number of units produced or to be produced by the facility in one year by the number of years in the measurement period of that facility for that issue.

(i) *Generating facilities.* The number of units produced or to be produced by a generating facility in one year is determined by reference to its nameplate capacity or the equivalent (or where there is no nameplate capacity or the equivalent, its maximum capacity), which is not reduced for reserves, maintenance or other unutilized capacity.

(ii) *Transmission and other output facilities*—(A) *In general.* For transmission, distribution, cogeneration, and other output facilities, available output must be measured in a reasonable manner to reflect capacity.

(B) *Electric transmission facilities.* Measurement of the available output of all or a portion of electric transmission facilities may be determined in a manner consistent with the reporting rules and requirements for transmission networks promulgated by the Federal Energy Regulatory Commission (FERC). For example, for a transmission network, the use of aggregate load and load share ratios in a manner consistent with the requirements of the FERC may be reasonable. In addition, depending on the facts and circumstances, measurement of the available output of transmission facilities using thermal capacity or transfer capacity may be reasonable.

(iii) *Special rule for facilities with significant unutilized capacity.* If an issuer reasonably expects on the issue date that persons that are treated as private business users will purchase more than 30 percent of the actual output of the facility financed with the issue, the Commissioner may determine the number of units produced or to be produced by the facility in one year on a reasonable basis other than by reference to nameplate or other capacity, such as the average expected annual output of the facility. For example, the Commissioner may determine the available output of a financed peaking electric generating unit by reference to the reasonably expected annual output of that unit if the issuer reasonably expects, on the issue date of bonds that finance the unit, that an investor-owned utility will purchase more than 30 percent of the actual output of the facility during the measurement period under a take or pay contract, even if the amount of output purchased is less than 10 percent of the available output determined by reference to nameplate capacity. The reasonably expected annual output of the generating facility must be consistent with the capacity reported for prudent reliability purposes.

(iv) *Special rule for facilities with a limited source of supply.* If a limited source of supply constrains the output of an output facility, the number of units produced or to be produced by the facility must be determined by reasonably taking into account those constraints. For this purpose, a limited source of supply shall include a physical limitation (for example, flow of water), but not an economic limitation (for example, cost of coal or gas). For example, the available output of a hydroelectric unit must be determined by reference to the reasonably expected annual flow of water through the unit.

(2) *Measurement period.* The measurement period of an output facility financed by an issue is determined under § 1.141–3(g).

(3) *Sale at wholesale.* A sale at wholesale means a sale of output to any person for resale.

(4) *Take contract and take or pay contract.* A *take contract* is an output contract under which a purchaser agrees

to pay for the output under the contract if the output facility is capable of providing the output. A *take or pay contract* is an output contract under which a purchaser agrees to pay for the output under the contract, whether or not the output facility is capable of providing the output.

(5) *Requirements contract.* A *requirements contract* is an output contract, other than a take contract or a take or pay contract, under which a nongovernmental person agrees to purchase all or part of its output requirements.

(6) *Nonqualified amount.* The nonqualified amount with respect to an issue is determined under section 141(b)(8).

(c) *Output contracts*—(1) *General rule.* The purchase pursuant to a contract by a nongovernmental person of available output of an output facility (output contract) financed with proceeds of an issue is taken into account under the private business tests if the purchase has the effect of transferring the benefits of owning the facility and the burdens of paying the debt service on bonds used (directly or indirectly) to finance the facility (the benefits and burdens test). See paragraph (c)(4) of this section for the treatment of an output contract that is properly characterized as a lease for Federal income tax purposes. See paragraphs (d) and (e) of this section for rules regarding measuring the use of, and payments of debt service for, an output facility for determining whether the private business tests are met. See also §1.141–8 for rules for when an issue that finances an output facility (other than a water facility) meets the private business tests because the nonqualified amount of the issue exceeds $15 million.

(2) *Take contract or take or pay contract.* The benefits and burdens test is met if a nongovernmental person agrees pursuant to a take contract or a take or pay contract to purchase available output of a facility.

(3) *Requirements contract*—(i) *In general.* A requirements contract may satisfy the benefits and burdens test under paragraph (c)(3)(ii) or (iii) of this section. See §1.141–15(f)(2) for special effective dates for the application of this paragraph (c)(3) to issues financing facilities subject to requirements contracts.

(ii) *Requirements contract similar to take contract or take or pay contract.* A requirements contract generally meets the benefits and burdens test to the extent that it contains contractual terms that obligate the purchaser to make payments that are not contingent on the output requirements of the purchaser or that obligate the purchaser to have output requirements. For example, a requirements contract with an industrial purchaser meets the benefits and burdens test if the purchaser enters into additional contractual obligations with the issuer or another governmental unit not to cease operations. A requirements contract does not meet the benefits and burdens test, however, by reason of a provision that requires the purchaser to pay reasonable and customary damages (including liquidated damages) in the event of a default, or a provision that permits the purchaser to pay a specified amount to terminate the contract while the purchaser has requirements, in each case if the amount of the payment is reasonably related to the purchaser's obligation to buy requirements that is discharged by the payment.

(iii) *Wholesale requirements contract*—(A) *In general.* A requirements contract that is a sale at wholesale (a *wholesale requirements contract*) may satisfy the benefits and burdens test, depending on all the facts and circumstances.

(B) *Significant factors.* Significant factors that tend to establish that a wholesale requirements contract meets the benefits and burdens test include, but are not limited to—

(*1*) The term of the contract is substantial relative to the term of the issue or issues that finance the facility; and

(*2*) The amount of output to be purchased under the contract represents a substantial portion of the available output of the facility.

(C) *Safe harbors.* A wholesale requirements contract does not meet the benefits and burdens test if—

(*1*) The term of the contract, including all renewal options, does not exceed the lesser of 5 years or 30 percent of the term of the issue; or

(*2*) The amount of output to be purchased under the contract (and any other requirements contract with the same purchaser or a related party with respect to the facility) does not exceed 5 percent of the available output of the facility.

(iv) *Retail requirements contract.* Except as otherwise provided in this paragraph (c)(3), a requirements contract that is not a sale at wholesale does not meet the benefits and burdens test.

(4) *Output contract properly characterized as a lease.* Notwithstanding any other provision of this section, an output contract that is properly characterized as a lease for Federal income tax purposes shall be tested under the rules contained in §§1.141–3 and 1.141–4 to determine whether it is taken into account under the private business tests.

(d) *Measurement of private business use.* If an output contract results in private business use under this section, the amount of private business use generally is the amount of output purchased under the contract.

(e) *Measurement of private security or payment.* The measurement of payments made or to be made by nongovernmental persons under output contracts as a percent of the debt service of an issue is determined under the rules provided in §1.141–4.

(f) *Exceptions for certain contracts*—(1) *Small purchases of output.* An output contract for the use of a facility is not taken into account under the private business tests if the average annual payments to be made under the contract do not exceed 1 percent of the average annual debt service on all outstanding tax-exempt bonds issued to finance the facility, determined as of the effective date of the contract.

(2) *Swapping and pooling arrangements.* An agreement that provides for swapping or pooling of output by one or more governmental persons and one or more nongovernmental persons does not result in private business use of the output facility owned by the governmental person to the extent that—

(i) The swapped output is reasonably expected to be approximately equal in value (determined over periods of three years or less); and

(ii) The purpose of the agreement is to enable each of the parties to satisfy different peak load demands, to accommodate temporary outages, to diversify supply, or to enhance reliability in accordance with prudent reliability standards.

(3) *Short-term output contracts.* An output contract with a nongovernmental person is not taken into account under the private business tests if—

(i) The term of the contract, including all renewal options, is not longer than 3 years;

(ii) The contract either is a negotiated, arm's-length arrangement that provides for compensation at fair market value, or is based on generally applicable and uniformly applied rates; and

(iii) The output facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.

(4) *Certain conduit parties disregarded.* A nongovernmental person acting solely as a conduit for the exchange of output among governmentally owned and operated utilities is disregarded in determining whether the private business tests are met with respect to financed facilities owned by a governmental person.

(g) *Special rules for electric output facilities used to provide open access*—(1) *Operation of transmission facilities by nongovernmental persons*—(i) *In general.* The operation of an electric transmission facility by a nongovernmental person may result in private business use of the facility under §1.141–3 and this section based on all the facts and circumstances. For example, a transmission facility is generally used for a private business use if a nongovernmental person enters into a contract to operate the facility and receives compensation based, in whole or in part, on a share of net profits from the operation of the facility.

(ii) *Certain use by independent transmission operators.* A contract for the operation of an electric transmission facility by an independent entity, such as a regional transmission organization or an independent system operator (*independent transmission operator*), does not constitute private business use of the facility if—

(A) The facility is owned by a governmental person;

(B) The operation of the facility by the independent transmission operator is approved by the FERC under one or more provisions of the Federal Power Act (16 U.S.C. 791a through 825r) (or by a state authority under comparable provisions of state law);

(C) No portion of the compensation of the independent transmission operator is based on a share of net profits from the operation of the facility; and

(D) The independent transmission operator does not bear risk of loss of the facility.

(2) *Certain use by nongovernmental persons under output contracts*—(i) *Transmission facilities.* The use of an electric transmission facility by a nongovernmental person pursuant to an output contract does not constitute private business use of the facility if—

(A) The facility is owned by a governmental person;

(B) The facility is operated by an independent transmission operator in a manner that satisfies paragraph (g)(1)(ii) of this section; and

(C) The facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person.

(ii) *Distribution facilities.* The use of an electric distribution facility by a nongovernmental person pursuant to an output contract does not constitute private business use of the facility if—

(A) The facility is owned by a governmental person;

(B) The facility is available for use on a nondiscriminatory, open access basis by buyers and sellers of electricity in accordance with rates that are generally applicable and uniformly applied within the meaning of §1.141–3(c)(2); and

(C) The facility is not financed for a principal purpose of providing that facility for use by that nongovernmental person (other than a retail end-user).

(3) *Ancillary services.* The use of an electric output facility to provide ancillary services required to be offered as part of an open access transmission tariff under rules promulgated by the FERC under the Federal Power Act (16 U.S.C. 791a through 825r) (or by a state regulatory authority under comparable provisions of state law) does not result in private business use.

(4) *Exceptions to deliberate action rules*—(i) *Mandated wheeling.* Entering into a contract for the use of electric transmission or distribution facilities is not treated as a deliberate action under §1.141–2(d) if—

(A) The contract is entered into in response to (or in anticipation of) an order by the United States under sections 211 and 212 of the Federal Power Act (16 U.S.C. 824j and 824k) (or a state regulatory authority under comparable provisions of state law); and

(B) The terms of the contract are bona fide and arm's-length, and the consideration paid is consistent with the provisions of section 212(a) of the Federal Power Act.

(ii) *Actions taken to implement non-discriminatory, open access.* An action is not treated as a deliberate action under §1.141–2(d) if it is taken to implement the offering of non-discriminatory, open access tariffs for the use of electric transmission or distribution facilities in a manner consistent with rules promulgated by the FERC under sections 205 and 206 of the Federal Power Act (16 U.S.C. 824d and 824e) (or comparable provisions of state law). This paragraph (g)(4)(ii) does not apply, however, to the sale, exchange, or other disposition (within the meaning of section 1001(a)) of transmission or distribution facilities to a nongovernmental person.

(iii) *Application of reasonable expectations test to certain current refunding bonds.* An action taken or to be taken with respect to electric transmission or distribution facilities refinanced by an issue is not taken into account under the reasonable expectations test of §1.141–2(d) if—

(A) The action is described in paragraph (g)(4)(i) or (ii) of this section;

(B) The bonds of the issue are current refunding bonds that refund bonds originally issued before February 23, 1998; and

(C) The weighted average maturity of the refunding bonds is not greater than the remaining weighted average maturity of the prior bonds.

(5) *Additional transactions as permitted by the Commissioner.* The Commissioner may, by published guidance, set forth additional circumstances in which the use of electric output facilities in a restructured electric industry does not constitute private business use.

(h) *Allocations of output facilities and systems*—(1) *Facts and circumstances analysis.* Whether output sold under an output contract is allocated to a particular facility (for example, a generating unit), to the entire system of the seller of that output (net of any uses of that system output allocated to a particular facility), or to a portion of a facility is based on all the facts and circumstances. Significant factors to be considered in determining the allocation of an output contract to financed property are the following:

(i) The extent to which it is physically possible to deliver output to or from a particular facility or system.

(ii) The terms of a contract relating to the delivery of output (such as delivery limitations and options or obligations to deliver power from additional sources).

(iii) Whether a contract is entered into as part of a common plan of financing for a facility.

(iv) The method of pricing output under the contract, such as the use of market rates rather than rates designed to pay debt service of tax-exempt bonds used to finance a particular facility.

(2) *Illustrations.* The following illustrate the factors set forth in paragraph (h)(1) of this section:

(i) *Physical possibility.* Output from a generating unit that is fed directly into a low voltage distribution system of the owner of that unit and that cannot physically leave that distribution system generally must be allocated to those receiving electricity through that distribution system. Output may be allocated without regard to physical limitations, however, if exchange or similar agreements provide output to a purchaser where, but for the exchange agreements, it would not be possible for the seller to provide output to that purchaser.

(ii) *Contract terms relating to performance.* A contract to provide a specified amount of electricity from a system, but only when at least that amount of electricity is being generated by a particular unit, is allocated to that unit. For example, a contract to buy 20 MW of system power with a right to take up to 40 percent of the actual output of a specific 50 MW facility whenever total system output is insufficient to meet all of the seller's obligations generally is allocated to the specific facility rather than to the system.

(iii) *Common plan of financing.* A contract entered into as part of a common plan of financing for a facility generally is allocated to the facility if debt service for the issue of bonds is reasonably expected to be paid, directly or indirectly, from payments under the contract.

(iv) *Pricing method.* Pricing based on the capital and generating costs of a particular turbine tends to indicate that output under the contract is properly allocated to that turbine.

(3) *Transmission and distribution contracts.* Whether use under an output contract for transmission or distribution is allocated to a particular facility or to a transmission or distribution network is based on all the facts and circumstances, in a manner similar to paragraphs (h)(1) and (2) of this section. In general, the method used to determine payments under a contract is a more significant contract term for this purpose than nominal contract path. In general, if reasonable and consistently applied, the determination of use of transmission or distribution facilities under an output contract may be based on a method used by third parties, such as reliability councils.

(4) *Allocation of payments.* Payments for output provided by an output facility financed with two or more sources of funding are generally allocated under the rules in §1.141–4(c).

(i) *Examples.* The following examples illustrate the application of this section:

Example 1 Joint ownership. Z, an investor-owned electric utility, and City H agree to construct an electric generating facility of a size sufficient to take advantage of the economies of scale. H will issue $50 million of its 24-year bonds, and Z will use $100 million of its funds for construction of a facility they will jointly own as tenants in common. Each of the participants will share in the ownership, output, and operating expenses of the facility in proportion to its contribution to the cost of the facility, that is, one-third by H and two-thirds by Z. H's bonds will be secured by H's ownership interest in the facility and by revenues to be derived from its share of the annual output of the facility. H will need only 50 percent of its share of the annual output of the facility during the first 20 years of operations. It agrees to sell 10 percent of its share of the annual output to Z for a period of 20 years pursuant to a contract under which Z agrees to take that power if available. The facility will begin operation, and Z will begin to receive power, 4 years after the H bonds are issued. The measurement period for the property financed by the issue is 20 years. H also will sell the remaining 40 percent of its share of the annual output to numerous other private utilities under contracts of three years or less that satisfy the exception under paragraph (f)(3) of this section. No other contracts will be executed obligating any person to purchase any specified amount of the power for any specified period of time. No person (other than Z) will make payments that will result in a transfer of the burdens of paying debt service on bonds used directly or indirectly to provide H's share of the facilities. The bonds are not private activity bonds, because H's one-third interest in the facility is not treated as used by the other owners of the facility. Although 10 percent of H's share of the annual output of the facility will be used in the trade or business of Z, a nongovernmental person, under this section, that portion constitutes not more than 10 percent of the available output of H's ownership interest in the facility.

Example 2 Wholesale requirements contract. (i) City J issues 20-year bonds to acquire an electric generating facility having a reasonably expected economic life substantially greater than 20 years and a nameplate capacity of 100 MW. The available output of the facility under paragraph (b)(1) of this section is approximately 17,520,000 MWh (100 MW × 24 hours × 365 days × 20 years). On the issue date, J enters into a contract with T, an investor-owned utility, to provide T with all of its power requirements for a period of 10 years, commencing on the issue date. J reasonably expects that T will actually purchase an average of 30 MW over the 10-year period. The contract is taken into account under the private business tests pursuant to paragraph (c)(3) of this section because the term of the contract is substantial relative to the term of the issue and the amount of output to be purchased is a substantial portion of the available output.

(ii) Under paragraph (d) of this section, the amount of reasonably expected private business use under this contract is approximately 15 percent (30 MW × 24 hours × 365 days × 10 years, or 2,628,000 MWh) of the available output. Accordingly, the issue meets the private business use test. J reasonably expects that the amount to be paid for an average of 30 MW of power (less the operation and maintenance costs directly attributable to generating that 30 MW of power), will be more than 10 percent of debt service on the issue on a present-value basis. Accordingly, the issue meets the private security or payment test because J reasonably expects that payment of more than 10 percent of the debt service will be indirectly derived from payments by T. The bonds are private activity bonds under paragraph (c) of this section. Further, if 15 percent of the sale proceeds of the issue is greater than $15 million and the issue meets the private security or payment test with respect to the $15 million output limitation, the bonds are also private activity bonds under section 141(b)(4). See § 1.141–8.

Example 3 Retail contracts. (i) State Agency M, a political subdivision, issues bonds in 2003 to finance the construction of a generating facility that will be used to furnish electricity to M's retail customers. In 2007, M enters into a 10-year contract with industrial corporation I. Under the contract, M agrees to supply I with all of its power requirements during the contract term, and I agrees to pay for that power at a negotiated price as it is delivered. The contract does not require I to pay for any power except to the extent I has requirements. In addition, the contract requires I to pay reasonable and customary liquidated damages in the event of a default by I, and permits I to terminate the contract while it has requirements by paying M a specified amount that is a reasonable and customary amount for terminating the contract. Any damages or termination payment by I will be reasonably related to I's obligation to buy requirements that is discharged by the payment. Under paragraph (c)(3) of this section, the contract does not meet the benefits and burdens test. Thus, it is not taken into account under the private business tests.

(ii) The facts are the same as in paragraph (i) of this *Example 3*, except that the contract requires I to make guaranteed minimum payments, regardless of I's requirements, in an amount such that the contract does not meet the exception for small purchases in paragraph (f)(1) of this section. Under paragraph (c)(3)(ii) of this section, the contract meets the benefits and burdens test because it obligates I to make payments that are not contingent on its output requirements. Thus, it is taken into account under the private business tests.

Example 4 Allocation of existing contracts to new facilities. Power Authority K, a political subdivision created by the legislature in State X to own and operate certain power generating facilities, sells all of the power from its existing facilities to four private utility systems under contracts executed in

1999, under which the four systems are required to take or pay for specified portions of the total power output until the year 2029. Existing facilities supply all of the present needs of the four utility systems, but their future power requirements are expected to increase substantially beyond the capacity of K's current generating system. K issues 20-year bonds in 2004 to construct a large generating facility. As part of the financing plan for the bonds, a fifth private utility system contracts with K to take or pay for 15 percent of the available output of the new facility. The balance of the output of the new facility will be available for sale as required, but initially it is not anticipated that there will be any need for that power. The revenues from the contract with the fifth private utility system will be sufficient to pay less than 10 percent of the debt service on the bonds (determined on a present value basis). The balance, which will exceed 10 percent of the debt service on the bonds, will be paid from revenues derived from the contracts with the four systems initially from sale of power produced by the old facilities. The output contracts with all the private utilities are allocated to K's entire generating system. See paragraphs (h)(1) and (2) of this section. Thus, the bonds meet the private business use test because more than 10 percent of the proceeds will be used in the trade or business of a nongovernmental person. In addition, the bonds meet the private security or payment test because payment of more than 10 percent of the debt service, pursuant to underlying arrangements, will be derived from payments in respect of property used for a private business use.

Example 5 Allocation to displaced resource. Municipal utility MU, a political subdivision, purchases all of the electricity required to meet the needs of its customers (1,000 MW) from B, an investor-owned utility that operates its own electric generating facilities, under a 50-year take or pay contract. MU does not anticipate that it will require additional electric resources, and any new resources would produce electricity at a higher cost to MU than its cost under its contract with B. Nevertheless, B encourages MU to construct a new generating plant sufficient to meet MU's requirements. MU issues obligations to construct facilities that will produce 1,000 MW of electricity. MU, B, and I, another investor-owned utility, enter into an agreement under which MU assigns to I its rights under MU's take or pay contract with B. Under this arrangement, I will pay MU, and MU will continue to pay B, for the 1,000 MW. I's payments to MU will at least equal the amounts required to pay debt service on MU's bonds. In addition, under paragraph (h)(1)(iii) of this section, the contract among MU, B, and I is entered into as part of a common plan of financing of the MU facilities. Under all the facts and circumstances, MU's assignment to I of its rights under the original take or pay contract is allocable to MU's new facilities under paragraph (h) of this section. Because I is a nongovernmental person, MU's bonds are private activity bonds.

Example 6 Operation of transmission facilities by regional transmission organization. (i) Public Power Agency D is a political subdivision that owns and operates electric generation, transmission and distribution facilities. In 2003, D transfers operating control of its transmission system to a regional transmission organization (RTO), a nongovernmental person, pursuant to an operating agreement that is approved by the FERC under sections 205 and 206 of the Federal Power Act. D retains ownership of its facilities. No portion of the RTO's compensation is based on a share of net profits from the operation of D's facilities, and the RTO does not bear any risk of loss of those facilities. Under paragraph (g)(1)(ii) of this section, the RTO's use of D's facilities does not constitute a private business use.

(ii) Company A is located in D's service territory. In 2004, Power Supplier E, a nongovernmental person, enters into a 10-year contract with A to supply A's electricity requirements. The electricity supplied by E to A will be transmitted over D's transmission and distribution facilities. D's distribution facilities are available for use on a nondiscriminatory, open access basis by buyers and sellers of electricity in accordance with rates that are generally applicable and uniformly applied within the meaning of §1.141–3(c)(2). D's facilities are not financed for a principal purpose of providing the facilities for use by E. Under paragraph (g)(2) of this section, the contract between A and E does not result in private business use of D's facilities.

Example 7 Certain actions not treated as deliberate actions. The facts are the same as in *Example 6* of this paragraph (i), except that the RTO's compensation is based on a share of net profits from operating D's facilities. In addition, D had issued bonds in 1994 to finance improvements to its transmission system. At the time D transfers operating control of its transmission system to the RTO, D chooses to apply the private activity bond regulations of §§1.141–1 through 1.141–15 to the 1994 bonds. The operation of D's facilities by the RTO results in private business use under §1.141–3 and paragraph (g)(1)(i) of this section. Under the special exception in paragraph (g)(4)(ii) of this section, however, the transfer of control is not treated as a deliberate action. Accordingly, the transfer of control does not cause the 1994 bonds to meet the private activity bond tests.

Example 8 Current refunding. The facts are the same as in *Example 7* of this paragraph (i), and in addition D issues bonds in 2004 to currently refund the 1994 bonds. The weighted average maturity of the 2004 bonds is not greater than the remaining weighted average maturity of the 1994 bonds. D chooses to apply the private activity bond regulations of §§1.141–1 through 1.141–15 to the refunding bonds. In general, reasonable expectations must be separately tested on the date that refunding bonds are issued under §1.141–2(d). Under the special exception in paragraph (g)(4)(iii) of this section, however, the transfer of the financed facilities to the RTO need not be taken into account in applying the reasonable expectations test to the refunding bonds.

[T.D. 9016, 67 FR 59759, Sept. 23, 2002; 67 FR 70845, Nov. 27, 2002]

§ 1.141–8 $15 million limitation for output facilities.

(a) *In general*—(1) *General rule*. Section 141(b)(4) provides a special private activity bond limitation (the $15 million output limitation) for issues 5 percent or more of the proceeds of which are to be used to finance output facilities (other than a facility for the furnishing of water). Under this rule, an issue consists of private activity bonds under the private business tests of section 141(b)(1) and (2) if the nonqualified amount with respect to output facilities financed by the proceeds of the issue exceeds $15 million. The $15 million output limitation applies in addition to the private business tests of section 141(b)(1) and (2). Under section 141(b)(4) and paragraph (a)(2) of this section, the $15 million output limitation is reduced in certain cases. Specifically, an issue meets the test in section 141(b)(4) if both of the following tests are met:

(i) More than $15 million of the proceeds of the issue to be used with respect to an output facility are to be used for a private business use. Investment proceeds are disregarded for this purpose if they are not allocated disproportionately to the private business use portion of the issue.

(ii) The payment of the principal of, or the interest on, more than $15 million of the sale proceeds of the portion of the issue used with respect to an output facility is (under the terms of the issue or any underlying arrangement) directly or indirectly—

(A) Secured by any interest in an output facility used or to be used for a private business use (or payments in respect of such an output facility); or

(B) To be derived from payments (whether or not to the issuer) in respect of an output facility used or to be used for a private business use.

(2) *Reduction in $15 million output limitation for outstanding issues*—(i) *General rule*. In determining whether an issue 5 percent or more of the proceeds of which are to be used with respect to an output facility consists of private activity bonds under the $15 million output limitation, the $15 million limitation on private business use and private security or payments is applied by taking into account the aggregate nonqualified amounts of any outstanding bonds of other issues 5 percent or more of the proceeds of which are or will be used with respect to that output facility or any other output facility that is part of the same project.

(ii) *Bonds taken into account*. For purposes of this paragraph (a)(2), in applying the $15 million output limitation to an issue (the later issue), a tax-exempt bond of another issue (the earlier issue) is taken into account if—

(A) That bond is outstanding on the issue date of the later issue;

(B) That bond will not be redeemed within 90 days of the issue date of the later issue in connection with the refunding of that bond by the later issue; and

(C) 5 percent or more of the sale proceeds of the earlier issue financed an output facility that is part of the same project as the output facility that is financed by 5 percent or more of the sale proceeds of the later issue.

(3) *Benefits and burdens test applicable*—(i) *In general*. In applying the $15 million output limitation, the benefits and burdens test of §1.141–7 applies, except that ''$15 million'' is applied in place of ''10 percent'', or ''5 percent'' as appropriate.

(ii) *Earlier issues for the project*. If bonds of an earlier issue are outstanding and must be taken into account under paragraph (a)(2) of this section, the nonqualified amount for that earlier issue is multiplied by a fraction, the numerator of which is the adjusted issue price of the earlier issue as of the issue date of the later issue, and the denominator of which is the issue price of the earlier issue. Preissuance accrued interest as defined in §1.148–1(b) is disregarded for this purpose.

(b) *Definition of project*—(1) *General rule*. For purposes of paragraph (a)(2) of this section, *project* has the meaning provided in this paragraph. Facilities that are functionally related and subordinate to a project are treated as part of that same project. Facilities having different purposes or serving different customer bases are not ordinarily part of the same project. For example, the following are generally not part of the same project—

(i) Generation, transmission and distribution facilities;

(ii) Separate facilities designed to serve wholesale customers and retail customers; and

(iii) A peaking unit and a baseload unit (regardless of the location of the units).

(2) *Separate ownership*. Except as otherwise provided in this paragraph (b)(2), facilities that are not owned by the same person are not part of the same project. If different governmental persons act in concert to finance a project, however (for example as participants in a joint powers authority), their interests are aggregated with respect to that project to determine whether the $15 million output limitation is met. In the case of undivided ownership interests in a single output facility, property that is not owned by different persons is treated as separate projects only if the separate interests are financed—

(i) With bonds of different issuers; and

(ii) Without a principal purpose of avoiding the limitation in this section.

(3) *Generating property*—(i) *Property on same site*. In the case of generation and related facilities, *project* means property located at the same site.

(ii) *Special rule for generating units*. Separate generating units are not part of the same project if one unit is reasonably expected, on the issue date of each issue that finances the units, to be placed in service more than 3 years before the other. Common facilities or property that will be functionally related to more than one generating unit must be allocated on a reasonable basis. If a generating unit already is constructed or is under construction (the first unit) and bonds are to be issued to finance an additional generating unit (the second unit), all costs for any common facilities paid or incurred before the earlier of the issue date of bonds to finance the second unit or the commencement of construction of the second unit are allocated to the first unit. At the time that bonds are issued to finance the second unit (or, if earlier, upon commencement of construction of that unit), any remaining costs of the common facilities may be allocated between the first and second units so that in the aggregate the allocation is reasonable.

(4) *Transmission and distribution*. In the case of transmission or distribution facilities, *project* means functionally related or contiguous property. Separate transmission or distribution facilities are not part of the same project if one facility is reasonably expected, on the issue date of each issue that finances the facilities, to be placed in service more than 2 years before the other.

(5) *Subsequent improvements*—(i) In general. An improvement to generation, transmission or distribution facilities that is not part of the original design of those facilities (the original project) is not part of the same project as the original project if the construction, reconstruction, or acquisition of that improvement commences more than 3 years after the original project was placed in service and the bonds issued to finance that improvement are issued more than 3 years after the original project was placed in service.

(ii) *Special rule for transmission and distribution facilities*. An improvement to transmission or distribution facilities that is not part of the original design of that property is not part of the same project as the original project if the issuer did not reasonably expect the need to make that improvement when it commenced construction of the original project and the construction, reconstruction, or acquisition of that improvement is mandated by the federal government or a state regulatory authority to accommodate requests for wheeling.

(6) *Replacement property*. For purposes of this section, property that replaces existing property of an output facility is treated as part of the same project as the replaced property unless—

(i) The need to replace the property was not reasonably expected on the issue date or the need to replace the property occurred more than 3 years before the issuer reasonably expected (determined on the issue date of the bonds financing the property) that it would need to replace the property; and

(ii) The bonds that finance (and refinance) the output facility have a weighted average maturity that is not greater than 120 percent of the reasonably expected economic life of the facility.

(c) *Example*. The application of the provisions of this section is illustrated by the following example:

Example. (i) Power Authority K, a political subdivision, intends to issue a single issue of tax-exempt bonds at par with a stated principal amount and sale proceeds of $500 million to finance the acquisition of an electric generating facility. No portion of the facility will be used for a private business use, except that L, an investor-owned utility, will purchase 10 percent of the output of the facility under a take contract and will pay 10 percent of the debt service on the bonds. The nonqualified amount with respect to the bonds is $50 million.

(ii) The maximum amount of tax-exempt bonds that may be issued for the acquisition of an interest in the facility in paragraph (i) of this *Example* is $465 million (that is, $450 million for the 90 percent of the facility that is governmentally owned and used plus a nonqualified amount of $15 million).

[T.D. 9016, 67 FR 59763, Sept. 23, 2002]

§ 1.141–9 Unrelated or disproportionate use test.

(a) *General rules*—(1) *Description of test*. Under section 141(b)(3) (the unrelated or disproportionate use test), an issue meets the private business tests if the amount of private business use and private security or payments attributable to unrelated or disproportionate private business use exceeds 5 percent of the proceeds of the issue. For this purpose, the private business use test is applied by taking into account only use that is not related to any government use of proceeds of the issue (unrelated use) and use that is related but disproportionate to any government use of those proceeds (disproportionate use).

(2) *Application of unrelated or disproportionate use test*—(i) *Order of application*. The unrelated or disproportionate use test is applied by first determining whether a private business use is related to a government use. Next, private business use that relates to a government use is examined to determine whether it is disproportionate to that government use.

(ii) *Aggregation of unrelated and disproportionate use*. All the unrelated use and disproportionate use financed with the proceeds of an issue are aggregated to determine compliance with the unrelated or disproportionate use test. The amount of permissible unrelated and disproportionate private business use is not reduced by the amount of private business use financed with the proceeds of an issue that is neither unrelated use nor disproportionate use.

(iii) *Deliberate actions*. A deliberate action that occurs after the issue date does not result in unrelated or disproportionate use if the issue meets the conditions of § 1.141–12(a).

(b) *Unrelated use*—(1) *In general*. Whether a private business use is related to a government use financed with the proceeds of an issue is determined on a case-by-case basis, emphasizing the operational relationship between the government use and the private business use. In general, a facility that is used for a related private business use must be located within, or adjacent to, the governmentally used facility.

(2) *Use for the same purpose as government use*. Use of a facility by a nongovernmental person for the same purpose as use by a governmental person is not treated as unrelated use if the government use is not insignificant. Similarly, a use of a facility in the same manner both for private business use that is related use and private business use that is unrelated use does not result in unrelated use if the related use is not insignificant. For example, a privately owned pharmacy in a governmentally owned hospital does not ordinarily result in unrelated use solely because the pharmacy also serves individuals not using the hospital. In addition, use of parking spaces in a garage

by a nongovernmental person is not treated as unrelated use if more than an insignificant portion of the parking spaces are used for a government use (or a private business use that is related to a government use), even though the use by the nongovernmental person is not directly related to that other use.

(c) *Disproportionate use*—(1) *Definition of disproportionate use.* A private business use is disproportionate to a related government use only to the extent that the amount of proceeds used for that private business use exceeds the amount of proceeds used for the related government use. For example, a private use of $100 of proceeds that is related to a government use of $70 of proceeds results in $30 of disproportionate use.

(2) *Aggregation of related uses.* If two or more private business uses of the proceeds of an issue relate to a single government use of those proceeds, those private business uses are aggregated to apply the disproportionate use test.

(3) *Allocation rule.* If a private business use relates to more than a single use of the proceeds of the issue (for example, two or more government uses of the proceeds of the issue or a government use and a private use), the amount of any disproportionate use may be determined by—

(i) Reasonably allocating the proceeds used for the private business use among the related uses;

(ii) Aggregating government uses that are directly related to each other; or

(iii) Allocating the private business use to the government use to which it is primarily related.

(d) *Maximum use taken into account.* The determination of the amount of unrelated use or disproportionate use of a facility is based on the maximum amount of reasonably expected government use of a facility during the measurement period. Thus, no unrelated use or disproportionate use arises solely because a facility initially has excess capacity that is to be used by a nongovernmental person if the facility will be completely used by the issuer during the term of the issue for more than an insignificant period.

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

Example 1. School and remote cafeteria. County X issues bonds with proceeds of $20 million and uses $18.1 million of the proceeds for construction of a new school building and $1.9 million of the proceeds for construction of a privately operated cafeteria in its administrative office building, which is located at a remote site. The bonds are secured, in part, by the cafeteria. The $1.9 million of proceeds is unrelated to the government use (that is, school construction) financed with the bonds and exceeds 5 percent of $20 million. Thus, the issue meets the private business tests.

Example 2. Public safety building and courthouse. City Y issues bonds with proceeds of $50 million for construction of a new public safety building ($32 million) and for improvements to an existing courthouse ($15 million). Y uses $3 million of the bond proceeds for renovations to an existing privately operated cafeteria located in the courthouse. The bonds are secured, in part, by the cafeteria. Y's use of the $3 million for the privately operated cafeteria does not meet the unrelated or disproportionate use test because these expenditures are neither unrelated use nor disproportionate use.

Example 3. Unrelated garage. City Y issues bonds with proceeds of $50 million for construction of a new public safety building ($30.5 million) and for improvements to an existing courthouse ($15 million). Y uses $3 million of the bond proceeds for renovations to an existing privately operated cafeteria located in the courthouse. The bonds are secured, in part, by the cafeteria. Y also uses $1.5 million of the proceeds to construct a privately operated parking garage adjacent to a private office building. The private business use of the parking garage is unrelated to any government use of proceeds of the issue. Since the proceeds used for unrelated uses and disproportionate uses do not exceed 5 percent of the proceeds, the unrelated or disproportionate use test is not met.

Example 4. Disproportionate use of garage. County Z issues bonds with proceeds of $20 million for construction of a hospital with no private business use ($17 million); renovation of an office building with no private business use ($1 million); and construction of a garage that is entirely used for a private business use ($2 million). The use of the garage is related to the use of the office building but not to the use of the hospital. The private business use of the garage results in $1 million of disproportionate use because the proceeds used for the garage ($2 million) exceed the proceeds used for the related government use ($1 million). The bonds are not private activity bonds, however, because the disproportionate use does not exceed 5 percent of the proceeds of the issue.

Example 5. Bonds for multiple projects. (i) County W issues bonds with proceeds of $80 million for the following purposes: (1) $72 million to construct a County-owned and operated waste incinerator; (2) $1 million for a County-owned and operated facility for the temporary storage of hazardous waste prior to final disposal; (3) $1 million to construct a privately owned recycling facility located at a remote site; and (4) $6 million to build a garage adjacent to the County-owned incinerator that will be leased to Company T to store and repair trucks that it owns and uses to haul County W refuse. Company T uses 75 percent of its trucks to haul materials to the incinerator and the remaining 25 percent of its trucks to haul materials to the temporary storage facility.

(ii) The $1 million of proceeds used for the recycling facility is used for an unrelated use. The garage is related use. In addition, 75 percent of the use of the $6 million of proceeds used for the garage is allocable to the government use of proceeds at the incinerator. The remaining 25 percent of the proceeds used for the garage ($1.5 million) relates to the government use of proceeds at the temporary storage facility. Thus, this portion of the proceeds used for the garage exceeds the proceeds used for the temporary storage facility by $0.5 million and this excess is disproportionate use (but not unrelated use). Thus, the aggregate amount of unrelated use and disproportionate use financed with the proceeds of the issue is $1.5 million. Alternatively, under paragraph (c)(3)(iii) of this section, the entire garage may be treated as related to the government use of the incinerator and, under that allocation, the garage is not disproportionate use. In either event, section 141(b)(3) limits the aggregate unrelated use and disproportionate use to $4 million. Therefore, the bonds are not private activity bonds under this section.

[T.D. 8712, 62 FR 2297, Jan. 16, 1997]

§ 1.141–10 Coordination with volume cap. [Reserved]

§ 1.141–11 Acquisition of nongovernmental output property. [Reserved]

§ 1.141–12 Remedial actions.

(a) *Conditions to taking remedial action.* An action that causes an issue to meet the private business tests or the private loan financing test is not treated as a deliberate action if the issuer takes a remedial action described in paragraph (d), (e), or (f) of this section with respect to the nonqualified bonds and if all of the requirements in paragraphs (a) (1) through (5) of this section are met.

(1) *Reasonable expectations test met.* The issuer reasonably expected on the issue date that the issue would meet neither the private business tests nor the private loan financing test for the entire term of the bonds. For this purpose, if the issuer reasonably expected on the issue date to take a deliberate action prior to the final maturity date of the issue that would cause either the private business tests or the private loan financing test to be met, the term of the bonds for this purpose may be determined by taking into account a redemption provision if the provisions of § 1.141–2(d)(2)(ii) (A) through (C) are met.

(2) *Maturity not unreasonably long.* The term of the issue must not be longer than is reasonably necessary for the governmental purposes of the issue (within the meaning of § 1.148–1(c)(4)). Thus, this requirement is met if the weighted average maturity of the bonds of the issue is not greater than 120 percent of the average reasonably expected economic life of the property financed with the proceeds of the issue as of the issue date.

(3) *Fair market value consideration.* Except as provided in paragraph (f) of this section, the terms of any arrangement that results in satisfaction of either the private business tests or the private loan financing test are bona fide and arm's-length, and the new user pays fair market value for the use of the financed property. Thus, for example, fair market value may be determined in a manner that takes into account restrictions on the use of the financed property that serve a bona fide governmental purpose.

(4) *Disposition proceeds treated as gross proceeds for arbitrage purposes.* The issuer must treat any disposition proceeds as gross proceeds for purposes of section 148. For purposes of eligibility for temporary periods under section 148(c) and exemptions from the requirement of section 148(f) the issuer may treat the date of receipt of the disposition proceeds as the issue date of the bonds and disregard the receipt of disposition proceeds for exemptions based on expenditure of proceeds under

§ 1.148–7 that were met before the receipt of the disposition proceeds.

(5) *Proceeds expended on a governmental purpose.* Except for a remedial action under paragraph (d) of this section, the proceeds of the issue that are affected by the deliberate action must have been expended on a governmental purpose before the date of the deliberate action.

(b) *Effect of a remedial action*—(1) *In general.* The effect of a remedial action is to cure use of proceeds that causes the private business use test or the private loan financing test to be met. A remedial action does not affect application of the private security or payment test.

(2) *Effect on bonds that have been advance refunded.* If proceeds of an issue were used to advance refund another bond, a remedial action taken with respect to the refunding bond proportionately reduces the amount of proceeds of the advance refunded bond that is taken into account under the private business use test or the private loan financing test.

(c) *Disposition proceeds*—(1) *Definition. Disposition proceeds* are any amounts (including property, such as an agreement to provide services) derived from the sale, exchange, or other disposition (disposition) of property (other than investments) financed with the proceeds of an issue.

(2) *Allocating disposition proceeds to an issue.* In general, if the requirements of paragraph (a) of this section are met, after the date of the disposition, the proceeds of the issue allocable to the transferred property are treated as financing the disposition proceeds rather than the transferred property. If a disposition is made pursuant to an installment sale, the proceeds of the issue continue to be allocated to the transferred property. If an issue does not meet the requirements for remedial action in paragraph (a) of this section or the issuer does not take an appropriate remedial action, the proceeds of the issue are allocable to either the transferred property or the disposition proceeds, whichever allocation produces the greater amount of private business use and private security or payments.

(3) *Allocating disposition proceeds to different sources of funding.* If property has been financed by different sources of funding, for purposes of this section, the disposition proceeds from that property are first allocated to the outstanding bonds that financed that property in proportion to the principal amounts of those outstanding bonds. In no event may disposition proceeds be allocated to bonds that are no longer outstanding or to a source of funding not derived from a borrowing (such as revenues of the issuer) if the disposition proceeds are not greater than the total principal amounts of the outstanding bonds that are allocable to that property. For purposes of this paragraph (c)(3), principal amount has the same meaning as in § 1.148–9(b)(2) and outstanding bonds do not include advance refunded bonds.

(d) *Redemption or defeasance of nonqualified bonds*—(1) *In general.* The requirements of this paragraph (d) are met if all of the nonqualified bonds of the issue are redeemed. Proceeds of tax-exempt bonds must not be used for this purpose, unless the tax-exempt bonds are qualified bonds, taking into account the purchaser's use of the facility. Except as provided in paragraph (d)(3) of this section, if the bonds are not redeemed within 90 days of the date of the deliberate action, a defeasance escrow must be established for those bonds within 90 days of the deliberate action.

(2) *Special rule for dispositions for cash.* If the consideration for the disposition of financed property is exclusively cash, the requirements of this paragraph (d) are met if the disposition proceeds are used to redeem a pro rata portion of the nonqualified bonds at the earliest call date after the deliberate action. If the bonds are not redeemed within 90 days of the date of the deliberate action, the disposition proceeds must be used to establish a defeasance escrow for those bonds within 90 days of the deliberate action.

(3) *Anticipatory remedial action.* The requirements of paragraphs (d)(1) and (2) of this section for redemption or defeasance of the nonqualified bonds within 90 days of the deliberate action are met if the issuer declares its official intent to redeem or defease all of

the bonds that would become nonqualified bonds in the event of a subsequent deliberate action that would cause the private business tests or the private loan financing test to be met and redeems or defeases such bonds prior to that deliberate action. The issuer must declare its official intent on or before the date on which it redeems or defeases such bonds, and the declaration of intent must identify the financed property or loan with respect to which the anticipatory remedial action is being taken and describe the deliberate action that potentially may result in the private business tests being met (for example, sale of financed property that the buyer may then lease to a nongovernmental person). Rules similar to those in §1.150–2(e) (regarding official intent for reimbursement bonds) apply to declarations of intent under this paragraph (d)(3), including deviations in the descriptions of the project or loan and deliberate action and the reasonableness of the official intent.

(4) *Notice of defeasance*. The issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the defeasance escrow is established.

(5) *Special limitation*. The establishment of a defeasance escrow does not satisfy the requirements of this paragraph (d) if the period between the issue date and the first call date of the bonds is more than 10½ years.

(6) *Defeasance escrow defined*. A defeasance escrow is an irrevocable escrow established to redeem bonds on their earliest call date in an amount that, together with investment earnings, is sufficient to pay all the principal of, and interest and call premium on, bonds from the date the escrow is established to the earliest call date. The escrow may not be invested in higher yielding investments or in any investment under which the obligor is a user of the proceeds of the bonds.

(e) *Alternative use of disposition proceeds*—(1) *In general*. The requirements of this paragraph (e) are met if—

(i) The deliberate action is a disposition for which the consideration is exclusively cash;

(ii) The issuer reasonably expects to expend the disposition proceeds within two years of the date of the deliberate action;

(iii) The disposition proceeds are treated as proceeds for purposes of section 141 and are used in a manner that does not cause the issue to meet either the private business tests or the private loan financing test, and the issuer does not take any action subsequent to the date of the deliberate action to cause either of these tests to be met; and

(iv) If the issuer does not use all of the disposition proceeds for an alternative use described in paragraph (e)(1)(iii) of this section, the issuer uses those remaining disposition proceeds for a remedial action that meets paragraph (d) of this section.

(2) *Special rule for use by 501(c)(3) organizations*. If the disposition proceeds are to be used by a 501(c)(3) organization, the nonqualified bonds must in addition be treated as reissued for purposes of sections 141, 145, 147, 149, and 150 and, under this treatment, satisfy all of the applicable requirements for qualified 501(c)(3) bonds. Thus, beginning on the date of the deliberate action, nonqualified bonds that satisfy these requirements must be treated as qualified 501(c)(3) bonds for all purposes, including sections 145(b) and 150(b).

(f) *Alternative use of facility*. The requirements of this paragraph (f) are met if—

(1) The facility with respect to which the deliberate action occurs is used in an alternative manner (for example, used for a qualifying purpose by a nongovernmental person or used by a 501(c)(3) organization rather than a governmental person);

(2) The nonqualified bonds are treated as reissued, as of the date of the deliberate action, for purposes of sections 55 through 59 and 141, 142, 144, 145, 146, 147, 149 and 150, and under this treatment, the nonqualified bonds satisfy all the applicable requirements for qualified bonds throughout the remaining term of the nonqualified bonds;

(3) The deliberate action does not involve a disposition to a purchaser that finances the acquisition with proceeds

of another issue of tax-exempt bonds; and

(4) Any disposition proceeds other than those arising from an agreement to provide services (including disposition proceeds from an installment sale) resulting from the deliberate action are used to pay the debt service on the bonds on the next available payment date or, within 90 days of receipt, are deposited into an escrow that is restricted to the yield on the bonds to pay the debt service on the bonds on the next available payment date.

(g) *Rules for deemed reissuance.* For purposes of determining whether bonds that are treated as reissued under paragraphs (e) and (f) of this section are qualified bonds—

(1) The provisions of the Code and regulations thereunder in effect as of the date of the deliberate action apply; and

(2) For purposes of paragraph (f) of this section, section 147(d) (relating to the acquisition of existing property) does not apply.

(h) *Authority of Commissioner to provide for additional remedial actions.* The Commissioner may, by publication in the FEDERAL REGISTER or the Internal Revenue Bulletin, provide additional remedial actions, including making a remedial payment to the United States, under which a subsequent action will not be treated as a deliberate action for purposes of §1.141–2.

(i) *Effect of remedial action on continuing compliance.* Solely for purposes of determining whether deliberate actions that are taken after a remedial action cause an issue to meet the private business tests or the private loan financing test—

(1) If a remedial action is taken under paragraph (d) of this section, the amount of private business use or private loans resulting from the deliberate action that is taken into account for purposes of determining whether the bonds are private activity bonds is that portion of the remaining bonds that is used for private business use or private loans (as calculated under paragraph (j) of this section);

(2) If a remedial action is taken under paragraph (e) or (f) of this section, the amount of private business use or private loans resulting from the deliberate action is not taken into account for purposes of determining whether the bonds are private activity bonds; and

(3) After a remedial action is taken, the amount of disposition proceeds is treated as equal to the proceeds of the issue that had been allocable to the transferred property immediately prior to the disposition. See paragraph (k) of this section, *Example 5*.

(j) *Nonqualified bonds*—(1) *Amount of nonqualified bonds.* The nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not meet the private business use test or private loan financing test, as applicable. For this purpose, the amount of private business use is the greatest percentage of private business use in any one-year period commencing with the one-year period in which the deliberate action occurs.

(2) *Allocation of nonqualified bonds.* Allocations of nonqualified bonds must be made on a pro rata basis, except that, for purposes of paragraph (d) of this section (relating to redemption or defeasance), an issuer may treat any bonds of an issue as the nonqualified bonds so long as—

(i) The remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer in accordance with this section, is not greater than

(ii) The remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

(k) *Examples.* The following examples illustrate the application of this section:

Example 1 Disposition proceeds less than outstanding bonds used to retire bonds. On June 1, 1997, City C issues 30-year bonds with an issue price of $10 million to finance the construction of a hospital building. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the building. On the issue date, C reasonably expects that it will be the only user of the building for the entire term of the bonds. Six years after the issue date, C sells the building to Corporation P for $5 million. The sale price is the fair market value of the building, as verified by an independent appraiser. C uses all of the $5 million disposition proceeds to immediately retire a pro rata portion of the bonds. The sale does not cause the bonds to be private activity bonds because C has taken a remedial action described in paragraph (d) of this section so that P is not treated as a private business user of bond proceeds.

Example 2. Lease to nongovernmental person. The facts are the same as in *Example 1,* except that instead of selling the building, C, 6 years after the issue date, leases the building to P for 7 years and uses other funds to redeem all of the $10 million outstanding bonds within 90 days of the deliberate act. The bonds are not treated as private activity bonds because C has taken the remedial action described in paragraph (d) of this section.

Example 3. Sale for less than fair market value. The facts are the same as in *Example 1,* except that the fair market value of the building at the time of the sale to P is $6 million. Because the transfer was for less than fair market value, the bonds are ineligible for the remedial actions under this section. The bonds are private activity bonds because P is treated as a user of all of the proceeds and P makes a payment ($6 million) for this use that is greater than 10 percent of the debt service on the bonds, on a present value basis.

Example 4. Fair market value determined taking into account governmental restrictions. The facts are the same as in *Example 1,* except that the building was used by C only for hospital purposes and C determines to sell the building subject to a restriction that it be used only for hospital purposes. After conducting a public bidding procedure as required by state law, the best price that C is able to obtain for the building subject to this restriction is $4.5 million from P. C uses all of the $4.5 million disposition proceeds to immediately retire a pro rata portion of the bonds. The sale does not cause the bonds to be private activity bonds because C has taken a remedial action described in paragraph (d) of this section so that P is not treated as a private business user of bond proceeds.

Example 5. Alternative use of disposition proceeds. The facts are the same as in *Example 1,* except that C reasonably expects on the date of the deliberate action to use the $5 million disposition proceeds for another governmental purpose (construction of governmentally owned roads) within two years of receipt, rather than using the $5 million to redeem outstanding bonds. C treats these disposition proceeds as gross proceeds for purposes of section 148. The bonds are not private activity bonds because C has taken a remedial action described in paragraph (e) of this section. After the date of the deliberate action, the proceeds of all of the outstanding bonds are treated as used for the construction of the roads, even though only $5 million of disposition proceeds was actually used for the roads.

Example 6. Alternative use of financed property. The facts are the same as in *Example 1,* except that C determines to lease the hospital building to Q, an organization described in section 501(c)(3), for a term of 10 years rather than to sell the building to P. In order to induce Q to provide hospital services, C agrees to lease payments that are less than fair market value. Before entering into the lease, an applicable elected representative of C approves the lease after a noticed public hearing. As of the date of the deliberate action, the issue meets all the requirements for qualified 501(c)(3) bonds, treating the bonds as reissued on that date. For example, the issue meets the two percent restriction on use of proceeds of finance issuance costs of section 147(g) because the issue pays no costs of issuance from disposition proceeds in connection with the deemed reissuance. C and Q treat the bonds as qualified 501(c)(3) bonds for all purposes commencing with the date of the deliberate action. The bonds are treated as qualified 501(c)(3) bonds commencing with the date of the deliberate action.

Example 7. Deliberate action before proceeds are expended on a governmental purpose. County J issues bonds with proceeds of $10 million that can be used only to finance a correctional facility. On the issue date of the bonds, J reasonably expects that it will be the sole user of the bonds for the useful life of the facility. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the facility. After the issue date of the bonds, but before the facility is placed in service, J enters into a contract with the federal government pursuant to which the federal government will make a fair market value, lump sum payment equal to 25 percent of the cost of the facility. In exchange for this payment, J provides the federal government with priority rights to use of 25 percent of the facility. J uses the payment received from the federal government to defease the nonqualified bonds. The agreement does not cause the bonds to be private activity bonds because J has taken a remedial action described in paragraph (d) of this section. See paragraph (a)(5) of this section.

Example 8. Compliance after remedial action. In 2007, City G issues bonds with proceeds of $10 million to finance a courthouse. The bonds have a weighted average maturity that does not exceed 120 percent of the reasonably expected economic life of the courthouse. City G enters into contracts with nongovernmental persons that result in private business use of 10 percent of the courthouse per year. More than 10 percent of the debt service on the issue is secured by private security or payments. In 2019, in a bona fide and arm's length arrangement, City G enters into a management contract with a nongovernmental person that results in private business use of an additional 40 percent of the courthouse per year during the remaining term of the bonds. City G immediately redeems the nonqualified bonds, or 44.44 percent of the outstanding bonds. This is the portion of the outstanding bonds that, if the remaining bonds were issued on the date on which the deliberate action occurs, the remaining bonds would not meet the private business use test, treating the amount of private business use as the greatest percentage of private business use in any one-year period commencing with the one-year period in which the deliberate action occurs (50 percent). This percentage is computed by dividing the percentage of the facility used for a government use (50 percent) by the minimum amount of government use required (90 percent), and subtracting the resulting percentage (55.56 percent) from 100 percent (44.44 percent). For purposes of subsequently applying section 141 to the issue, City G may continue to use all of the proceeds of the outstanding bonds in the same manner (that is, for the courthouse and the private business use) without causing the issue to meet the private business use test. The issue continues to meet the private security or payment test. The result would be the same if City G, instead of redeeming the bonds, established a defeasance escrow for those bonds, provided that the requirement of paragraph (d)(5) of this section is met. If City G takes a subsequent deliberate action that results in further private business use, it must take into account 10 percent of private business use in addition to that caused by the second deliberate act.

[T.D. 8712, 62 FR 2298, Jan. 16, 1997, as amended by T.D. 9741, 80 FR 65644, Oct. 27, 2015]

§ 1.141–13 Refunding issues.

(a) *In general.* Except as provided in this section, a refunding issue and a prior issue are tested separately under section 141. Thus, the determination of whether a refunding issue consists of private activity bonds generally does not depend on whether the prior issue consists of private activity bonds.

(b) *Application of private business use test and private loan financing test*—(1) *Allocation of proceeds.* In applying the private business use test and the private loan financing test to a refunding issue, the proceeds of the refunding issue are allocated to the same expenditures and purpose investments as the proceeds of the prior issue.

(2) *Determination of amount of private business use*—(i) *In general.* Except as provided in paragraph (b)(2)(ii) of this section, the amount of private business use of a refunding issue is determined under §1.141–3(g), based on the measurement period for that issue (for example, without regard to any private business use that occurred prior to the issue date of the refunding issue).

(ii) *Refundings of governmental bonds.* In applying the private business use test to a refunding issue that refunds a prior issue of governmental bonds, the amount of private business use of the refunding issue is the amount of private business use—

(A) During the combined measurement period; or

(B) At the option of the issuer, during the period described in paragraph (b)(2)(i) of this section, but only if, without regard to the reasonable expectations test of §1.141–2(d), the prior issue does not satisfy the private business use test, based on a measurement period that begins on the first day of the combined measurement period and ends on the issue date of the refunding issue.

(iii) *Combined measurement period*—(A) *In general.* Except as provided in paragraph (b)(2)(iii)(B) of this section, the *combined measurement period* is the period that begins on the first day of the measurement period (as defined in §1.141–3(g)) for the prior issue (or, in the case of a series of refundings of governmental bonds, the first issue of governmental bonds in the series) and ends on the last day of the measurement period for the refunding issue.

(B) *Transition rule for refundings of bonds originally issued before May 16, 1997.* If the prior issue (or, in the case of a series of refundings of governmental bonds, the first issue of governmental bonds in the series) was issued before May 16, 1997, then the issuer, at its option, may treat the combined measurement period as beginning on the date (the transition date) that is the earlier of December 19, 2005 or the first date on which the prior issue (or an earlier issue in the case of a series of refundings of governmental bonds) became subject to the 1997 regulations (as defined in §1.141–15(b)). If the issuer treats the combined measurement period as beginning on the transition date in accordance with this paragraph (b)(2)(iii)(B), then paragraph (c)(2) of this section shall be applied by treating the transition date as the issue date of the earliest issue, by treating the bonds as reissued on the transition date at an issue price equal to the value of the bonds (as determined under §1.148–4(e)) on that date, and by disregarding any private security or private payments before the transition date.

(iv) *Governmental bond.* For purposes of this section, the term *governmental bond* means any bond that, when issued, purported to be a governmental bond, as defined in §1.150–1(b), or a qualified 501(c)(3) bond, as defined in section 145(a).

(v) *Special rule for refundings of qualified 501(c)(3) bonds with governmental bonds.* For purposes of applying this paragraph (b)(2) to a refunding issue that refunds a qualified 501(c)(3) bond, any use of the property refinanced by the refunding issue before the issue date of the refunding issue by a 501(c)(3) organization with respect to its activities that do not constitute an unrelated trade or business under section 513(a) is treated as government use.

(c) *Application of private security or payment test—(1) Separate issue treatment.* If the amount of private business use of a refunding issue is determined based on the measurement period for that issue in accordance with paragraph (b)(2)(i) or (b)(2)(ii)(B) of this section, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141–4 by treating the refunding issue as a separate issue.

(2) *Combined issue treatment.* If the amount of private business use of a refunding issue is determined based on the combined measurement period for that issue in accordance with paragraph (b)(2)(ii)(A) of this section, then the amount of private security and private payments allocable to the refunding issue is determined under §1.141–4 by treating the refunding issue and all earlier issues taken into account in determining the combined measurement period as a combined issue. For this purpose, the present value of the private security and private payments is compared to the present value of the debt service on the combined issue (other than debt service paid with proceeds of any refunding bond). Present values are computed as of the issue date of the earliest issue taken into account in determining the combined measurement period (the earliest issue). Except as provided in paragraph (c)(3) of this section, present values are determined by using the yield on the combined issue as the discount rate. The yield on the combined issue is determined by taking into account payments on the refunding issue and all earlier issues taken into account in determining the combined measurement period (other than payments made with proceeds of any refunding bond), and based on the issue price of the earliest issue. In the case of a refunding of only a portion of the original principal amount of a prior issue, the refunded portion of the prior issue is treated as a separate issue and any private security or private payments with respect to the prior issue are allocated ratably between the combined issue and the unrefunded portion of the prior issue in a consistent manner based on relative debt service. See paragraph (b)(2)(iii)(B) of this section for special rules relating to certain refundings of governmental bonds originally issued before May 16, 1997.

(3) *Special rule for arrangements not entered into in contemplation of the refunding issue.* In applying the private security or payment test to a refunding issue that refunds a prior issue of governmental bonds, the issuer may use the yield on the prior issue to determine the present value of private security and private payments under arrangements that were not entered into in contemplation of the refunding issue. For this purpose, any arrangement that was entered into more than 1 year before the issue date of the refunding issue is treated as not entered into in contemplation of the refunding issue.

(d) *Multipurpose issue allocations*—(1) *In general.* For purposes of section 141, unless the context clearly requires otherwise, § 1.148–9(h) applies to allocations of multipurpose issues (as defined in § 1.148–1(b)), including allocations involving the refunding purposes of the issue. An allocation under this paragraph (d) may be made at any time, but once made, may not be changed. An allocation is not reasonable under this paragraph (d) if it achieves more favorable results under section 141 than could be achieved with actual separate issues. Each of the separate issues under the allocation must consist of one or more tax-exempt bonds. Allocations made under this paragraph (d) and § 1.148–9(h) must be consistent for purposes of sections 141 and 148.

(2) *Exceptions.* This paragraph (d) does not apply for purposes of sections 141(c)(1) and 141(d)(1).

(e) *Application of reasonable expectations test to certain refunding bonds.* An action that would otherwise cause a refunding issue to satisfy the private business tests or the private loan financing test is not taken into account under the reasonable expectations test of § 1.141–2(d) if—

(1) The action is not a deliberate action within the meaning of § 1.141–2(d)(3); and

(2) The weighted average maturity of the refunding bonds is not greater than the weighted average reasonably expected economic life of the property financed by the prior bonds.

(f) *Special rule for refundings of certain general obligation bonds.* Notwithstanding any other provision of this section, a refunding issue does not consist of private activity bonds if—

(1) The prior issue meets the requirements of § 1.141–2(d)(5) (relating to certain general obligation bond programs that finance a large number of separate purposes); or

(2) The refunded portion of the prior issue is part of a series of refundings of all or a portion of an issue that meets the requirements of § 1.141–2(d)(5).

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

Example 1. Measuring private business use. In 2002, Authority A issues tax-exempt bonds that mature in 2032 to acquire an office building. The measurement period for the 2002 bonds under § 1.141–3(g) is 30 years. At the time A acquires the building, it enters into a 10-year lease with a nongovernmental person under which the nongovernmental person will use 5 percent of the building in its trade or business during each year of the lease term. In 2007, A issues bonds to refund the 2002 bonds. The 2007 bonds mature on the same date as the 2002 bonds and have a measurement period of 25 years under § 1.141–3(g). Under paragraph (b)(2)(ii)(A) of this section, the amount of private business use of the proceeds of the 2007 bonds is 1.67 percent, which equals the amount of private business use during the combined measurement period (5 percent of ⅓ of the 30-year combined measurement period). In addition, the 2002 bonds do not satisfy the private business use test, based on a measurement period beginning on the first day of the measurement period for the 2002 bonds and ending on the issue date of the 2007 bonds, because only 5 percent of the proceeds of the 2002 bonds are used for a private business use during that period. Thus, under paragraph (b)(2)(ii)(B) of this section, A may treat the amount of private business use of the 2007 bonds as 1 percent (5 percent of ⅕ of the 25-year measurement period for the 2007 bonds). The 2007 bonds do not satisfy the private business use test.

Example 2. Combined issue yield computation. (i) On January 1, 2000, County B issues 20-year bonds to finance the acquisition of a municipal auditorium. The 2000 bonds have a yield of 7.7500 percent, compounded annually, and an issue price and par amount of $100 million. The debt service payments on the 2000 bonds are as follows:

Date	Debt service
1/1/01	$9,996,470
1/1/02	9,996,470
1/1/03	9,996,470
1/1/04	9,996,470
1/1/05	9,996,470
1/1/06	9,996,470
1/1/07	9,996,470
1/1/08	9,996,470
1/1/09	9,996,470
1/1/10	9,996,470
1/1/11	9,996,470
1/1/12	9,996,470
1/1/13	9,996,470
1/1/14	9,996,470
1/1/15	9,996,470
1/1/16	9,996,470
1/1/17	9,996,470
1/1/18	9,996,470
1/1/19	9,996,470
1/1/20	9,996,470
	199,929,400

(ii) On January 1, 2005, B issues 15-year bonds to refund all of the outstanding 2000 bonds maturing after January 1, 2005 (in the aggregate principal amount of $86,500,000).

The 2005 bonds have a yield of 6.0000 percent, compounded annually, and an issue price and par amount of $89,500,000. The debt service payments on the 2005 bonds are as follows:

Date	Debt service
1/1/06	$9,215,167
1/1/07	9,215,167
1/1/08	9,215,167
1/1/09	9,215,167
1/1/10	9,215,167
1/1/11	9,215,167
1/1/12	9,215,167
1/1/13	9,215,167
1/1/14	9,215,167
1/1/15	9,215,167
1/1/16	9,215,167
1/1/17	9,215,167
1/1/18	9,215,167
1/1/19	9,215,167
1/1/20	9,215,167
	138,227,511

(iii) In accordance with §1.141–15(h), B chooses to apply §1.141–13 (together with the other provisions set forth in §1.141–15(h)), to the 2005 bonds. For purposes of determining the amount of private security and private payments with respect to the 2005 bonds, the 2005 bonds and the refunded portion of the 2000 bonds are treated as a combined issue under paragraph (c)(2) of this section. The yield on the combined issue is determined in accordance with §§1.148–4, 1.141–4(b)(2)(iii) and 1.141–13(c)(2). Under this methodology, the yield on the combined issue is 7.1062 percent per year compounded annually, illustrated as follows:

Date	Previous debt service on refunded portion of prior issue	Refunding debt service	Total debt service	Present value on 1/1/00
1/1/00				($86,500,000.00)
1/1/01	6,689,793		6,689,793	6,245,945.33
1/1/02	6,689,793		6,689,793	5,831,545.62
1/1/03	6,689,793		6,689,793	5,444,640.09
1/1/04	6,689,793		6,689,793	5,083,404.58
1/1/05	6,689,793		6,689,793	4,746,135.95
1/1/06		9,215,167	9,215,167	6,104,023.84
1/1/07		9,215,167	9,215,167	5,699,040.20
1/1/08		9,215,167	9,215,167	5,320,926.00
1/1/09		9,215,167	9,215,167	4,967,898.55
1/1/10		9,215,167	9,215,167	4,638,293.40
1/1/11		9,215,167	9,215,167	4,330,556.57
1/1/12		9,215,167	9,215,167	4,043,237.15
1/1/13		9,215,167	9,215,167	3,774,980.51
1/1/14		9,215,167	9,215,167	3,524,521.90
1/1/15		9,215,167	9,215,167	3,290,680.46
1/1/16		9,215,167	9,215,167	3,072,353.70
1/1/17		9,215,167	9,215,167	2,868,512.26
1/1/18		9,215,167	9,215,167	2,678,195.09
1/1/19		9,215,167	9,215,167	2,500,504.89
1/1/20		9,215,167	9,215,167	2,334,603.90
	33,448,965	138,227,511	171,676,4760.00	0.00

Example 3. Determination of private payments allocable to combined issue. The facts are the same as in *Example 2*. In addition, on January 1, 2001, B enters into a contract with a nongovernmental person for the use of the auditorium. The contract results in a private payment in the amount of $500,000 on each January 1 beginning on January 1, 2001, and ending on January 1, 2020. Under paragraph (c)(2) of this section, the amount of the private payments allocable to the combined issue is determined by treating the refunded portion of the 2000 bonds ($86,500,000 principal amount) as a separate issue, and by allocating the total private payments ratably between the combined issue and the unrefunded portion of the 2000 bonds ($13,500,000 principal amount) based on relative debt service, as follows:

Date	Private payments	Debt service on unrefunded portion of prior issue	Debt service on combined issue	Percentage of private payments allocable to combined issue	Amount of private payments allocable to combined issue
1/1/01	$500,000	$3,306,677	$6,689,793	66.92	$334,608
1/1/02	500,000	3,306,677	6,689,793	66.92	334,608

Date	Private payments	Debt service on unrefunded portion of prior issue	Debt service on combined issue	Percentage of private payments allocable to combined issue	Amount of private payments allocable to combined issue
1/1/03	500,000	3,306,677	6,689,793	66.92	334,608
1/1/04	500,000	3,306,677	6,689,793	66.92	334,608
1/1/05	500,000	3,306,677	6,689,793	66.92	334,608
1/1/06	500,000	....	9,215,167	100.00	500,000
1/1/07	500,000	....	9,215,167	100.00	500,000
1/1/08	500,000	....	9,215,167	100.00	500,000
1/1/09	500,000	....	9,215,167	100.00	500,000
1/1/10	500,000	....	9,215,167	100.00	500,000
1/1/11	500,000	....	9,215,167	100.00	500,000
1/1/12	500,000	....	9,215,167	100.00	500,000
1/1/13	500,000	....	9,215,167	100.00	500,000
1/1/14	500,000	....	9,215,167	100.00	500,000
1/1/15	500,000	....	9,215,167	100.00	500,000
1/1/16	500,000	....	9,215,167	100.00	500,000
1/1/17	500,000	....	9,215,167	100.00	500,000
1/1/18	500,000	....	9,215,167	100.00	500,000
1/1/19	500,000	....	9,215,167	100.00	500,000
1/1/20	500,000	....	9,215,167	100.00	500,000
	$10,000,000	$16,533,385	$171,676,476	....	$9,173,039

Example 4. Refunding taxable bonds and qualified bonds. (i) In 1999, City C issues taxable bonds to finance the construction of a facility for the furnishing of water. The bonds are secured by revenues from the facility. The facility is managed pursuant to a management contract with a nongovernmental person that gives rise to private business use. In 2007, C terminates the management contract and takes over the operation of the facility. In 2009, C issues bonds to refund the 1999 bonds. On the issue date of the 2009 bonds, C reasonably expects that the facility will not be used for a private business use during the term of the 2009 bonds. In addition, during the term of the 2009 bonds, the facility is not used for a private business use. Under paragraph (b)(2)(i) of this section, the 2009 bonds do not satisfy the private business use test because the amount of private business use is based on the measurement period for those bonds and therefore does not take into account any private business use that occurred pursuant to the management contract.

(ii) The facts are the same as in paragraph (i) of this *Example 4*, except that the 1999 bonds are issued as exempt facility bonds under section 142(a)(4). The 2009 bonds do not satisfy the private business use test.

Example 5. Multipurpose issue. (i) In 2017, State D issues bonds to finance the construction of two office buildings, Building 1 and Building 2. D expends an equal amount of the proceeds on each building. D enters into arrangements that result in private business use of 8 percent of Building 1 and 12 percent of Building 2 during the measurement period under §1.141–3(g) and private payments of 4 percent of the 2017 bonds in respect of Building 1 and 6 percent of the 2017 bonds in respect of Building 2. These arrangements result in a total of 10 percent of the proceeds of the 2017 bonds being used for a private business use and total private payments of 10 percent. In 2022, D purports to make a multipurpose issue allocation under paragraph (d) of this section of the outstanding 2017 bonds, allocating the issue into two separate issues of equal amounts with one issue allocable to Building 1 and the second allocable to Building 2. An allocation is unreasonable under paragraph (d) of this section if it achieves more favorable results under section 141 than could be achieved with actual separate issues. D's allocation is unreasonable because, if permitted, it would allow more favorable results under section 141 for the 2017 bonds (that is, private business use and private payments that exceed 10 percent for the 2017 bonds allocable to Building 2) than could be achieved with actual separate issues. In addition, if D's purported allocation was intended to result in two separate issues of tax-exempt governmental bonds (versus tax-exempt private activity bonds), the allocation would violate paragraph (d) of this section in the first instance because the allocation to the separate issue for Building 2 would fail to qualify separately as an issue of tax-exempt governmental bonds as a result of its 12 percent of private business use and private payments.

(ii) The facts are the same as in paragraph (i) of this *Example 5*, except that D enters into arrangements only for Building 1, and it expects no private business use of Building 2. In 2022, D allocates an equal amount of the outstanding 2017 bonds to Building 1 and Building 2. D selects particular bonds for each separate issue such that the allocation does not achieve a more favorable result than could have been achieved by issuing actual separate issues. D uses the same allocation for purposes of both sections 141 and 148. D's allocation is reasonable.

(iii) The facts are the same as in paragraph (ii) of this *Example 5*, except that as part of the same issue, D issues bonds for a privately used airport. The airport bonds, if issued as a separate issue, would be qualified private activity bonds. The remaining bonds, if issued separately from the airport bonds, would be governmental bonds. Treated as one issue, however, the bonds are taxable private activity bonds. Therefore, D makes its allocation of the bonds under paragraph (d) of this section and §1.150–1(c)(3) into 3 separate issues on or before the issue date. Assuming all other applicable requirements are met, the bonds of the respective issues will be tax-exempt qualified private activity bonds or governmental bonds.

Example 6. Non-deliberate action. In 1998, City E issues bonds to finance the purchase of land and construction of a building (the prior bonds). On the issue date of the prior bonds, E reasonably expects that it will be the sole user of the financed property for the entire term of the bonds. In 2003, the federal government acquires the financed property in a condemnation action. In 2006, E issues bonds to refund the prior bonds (the refunding bonds). The weighted average maturity of the refunding bonds is not greater than the reasonably expected economic life of the financed property. In general, under §1.141–2(d) and this section, reasonable expectations must be separately tested on the issue date of a refunding issue. Under paragraph (e) of this section, however, the condemnation action is not taken into account in applying the reasonable expectations test to the refunding bonds because the condemnation action is not a deliberate action within the meaning of §1.141–2(d)(3) and the weighted average maturity of the refunding bonds is not greater than the weighted average reasonably expected economic life of the property financed by the prior bonds. Thus, the condemnation action does not cause the refunding bonds to be private activity bonds.

Example 7. Non-transitioned refunding of bonds subject to 1954 Code. In 1985, County F issues bonds to finance a court house. The 1985 bonds are subject to the provisions of the Internal Revenue Code of 1954. In 2006, F issues bonds to refund all of the outstanding 1985 bonds. The weighted average maturity of the 2006 bonds is longer than the remaining weighted average maturity of the 1985 bonds. In addition, the 2006 bonds do not satisfy any transitional rule for refundings in the Tax Reform Act of 1986, 100 Stat. 2085 (1986). Section 141 and this section apply to determine whether the 2006 bonds are private activity bonds including whether, for purposes of §1.141–13(b)(2)(ii)(B), the 1985 bonds satisfy the private business use test based on a measurement period that begins on the first day of the combined measurement period for the 2006 bonds and ends on the issue date of the 2006 bonds.

[T.D. 9234, 70 FR 75032, Dec. 19, 2006, as amended by T.D. 9741, 80 FR 65645, Oct. 27, 2015]

§ 1.141–14 Anti-abuse rules.

(a) *Authority of Commissioner to reflect substance of transactions.* If an issuer enters into a transaction or series of transactions with respect to one or more issues with a principal purpose of transferring to nongovernmental persons (other than as members of the general public) significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of section 141, the Commissioner may take any action to reflect the substance of the transaction or series of transactions, including—

(1) Treating separate issues as a single issue for purposes of the private activity bond tests;

(2) Reallocating proceeds to expenditures, property, use, or bonds;

(3) Reallocating payments to use or proceeds;

(4) Measuring private business use on a basis that reasonably reflects the economic benefit in a manner different than as provided in §1.141–3(g); and

(5) Measuring private payments or security on a basis that reasonably reflects the economic substance in a manner different than as provided in §1.141–4.

(b) *Examples.* The following examples illustrate the application of this section:

Example 1. Reallocating proceeds to indirect use. City C issues bonds with proceeds of $20 million for the stated purpose of financing improvements to roads that it owns. As a part of the same plan of financing, however, C also agrees to make a loan of $7 million to Corporation M from its general revenues that it otherwise would have used for the road improvements. The interest rate of the loan corresponds to the interest rate on a portion of the issue. A principal purpose of the financing arrangement is to transfer to M significant benefits of the tax-exempt financing. Although C actually allocates all of the proceeds of the bonds to the road improvements, the Commissioner may reallocate a portion of the proceeds of the bonds to the loan to M because a principal purpose of the financing arrangement is to transfer to

M significant benefits of tax-exempt financing in a manner that is inconsistent with the purposes of section 141. The bonds are private activity bonds because the issue meets the private loan financing test. The bonds also meet the private business tests. See also §§ 1.141–3(a)(2), 1.141–4(a)(1), and 1.141–5(a), under which indirect use of proceeds and payments are taken into account.

Example 2. Taking into account use of amounts derived from proceeds that would be otherwise disregarded. County B issues bonds with proceeds of $10 million to finance the purchase of land. On the issue date, B reasonably expects that it will be the sole user of the land. Subsequently, the federal government acquires the land for $3 million in a condemnation action. B uses this amount to make a loan to Corporation M. In addition, the interest rate on the loan reflects the tax-exempt interest rate on the bonds and thus is substantially less than a current market rate. A principal purpose of the arrangement is to transfer to M significant benefits of the tax-exempt financing. Although the condemnation action is not a deliberate action, the Commissioner may treat the condemnation proceeds as proceeds of the issue because a principal purpose of the arrangement is to transfer to M significant benefits of tax-exempt financing in a manner inconsistent with the purposes of section 141. The bonds are private activity bonds.

Example 3. Measuring private business use on an alternative basis. City F issues bonds with a 30-year term to finance the acquisition of an industrial building having a remaining reasonably expected useful economic life of more than 30 years. On the issue date, F leases the building to Corporation G for 3 years. F reasonably expects that it will be the sole user of the building for the remaining term of the bonds. Because of the local market conditions, it is reasonably expected that the fair rental value of the industrial building will be significantly greater during the early years of the term of the bonds than in the later years. The annual rental payments are significantly less than fair market value, reflecting the interest rate on the bonds. The present value of these rental payments (net of operation and maintenance expenses) as of the issue date, however, is approximately 25 percent of the present value of debt service on the issue. Under § 1.141–3, the issue does not meet the private business tests, because only 10 percent of the proceeds are used in a trade or business by a nongovernmental person. A principal purpose of the issue is to transfer to G significant benefits of tax-exempt financing in a manner inconsistent with the purposes of section 141. The method of measuring private business use over the reasonably expected useful economic life of financed property is for the administrative convenience of issuers of state and local bonds. In cases where this method is used in a manner inconsistent with the purposes of section 141, the Commissioner may measure private business use on another basis that reasonably reflects economic benefit, such as in this case on an annual basis. If the Commissioner measures private business use on an annual basis, the bonds are private activity bonds because the private payment test is met and more than 10 percent of the proceeds are used in a trade or business by a nongovernmental person.

Example 4. Treating separate issues as a single issue. City D enters into a development agreement with Corporation T to induce T to locate its headquarters within D's city limits. Pursuant to the development agreement, in 1997 D will issue $20 million of its general obligation bonds (the 1997 bonds) to purchase land that it will grant to T. The development agreement also provides that, in 1998, D will issue $20 million of its tax increment bonds (the 1998 bonds), secured solely by the increase in property taxes in a special taxing district. Substantially all of the property within the special taxing district is owned by T or D. T will separately enter into an agreement to guarantee the payment of tax increment to D in an amount sufficient to retire the 1998 bonds. The proceeds of the 1998 bonds will be used to finance improvements owned and operated by D that will not give rise to private business use. Treated separately, the 1997 issue meets the private business use test, but not the private security or payment test; the 1998 issue meets the private security or payment test, but not the private business use test. A principal purpose of the financing plan, including the two issues, is to transfer significant benefits of tax-exempt financing to T for its headquarters. Thus, the 1997 issue and the 1998 issue may be treated by the Commissioner as a single issue for purposes of applying the private activity bond tests. Accordingly, the bonds of both the 1997 issue and the 1998 issue may be treated as private activity bonds.

Example 5. Reallocating proceeds. City E acquires an electric generating facility with a useful economic life of more than 40 years and enters into a 30-year take or pay contract to sell 30 percent of the available output to investor-owned utility M. E plans to use the remaining 70 percent of available output for its own governmental purposes. To finance the entire cost of the facility, E issues $30 million of its series A taxable bonds at taxable interest rates and $70 million series B bonds, which purport to be tax-exempt bonds, at tax-exempt interest rates. E allocates all of M's private business use to the proceeds of the series A bonds and all of its own government use to the proceeds of the series B bonds. The series A bonds have a weighted average maturity of 15 years, while the series B bonds have a weighted average maturity of 26 years. M's payments under the take or pay contract are expressly determined by reference to 30 percent of M's total costs (that is, the sum of the debt service required to be paid on both the series A and the series B bonds and all other operating costs). The allocation of all of M's private business use to the series A bonds does not reflect economic substance because the series of transactions transfers to M significant benefits of the tax-exempt interest rates paid on the series B bonds. A principal purpose of the financing arrangement is to transfer to M significant benefits of the tax-exempt financing. Accordingly, the Commissioner may allocate M's private business use on a pro rata basis to both the series B bonds as well as the series A bonds, in which case the series B bonds are private activity bonds.

Example 6. Allocations respected. The facts are the same as in *Example 5*, except that the debt service component of M's payments under the take or pay contract is based exclusively on the amounts necessary to pay the debt service on the taxable series A bonds. E's allocation of all of M's private business use to the series A bonds is respected because the series of transactions does not actually transfer benefits of tax-exempt interest rates to M. Accordingly, the series B bonds are not private activity bonds. The result would be the same if M's payments under the take or pay contract were based exclusively on fair market value pricing, rather than the tax-exempt interest rates on E's bonds. The result also would be the same if the series A bonds and the series B bonds had substantially equivalent weighted average maturities and E and M had entered into a customary contract providing for payments based on a ratable share of total debt service. E would not be treated by the Commissioner in any of these cases as entering into the contract with a principal purpose of transferring the benefits of tax-exempt financing to M in a manner inconsistent with the purposes of section 141.

[T.D. 8712, 62 FR 2301, Jan. 16, 1997]

§ 1.141–15 Effective/applicability dates.

(a) *Scope.* The effective dates of this section apply for purposes of §§ 1.141–1 through 1.141–14, 1.145–1 through 1.145–2, and 1.150–1(a)(3) and the definition of bond documents contained in § 1.150–1(b).

(b) *Effective dates*—(1) *In general.* Except as otherwise provided in this section, §§ 1.141–0 through 1.141–6(a), 1.141–9 through 1.141–12, 1.141–14, 1.145–1 through 1.145–2(c), and the definition of bond documents contained in § 1.150–1(b) (the 1997 regulations) apply to bonds issued on or after May 16, 1997, that are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602).

(2) *Certain short-term arrangements.* The provisions of § 1.141–3 that refer to arrangements for 200 days, 100 days, or 50 days apply to any bond sold on or after November 20, 2001 and may be applied to any bond outstanding on November 20, 2001 to which § 1.141–3 applies.

(3) *Certain prepayments.* Except as provided in paragraph (c) of this section, paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of § 1.141–5 apply to bonds sold on or after October 3, 2003. Issuers may apply paragraphs (c)(2)(ii), (c)(2)(iii) and (c)(2)(iv) of § 1.141–5, in whole but not in part, to bonds sold before October 3, 2003 that are subject to § 1.141–5.

(4) *Certain remedial actions*—(i) *General rule.* For bonds subject to § 1.141–12, the provisions of § 1.141–12(d)(3), (i), (j), and (k), *Example 8*, apply to deliberate actions that occur on or after January 25, 2016.

(ii) *Special rule for allocations of nonqualified bonds.* For purposes of § 1.141–12(j)(2), in addition to the allocation methods permitted in § 1.141–12(j)(2), an issuer may treat bonds with the longest maturities (determined on a bond-by-bond basis) as the nonqualified bonds, but only for bonds sold before January 25, 2016.

(c) *Refunding bonds.* Except as otherwise provided in this section, the 1997 regulations (defined in paragraph (b)(1) of this section) do not apply to any bonds issued on or after May 16, 1997, to refund a bond to which those regulations do not apply unless—

(1) The refunding bonds are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602); and

(2)(i) The weighted average maturity of the refunding bonds is longer than—

(A) The weighted average maturity of the refunded bonds; or

(B) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(ii) A principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

(d) *Permissive application of regulations.* Except as provided in paragraph (e) of this section, the 1997 regulations (defined in paragraph (b)(1) of this section) may be applied in whole, but not in part, to actions taken before February 23, 1998, with respect to—

(1) Bonds that are outstanding on May 16, 1997, and subject to section 141; or

(2) Refunding bonds issued on or after May 16, 1997, that are subject to 141.

(e) *Permissive application of certain sections*—(1) *In general.* The following sections may each be applied by issuers to any bonds:

(i) Section 1.141–3(b)(4);

(ii) Section 1.141–3(b)(6); and

(iii) Section 1.141–12.

(2) *Transition rule for pre-effective date bonds.* For purposes of paragraphs (e)(1) and (h) of this section, issuers may apply §1.141–12 to bonds issued before May 16, 1997, without regard to paragraph (d)(5) thereof with respect to deliberate actions that occur on or after April 21, 2003.

(f) *Effective dates for certain regulations relating to output facilities*—(1) *General rule.* Except as otherwise provided in this section, §§1.141–7 and 1.141–8 apply to bonds sold on or after November 22, 2002, that are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602).

(2) *Transition rule for requirements contracts.* For bonds otherwise subject to §§1.141–7 and 1.141–8, §1.141–7(c)(3) applies to output contracts entered into on or after September 19, 2002. An output contract is treated as entered into on or after that date if it is amended on or after that date, but only if the amendment results in a change in the parties to the contract or increases the amount of requirements covered by the contract by reason of an extension of the contract term or a change in the method for determining such requirements. For purposes of this paragraph (f)(2)—

(i) The extension of the term of a contract causes the contract to be treated as entered into on the first day of the additional term;

(ii) The exercise by a party of a legally enforceable right that was provided under a contract before September 19, 2002, on terms that were fixed and determinable before such date, is not treated as an amendment of the contract. For example, the exercise by a purchaser after September 19, 2002 of a renewal option that was provided under a contract before that date, on terms identical to the original contract, is not treated as an amendment of the contract; and

(iii) An amendment that increases the amount of requirements covered by the contract by reason of a change in the method for determining such requirements is treated as a separate contract that is entered into as of the effective date of the amendment, but only with respect to the increased output to be provided under the contract.

(g) *Refunding bonds for output facilities.* Except as otherwise provided in paragraph (h) or (i) of this section, §§1.141–7 and 1.141–8 do not apply to any bonds sold on or after November 22, 2002, to refund a bond to which §§1.141–7 and 1.141–8 do not apply unless—

(1) The refunding bonds are subject to section 1301 of the Tax Reform Act of 1986 (100 Stat. 2602); and

(2)(i) The weighted average maturity of the refunding bonds is longer than—

(A) The weighted average maturity of the refunded bonds; or

(B) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed; or

(ii) A principal purpose for the issuance of the refunding bonds is to make one or more new conduit loans.

(h) *Permissive retroactive application.* Except as provided in paragraphs (d), (e) or (i) of this section, §§1.141–1 through 1.141–6(a), 1.141–7 through 1.141–14, 1.145–1 through 1.145–2, 1.149(d)–1(g), 1.150–1(a)(3), the definition of bond documents contained in §1.150–1(b) and §1.150–1(c)(3)(ii) may be applied by issuers in whole, but not in part, to—

(1) Outstanding bonds that are sold before February 17, 2006, and subject to section 141; or

(2) Refunding bonds that are sold on or after February 17, 2006, and subject to section 141.

(i) *Permissive application of certain regulations relating to output facilities.* Issuers may apply each of the following sections to any bonds used to finance output facilities:

(1) Section 1.141–6;

(2) Section 1.141–7(f)(3); and

(3) Section 1.141–7(g).

(j) *Effective dates for certain regulations relating to refundings.* Except as otherwise provided in this section, §§1.141–13, 1.145–2(d), 1.149(d)–1(g), 1.150–1(a)(3) and 1.150–1(c)(3)(ii) apply to bonds that are sold on or after February 17, 2006, and that are subject to the 1997 regulations (defined in paragraph (b)(1) of this section).

(k) *Effective/applicability dates for certain regulations relating to generally applicable taxes and payments in lieu of tax*—(1) *In general.* Except as otherwise provided in paragraphs (k)(2) and (k)(3) of this section, revised §§1.141–4(e)(2), 1.141–4(e)(3) and 1.141–4(e)(5) apply to bonds sold on or after October 24, 2008 that are otherwise subject to the 1997 Regulations (defined in paragraph (b)(1) of this section).

(2) *Transitional rule for certain refundings.* Paragraph (k)(1) does not apply to bonds that are issued to refund bonds if—

(i) Either—

(A) The refunded bonds (or the original bonds in a series of refundings) were sold before October 24, 2008, or

(B) The refunded bonds (or the original bonds in a series of refundings) satisfied the transitional rule for projects substantially in progress under paragraph (k)(3) of this section; and

(ii) The weighted average maturity of the refunding bonds does not exceed the remaining weighted average maturity of the refunded bonds.

(3) *Transitional rule for certain projects substantially in progress.* Paragraph (k)(1) of this section does not apply to bonds issued for projects for which all of the following requirements are met:

(i) A governmental person (as defined in §1.141–1) took official action evidencing its preliminary approval of the project before October 19, 2006, and the plan of finance for the project in place at that time contemplated financing the project with tax-exempt bonds to be paid or secured by PILOTs.

(ii) Before October 19, 2006, significant expenditures were paid or incurred with respect to the project or a contract was entered into to pay or incur significant expenditures with respect to the project.

(iii) The bonds for the project (excluding refunding bonds) are issued on or before December 31, 2009.

(l) *Applicability date for certain regulations relating to allocation and accounting*—(1) *In general.* Except as otherwise provided in this section, §§1.141–1(e), 1.141–3(g)(2)(v), 1.141–6, 1.141–13(d), and 1.145–2(b)(4), (b)(5), and (c)(2) apply to bonds that are sold on or after January 25, 2016, and to which the 1997 regulations (as defined in paragraph (b)(1) of this section) apply.

(2) *Refunding bonds.* Except as otherwise provided in this section, §§1.141–1(e), 1.141–3(g)(2)(v), 1.141–6, and 1.145–2(b)(4), (5), and (c)(2) do not apply to any bonds sold on or after January 25, 2016, to refund a bond to which these sections do not apply, provided that the weighted average maturity of the refunding bonds is no longer than—

(i) The remaining weighted average maturity of the refunded bonds; or

(ii) In the case of a short-term obligation that the issuer reasonably expects to refund with a long-term financing (such as a bond anticipation note), 120 percent of the weighted average reasonably expected economic life of the facilities financed.

(3) *Permissive application.* Except as otherwise provided in this section, issuers may apply §§1.141–1(e), 1.141–3(g)(2)(v), 1.141–6, and 1.145–2(b)(4), (b)(5), and (c)(2), in whole but not in part, to bonds to which the 1997 regulations apply.

(m) *Permissive retroactive application of certain regulations.* Issuers may apply §1.141–13(d) to bonds to which §1.141–13 applies.

(n) *Effective/applicability dates for certain regulations relating to certain definitions.* §1.141–1(a) applies to bonds that are sold on or after October 17, 2016.

[T.D. 8757, 63 FR 3265, Jan. 22, 1998, as amended by T.D. 8941, 66 FR 4670, Jan. 18, 2001; T.D. 8967, 66 FR 58062, Nov. 20, 2001; T.D. 9016, 67 FR 59765, Sept. 23, 2002; T.D. 9085, 68 FR 45775, Aug. 4, 2003; T.D. 9234, 70 FR 75035, Dec. 19, 2005; 71 FR 1971, Jan. 12, 2006; T.D. 9429, 73 FR 63375, Oct. 24, 2008; T.D. 9741, 80 FR 65645, Oct. 27, 2015; 80 FR 74678, Nov. 30, 2015; T.D. 9777, 81 FR 46592, July 18, 2016]

§ 1.141–16 Effective dates for qualified private activity bond provisions.

(a) *Scope.* The effective dates of this section apply for purposes of §§1.142–0 through 1.142–2, 1.144–0 through 1.144–2, 1.147–0 through 1.147–2, and 1.150–4.

(b) *Effective dates.* Except as otherwise provided in this section, the regulations designated in paragraph (a) of this section apply to bonds issued on or after May 16, 1997 (the effective date).

(c) *Permissive application.* The regulations designated in paragraph (a) of this section may be applied by issuers in whole, but not in part, to bonds outstanding on the effective date. For this purpose, issuers may apply §1.142–2 without regard to paragraph (c)(3) thereof to failures to properly use proceeds that occur on or after April 21, 2003.

(d) *Certain remedial actions*—(1) *General rule.* The provisions of §1.142–2(e) apply to failures to properly use proceeds that occur on or after August 13, 2004 and may be applied by issuers to failures to properly use proceeds that occur on or after May 14, 2004, provided that the bonds are subject to §1.142–2.

(2) *Special rule for allocations of nonqualified bonds.* For purposes of §1.142–2(e)(2), in addition to the allocation methods permitted in §1.142–2(e)(2), an issuer may treat bonds with the longest maturities (determined on a bond-by-bond basis) as the nonqualified bonds, but only with respect to failures to properly use proceeds that occur on or after May 14, 2004, with respect to bonds sold before August 13, 2004.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997, as amended by T.D. 9150, 69 FR 50066, Aug. 13, 2004]

§ 1.142–0 Table of contents.

This section lists the captioned paragraphs contained in §§1.142–1 through 1.142–3.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997, as amended by T.D. 9150, 69 FR 50066, Aug. 13, 2004]

§ 1.142–1 Exempt facility bonds.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 141(e)(1)(A), an exempt facility bond issued under section 142 may be a qualified bond.

Under section 142(a), an exempt facility bond is any bond issued as a part of an issue using 95 percent or more of the proceeds for certain exempt facilities.

(b) *Scope.* Sections 1.142–0 through 1.142–3 apply for purposes of the rules for exempt facility bonds under section 142, except that, with respect to net proceeds that have been spent, §1.142–2 does not apply to bonds issued under section 142(d) (relating to bonds issued to provide qualified residential rental projects) and section 142(f) (2) and (4) (relating to bonds issued to provide local furnishing of electric energy or gas).

(c) *Effective dates.* For effective dates of §§1.142–0 through 1.142–2, see §1.141–16.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997]

§ 1.142–2 Remedial actions.

(a) *General rule.* If less than 95 percent of the net proceeds of an exempt facility bond are actually used to provide an exempt facility, and for no other purpose, the issue will be treated as meeting the use of proceeds requirement of section 142(a) if the issue meets the condition of paragraph (b) of this section and the issuer takes the remedial action described in paragraph (c) of this section.

(b) *Reasonable expectations requirement.* The issuer must have reasonably expected on the issue date that 95 percent of the net proceeds of the issue would be used to provide an exempt facility and for no other purpose for the entire term of the bonds (disregarding any redemption provisions). To meet this condition the amount of the issue must have been based on reasonable estimates about the cost of the facility.

(c) *Redemption or defeasance*—(1) *In general*. The requirements of this paragraph (c) are met if all of the nonqualified bonds of the issue are redeemed on the earliest call date after the date on which the failure to properly use the proceeds occurs under paragraph (d) of this section. Proceeds of tax-exempt bonds (other than those described in paragraph (d)(1) of this section) must not be used for this purpose. If the bonds are not redeemed within 90 days of the date on which the failure to properly use proceeds occurs, a defeasance escrow must be established for those bonds within 90 days of that date.

(2) *Notice of defeasance*. The issuer must provide written notice to the Commissioner of the establishment of the defeasance escrow within 90 days of the date the escrow is established.

(3) *Special limitation*. The establishment of a defeasance escrow does not satisfy the requirements of this paragraph (c) if the period between the issue date and the first call date is more than 10½ years.

(4) *Special rule for dispositions of personal property*. For dispositions of personal property exclusively for cash, the requirements of this paragraph (c) are met if the issuer expends the disposition proceeds within 6 months of the date of the disposition to acquire replacement property for the same qualifying purpose of the issue under section 142.

(5) *Definitions*. For purposes of paragraph (c)(4) of this section, *disposition proceeds* means disposition proceeds as defined in § 1.141–12(c).

(d) *When a failure to properly use proceeds occurs*—(1) *Proceeds not spent*. For net proceeds that are not spent, a failure to properly use proceeds occurs on the earlier of the date on which the issuer reasonably determines that the financed facility will not be completed or the date on which the financed facility is placed in service.

(2) *Proceeds spent*. For net proceeds that are spent, a failure to properly use proceeds occurs on the date on which an action is taken that causes the bonds not to be used for the qualifying purpose for which the bonds were issued.

(e) *Nonqualified bonds*—(1) *Amount of nonqualified bonds*. For purposes of this section, the nonqualified bonds are a portion of the outstanding bonds in an amount that, if the remaining bonds were issued on the date on which the failure to properly use the proceeds occurs, at least 95 percent of the net proceeds of the remaining bonds would be used to provide an exempt facility. If no proceeds have been spent to provide an exempt facility, all of the outstanding bonds are nonqualified bonds.

(2) *Allocation of nonqualified bonds*. Allocations of nonqualified bonds must be made on a pro rata basis, except that an issuer may treat any bonds of an issue as the nonqualified bonds so long as—

(i) The remaining weighted average maturity of the issue, determined as of the date on which the nonqualified bonds are redeemed or defeased (determination date), and excluding from the determination the nonqualified bonds redeemed or defeased by the issuer to meet the requirements of paragraph (c) of this section, is not greater than

(ii) The remaining weighted average maturity of the issue, determined as of the determination date, but without regard to the redemption or defeasance of any bonds (including the nonqualified bonds) occurring on the determination date.

[T.D. 8712, 62 FR 2302, Jan. 16, 1997, as amended by T.D. 9150, 69 FR 50067, Aug. 13, 2004]

§ 1.142–3 Refunding Issues. [Reserved]

§ 1.142–4 Use of proceeds to provide a facility.

(a) *In general*. [Reserved]

(b) *Reimbursement allocations*. If an expenditure for a facility is paid before the issue date of the bonds to provide that facility, the facility is described in section 142(a) only if the expenditure meets the requirements of § 1.150–2 (relating to reimbursement allocations). For purposes of this paragraph (b), if the proceeds of an issue are used to pay principal of or interest on an obligation other than a State or local bond (for example, temporary construction financing of the conduit borrower), that issue is not a refunding issue, and, thus, § 1.150–2(g) does not apply.

(c) *Limitation on use of facilities by substantial users*—(1) *In general.* If the original use of a facility begins before the issue date of the bonds to provide the facility, the facility is not described in section 142(a) if any person that was a substantial user of the facility at any time during the 5-year period before the issue date or any related person to that user receives (directly or indirectly) 5 percent or more of the proceeds of the issue for the user's interest in the facility and is a substantial user of the facility at any time during the 5-year period after the issue date, unless—

(i) An official intent for the facility is adopted under § 1.150–2 within 60 days after the date on which acquisition, construction, or reconstruction of that facility commenced; and

(ii) For an acquisition, no person that is a substantial user or related person after the acquisition date was also a substantial user more than 60 days before the date on which the official intent was adopted.

(2) *Definitions.* For purposes of paragraph (c)(1) of this section, *substantial user* has the meaning used in section 147(a)(1), *related person* has the meaning used in section 144(a)(3), and a user that is a governmental unit within the meaning of § 1.103–1 is disregarded.

(d) *Effective date*—(1) *In general.* This section applies to bonds sold on or after July 8, 1997. See § 1.103–8(a)(5) for rules applicable to bonds sold before that date.

(2) *Elective retroactive application.* An issuer may apply this section to any bond sold before July 8, 1997.

[T.D. 8718, 62 FR 25506, May 9, 1997]

§ 1.142(a)(5)–1 Exempt facility bonds: Sewage facilities.

(a) *In general.* Under section 103(a), a private activity bond is a tax-exempt bond only if it is a qualified bond. A qualified bond includes an exempt facility bond, defined as any bond issued as part of an issue 95 percent or more of the net proceeds of which are used to provide a facility specified in section 142. One type of facility specified in section 142(a) is a sewage facility. This section defines the term *sewage facility* for purposes of section 142(a).

(b) *Definitions*—(1) *Sewage facility defined.* A sewage facility is property—

(i) Except as provided in paragraphs (b)(2) and (d) of this section, used for the secondary treatment of wastewater; however, for property treating wastewater reasonably expected to have an average daily raw wasteload concentration of biochemical oxygen demand (BOD) that exceeds 350 milligrams per liter as oxygen (measured at the time the influent enters the facility) (the *BOD limit*), this paragraph (b)(1)(i) applies only to the extent the treatment is for wastewater having an average daily raw wasteload concentration of BOD that does not exceed the BOD limit;

(ii) Used for the preliminary and/or primary treatment of wastewater but only to the extent used in connection with secondary treatment (without regard to the BOD limit described in paragraph (b)(1)(i) of this section);

(iii) Used for the advanced or tertiary treatment of wastewater but only to the extent used in connection with and after secondary treatment;

(iv) Used for the collection, storage, use, processing, or final disposal of—

(A) Wastewater, which property is necessary for such preliminary, primary, secondary, advanced, or tertiary treatment; or

(B) Sewage sludge removed during such preliminary, primary, secondary, advanced, or tertiary treatment (without regard to the BOD limit described in paragraph (b)(1)(i) of this section);

(v) Used for the treatment, collection, storage, use, processing, or final disposal of septage (without regard to the BOD limit described in paragraph (b)(1)(i) of this section); and

(vi) Functionally related and subordinate to property described in this paragraph (b)(1), such as sewage disinfection property.

(2) *Special rules and exceptions*—(i) *Exception to BOD limit.* A facility treating wastewater with an average daily raw wasteload concentration of BOD exceeding the BOD limit will not fail to qualify as a sewage facility described in paragraph (b)(1) of this section to the extent that the failure to satisfy

the BOD limit results from the implementation of a federal, state, or local water conservation program (for example, a program designed to promote water use efficiency that results in BOD concentrations beyond the BOD limit).

(ii) *Anti-abuse rule for BOD limit.* A facility does not satisfy the BOD limit if there is any intentional manipulation of the BOD level to circumvent the BOD limit (for example, increasing the volume of water in the wastewater before the influent enters the facility with the intention of reducing the BOD level).

(iii) *Authority of Commissioner.* In appropriate cases upon application to the Commissioner, the Commissioner may determine that facilities employing technologically advanced or innovative treatment processes qualify as sewage facilities if it is demonstrated that these facilities perform functions that are consistent with the definition of sewage facilities described in paragraph (b)(1) of this section.

(3) *Other applicable definitions*—(i) *Advanced or tertiary treatment* means the treatment of wastewater after secondary treatment. Advanced or tertiary treatment ranges from biological treatment extensions to physical-chemical separation techniques such as denitrification, ammonia stripping, carbon adsorption, and chemical precipitation.

(ii) *Nonconventional pollutants* are any pollutants that are not listed in 40 CFR 401.15, 401.16, or appendix A to part 423.

(iii) *Preliminary treatment* means treatment that removes large extraneous matter from incoming wastewater and renders the incoming wastewater more amenable to subsequent treatment and handling.

(iv) *Pretreatment* means a process that preconditions wastewater to neutralize or remove toxic, priority, or nonconventional pollutants that could adversely affect sewers or inhibit a preliminary, primary, secondary, advanced, or tertiary treatment operation.

(v) *Primary treatment* means treatment that removes material that floats or will settle, usually by screens or settling tanks.

(vi) *Priority pollutants* are those pollutants listed in appendix A to 40 CFR part 423.

(vii) *Secondary treatment* means the stage in sewage treatment in which a bacterial process (or an equivalent process) consumes the organic parts of wastes, usually by trickling filters or an activated sludge process.

(viii) *Sewage sludge* is defined in 40 CFR 122.2 and includes septage.

(ix) *Toxic pollutants* are those pollutants listed in 40 CFR 401.15.

(c) *Other property not included in the definition of a sewage facility.* Property other than property described in paragraph (b)(1) of this section is not a sewage facility. Thus, for example, property is not a sewage facility, or functionally related and subordinate property, if the property is used for pretreatment of wastewater (whether or not this treatment is necessary to perform preliminary, primary, secondary, advanced, or tertiary treatment), or the related collection, storage, use, processing, or final disposal of the wastewater. In addition, property used to treat, process, or use wastewater subsequent to the time the wastewater can be discharged into navigable waters, as defined in 33 U.S.C. 1362, is not a sewage facility.

(d) *Allocation of costs.* In the case of property that has both a use described in paragraph (b)(1) of this section (a sewage treatment function) and a use other than sewage treatment, only the portion of the cost of the property allocable to the sewage treatment function is taken into account as an expenditure to provide sewage facilities. The portion of the cost of property allocable to the sewage treatment function is determined by allocating the cost of that property between the property's sewage treatment function and any other uses by any method which, based on all the facts and circumstances, reasonably reflects a separation of costs for each use of the property.

(e) *Effective date*—(1) *In general.* This section applies to issues of bonds issued after February 21, 1995.

(2) *Refundings.* In the case of a refunding bond issued to refund a bond to which this section does not apply, the issuer need not apply this section to that refunding bond. This paragraph

(e)(2) applies only if the weighted average maturity of the refunding bonds, as described in section 147(b), is not greater than the remaining weighted average maturity of the refunded bonds.

[T.D. 8576, 59 FR 66163, Dec. 23, 1994, as amended by T.D. 9546, Aug. 19, 2011]

§ 1.142(a)(6)–1 Exempt facility bonds: solid waste disposal facilities.

(a) *In general.* This section defines the term solid waste disposal facility for purposes of section 142(a)(6).

(b) *Solid waste disposal facility.* The term *solid waste disposal facility* means a facility to the extent that the facility—

(1) Processes solid waste (as defined in paragraph (c) of this section) in a qualified solid waste disposal process (as defined in paragraph (d) of this section);

(2) Performs a preliminary function (as defined in paragraph (f) of this section); or

(3) Is functionally related and subordinate (within the meaning of §1.103–8(a)(3)) to a facility described in paragraph (b)(1) or (b)(2) of this section.

(c) *Solid waste*—(1) *In general.* Except to the extent excluded under paragraph (c)(2) of this section, for purposes of section 142(a)(6), the term *solid waste* means garbage, refuse, and other solid material derived from any agricultural, commercial, consumer, governmental, or industrial operation or activity if the material meets the requirements of both paragraph (c)(1)(i) and paragraph (c)(1)(ii) of this section. For purposes of this section, material is solid if it is solid at ambient temperature and pressure.

(i) *Used material or residual material.* Material meets the requirements of this paragraph (c)(1)(i) if it is either used material (as defined in paragraph (c)(1)(i)(A)) of this section or residual material (as defined in paragraph (c)(1)(i)(B) of this section).

(A) *Used material.* The term *used material* means any material that is a product of any agricultural, commercial, consumer, governmental, or industrial operation or activity, or a component of any such product or activity, and that has been used previously. Used material also includes animal waste produced by animals from a biological process.

(B) *Residual material.* The term *residual material* means material that meets the requirements of this paragraph (c)(1)(i)(B). The material must be a residual byproduct or excess raw material that results from or remains after the completion of any agricultural, commercial, consumer, governmental, or industrial production process or activity or from the provision of any service. In the case of multiple processes constituting an integrated manufacturing or industrial process, the material must result from or remain after the completion of such integrated process. As of the issue date of the bonds used to finance the solid waste disposal facility, the material must be reasonably expected to have a fair market value that is lower than the value of all of the products made in that production process or lower than the value of the service that produces such residual material.

(ii) *Reasonably expected introduction into a qualified solid waste disposal process.* Material meets the requirements of this paragraph (c)(1)(ii) if it is reasonably expected by the person who generates, purchases, or otherwise acquires it to be introduced within a reasonable time after such generation, purchase or acquisition into a qualified solid waste disposal process described in paragraph (d) of this section.

(2) *Exclusions from solid waste.* The following materials do not constitute solid waste:

(i) *Virgin material.* Except to the extent that virgin material constitutes an input to a final disposal process or residual material, solid waste excludes any virgin material. The term *virgin material* means material that has not been processed into an agricultural, commercial, consumer, governmental, or industrial product, or a component of any such product. Further, for this purpose, material continues to be virgin material after it has been grown, harvested, mined, or otherwise extracted from its naturally occurring location and cleaned, divided into component elements, modified, or enhanced, as long as further processing is required before it becomes an agricultural, commercial, consumer, or industrial product, or a component of any such product.

(ii) *Solids within liquids and liquid waste.* Solid waste excludes any solid or dissolved material in domestic sewage or other significant pollutant in water resources, such as silt, dissolved or suspended solids in industrial waste water effluents, dissolved materials in irrigation return flows or other common water pollutants, and liquid or gaseous waste.

(iii) *Precious metals.* Except to the extent that a precious metal constitutes an input to a final disposal process and/or an unrecoverable trace of the particular precious metal, solid waste excludes gold, silver, ruthenium, rhodium, palladium, osmium, iridium, platinum, gallium, rhenium, and any other precious metal material as may be identified by the Internal Revenue Service in future public administrative guidance.

(iv) *Hazardous material.* Solid waste excludes any hazardous material that must be disposed of at a facility that is subject to final permit requirements under subtitle C of title II of the Solid Waste Disposal Act as in effect on the date of the enactment of the Tax Reform Act of 1986 (which is October 22, 1986). See section 142(h)(1) of the Internal Revenue Code for the definition of qualified hazardous waste facilities.

(v) *Radioactive material.* Solid waste excludes any radioactive material subject to regulation under the Nuclear Regulatory Act (10 CFR 1.1 *et seq.*), as in effect on the issue date of the bonds.

(d) *Qualified solid waste disposal process.* The term *qualified solid waste disposal process* means the processing of solid waste in a final disposal process (as defined in paragraph (d)(1) of this section), an energy conversion process (as defined in paragraph (d)(2) of this section), or a recycling process (as defined in paragraph (d)(3) of this section). Absent an express restriction to the contrary in this section, a qualified solid waste disposal process may employ any biological, engineering, industrial, or technological method.

(1) *Final disposal process.* The term *final disposal process* means the placement of solid waste in a landfill (including, for this purpose, the spreading of solid waste over land in an environmentally compliant and safe manner with no intent to remove such solid waste), the incineration of solid waste without capturing any useful energy, or the containment of solid waste with a reasonable expectation as of the date of issue of the bonds that the containment will continue indefinitely and that the solid waste has no current or future beneficial use.

(2) *Energy conversion process.* The term *energy conversion process* means a thermal, chemical, or other process that is applied to solid waste to create and capture synthesis gas, heat, hot water, steam, or other useful energy. The energy conversion process begins at the point of the first application of such process. The energy conversion process ends at the point at which the useful energy is first created, captured, or incorporated into the form of synthesis gas, heat, hot water, or other useful energy and before any transfer or distribution of such synthesis gas, heat, hot water or other useful energy, regardless of whether such synthesis gas, heat, hot water, or other useful energy constitutes a first useful product within the meaning of paragraph (e) of this section.

(3) *Recycling process*—(i) *In general.* The term *recycling process* means reconstituting, transforming, or otherwise processing solid waste into a useful product. The recycling process begins at the point of the first application of a process to reconstitute or transform the solid waste into a useful product, such as decontamination, melting, repulping, shredding, or other processing of the solid waste to accomplish this purpose. The recycling process ends at the point of completion of production of the first useful product from the solid waste.

(ii) *Refurbishment, repair, or similar activities.* The term *recycling process* does not include refurbishment, repair, or similar activities. The term *refurbishment* means the breakdown and reassembly of a product if such activity is done on a product-by-product basis and if the finished product contains more than 30 percent of its original materials or components.

(e) *First useful product.* The term *first useful product* means the first product produced from the processing of solid waste in a solid waste disposal process that is useful for consumption in agricultural, consumer, commercial, governmental, or industrial operation or activity and that could be sold for such use, whether or not actually sold. A useful product includes both a product useful to an individual consumer as an ultimate end-use consumer product and a product useful to an industrial user as a material or input for processing in some stage of a manufacturing or production process to produce a different end-use consumer product. The determination of whether a useful product has been produced may take into account operational constraints that affect the point in production when a useful product reasonably can be extracted or isolated and sold independently. For this purpose, the costs of extracting, isolating, storing, and transporting the product to a market may only be taken into account as operational constraints if the product is not to be used as part of an integrated manufacturing or industrial process in the same location as that in which the product is produced.

(f) *Preliminary function.* A *preliminary function* is a function to collect, separate, sort, store, treat, process, disassemble, or handle solid waste that is preliminary to and directly related to a qualified solid waste disposal process.

(g) *Mixed-use facilities*—(1) *In general.* If a facility is used for both a qualified solid waste disposal function (including a qualified solid waste disposal process or a preliminary function) and a nonqualified function (a mixed-use facility), then the costs of the facility allocable to the qualified solid waste disposal function are determined using any reasonable method, based on all the facts and circumstances. See §1.103–8(a)(1) for allocation rules on amounts properly allocable to an exempt facility. Facilities qualify as functionally related and subordinate to a qualified solid waste disposal function only to the extent that they are functionally related and subordinate to the portion of the mixed-use facility that is used for one or more qualified solid waste disposal functions (including a qualified solid waste disposal process or a preliminary function).

(2) *Mixed inputs*—(i) *In general.* Except as otherwise provided in paragraph (g)(2)(ii) of this section, for each facility (or a portion of a mixed-use facility) performing a qualified solid waste disposal process or a preliminary function, the percentage of the costs of the property used for such process that are allocable to a qualified solid waste disposal process or a preliminary function cannot exceed the average annual percentage of solid waste processed in that qualified solid waste disposal process or that preliminary function while the issue is outstanding. The annual percentage of solid waste processed in that qualified solid waste disposal process or preliminary function for any year is the percentage, by weight or volume, of the total materials processed in that qualified solid waste disposal process or preliminary function that constitute solid waste for that year.

(ii) *Special rule for mixed-input processes if at least 65 percent of the materials processed are solid waste*—(A) *In general.* Except as otherwise provided in paragraph (g)(2)(ii)(B) of this section, for each facility (or a portion of a mixed-use facility) performing a qualified solid waste disposal process or preliminary function, if the annual percentage of solid waste processed in that qualified solid waste disposal process or preliminary function for each year that the issue is outstanding (beginning with the date such facility is placed in service within the meaning of §1.150–2(c)) equals at least 65 percent of the materials processed in that qualified solid waste disposal process or preliminary function, then all of the costs of the property used for such process are treated as allocable to a qualified solid waste disposal process. The annual percentage of solid waste processed in such qualified solid waste disposal process or preliminary function for any year is the percentage, by weight or volume, of the total materials processed in that qualified solid waste disposal process or preliminary function that constitute solid waste for that year.

(B) *Special rule for extraordinary events.* In the case of an extraordinary event that is beyond the control of the operator of a solid waste disposal facility (such as a natural disaster, strike, major utility disruption, or governmental intervention) and that causes a solid waste disposal facility to be unable to meet the 65 percent test under paragraph (g)(2)(ii)(A) of this section for a particular year, the percentage of solid waste processed for that year equals—

(*1*) The sum of the amount of solid waste processed in the solid waste disposal facility for the year affected by the extraordinary event and the amount of solid waste processed in the solid waste disposal facility during the following two years in excess of the amount required to meet the general 65 percent threshold for the facility during each of such two years; divided by

(*2*) The total materials processed in the solid waste disposal facility during the year affected by the extraordinary event. If the resulting measure of solid waste processed for the year affected by the extraordinary event equals at least 65 percent, then the facility is treated as meeting the requirements of the 65 percent test under paragraph (g)(2)(ii)(A) of this section for such year.

(iii) *Facilities functionally related and subordinate to mixed-input facilities.* Except to the extent that facilities are functionally related and subordinate to a mixed-input facility that meets the 65 percent test under paragraph (g)(2)(ii) of this section, facilities qualify as functionally related and subordinate to a mixed-input facility only to the extent that they are functionally related and subordinate to the qualified portion of the mixed-input facility that is used for one or more qualified solid waste disposal functions (including a qualified solid waste disposal process or a preliminary function).

(h) *Examples.* The following examples illustrate the application of this section:

Example 1. Nonqualified Unused Material—Cloth. Company A takes wool and weaves it into cloth and then sells the cloth to a manufacturer to manufacture clothing. The cloth is material that has not been used previously as a product of or otherwise used in an agricultural, commercial, consumer, governmental, or industrial operation or activity, or as a component of any such product or activity. Accordingly, the cloth is not solid waste.

Example 2. Residual Material—Waste Coal. Company B mines coal. Some of the ore mined is a low quality byproduct of coal mining commonly known as waste coal, which cannot be converted to energy under a normal energy-production process because the BTU content is too low. Waste coal has the lowest fair market value of any product produced in Company B's coal mining process. Waste coal is solid waste because it is residual material within the meaning of paragraph (c)(1)(i)(B) of this section and Company B reasonably expects to introduce the waste coal into a solid waste disposal process.

Example 3. Virgin Material—Logs. Company C cuts down trees and sells the logs to another company, which further processes the logs into lumber. In order to facilitate shipping, Company C cuts the trees into uniform logs. The trees are not solid waste because they are virgin material within the meaning of paragraph (c)(2)(i) of this section that are not being introduced into a final disposal process within the meaning of paragraph (d)(1) of this section. The division of such trees into uniform logs does not change the status of the trees as virgin material.

Example 4. Qualified Solid Waste Disposal Process—Landfill. Company D plans to construct a landfill. The landfill will not be subject to the final permit requirements under subtitle C of title II of the Solid Waste Disposal Act (as in effect on the date of enactment of the Tax Reform Act of 1986). As of the issue date, Company D expects that the landfill will be filled entirely with material that will qualify as solid waste within the meaning of paragraph (c) of this section. Placing solid waste into a landfill is a qualified solid waste disposal process. The landfill is a qualified solid waste disposal facility.

Example 5. Qualified Solid Waste Disposal Process—Recycling Tires. Company E owns a facility that converts used tires into roadbed material. The used tires are used material within the meaning of paragraph (c)(1)(i)(A) of this section that qualifies as solid waste. Between the introduction of the old tires into the roadbed manufacturing process and the completion of the roadbed material, the facility does not create any interim useful products. The process for the manufacturing of the roadbed material from the old tires is a qualified solid waste disposal process as a recycling process and the facility that converts the tires into roadbed material is a qualified solid waste disposal facility. This conclusion would be the same if the recycling process took place at more than one plant.

Example 6. Qualified Solid Waste Disposal Process—Energy Conversion Process. Company F receives solid waste from a municipal garbage collector. Company F burns that solid waste in an incinerator to remove exhaust gas and to produce heat. Company F further processes the heat in a heat exchanger to produce steam. Company F further processes the steam to generate electricity. The energy conversion process ends with the production of steam. The facilities used to burn the solid waste and to capture the steam as useful energy are qualified solid waste disposal facilities because they process solid waste in an energy conversion process. The generating facilities used to process the steam further to generate electricity are not engaged in the energy conversion process and are not qualified solid waste disposal facilities.

Example 7. Nonqualified Refurbishment. Company G purchases used cars and restores them. This restoration process includes disassembly, cleaning, and repairing of the cars. Parts that cannot be repaired are replaced. The restored cars contain at least 30 percent of the original parts. While the cars are used material, the refurbishing process is not a qualified solid waste disposal process. Accordingly, Company G's facility is not a qualified solid waste disposal facility.

Example 8. Qualified Solid Waste Disposal Facility—First Useful Product Rule—Paper Recycling. (i) Company H employs an integrated process to re-pulp discarded magazines, clean the pulp, and produce retail paper towel products. Operational constraints on Company H's process do not allow for reasonable extraction, isolation, and sale of the cleaned paper pulp independently without degradation of the pulp. Company H further processes the paper pulp into large industrial-sized rolls of paper which are approximately 12 feet in diameter. At this point in the process, Company H could either sell such industrial-sized rolls of paper to another company for further processing to produce retail paper products or it could produce those retail products itself. In general, paper pulp is a useful product that is bought and sold on the market as a material for input into manufacturing or production processes. The discarded magazines are used material within the meaning of paragraph (c)(1)(i)(A) of this section. Company H's facility is engaged in a recycling process within the meaning of paragraph (d)(3) of this section to the extent that it repulps and cleans the discarded magazines generally and further to the extent that it produces industrial-sized rolls of paper under the particular circumstances here. Specifically, taking into account the operational constraints on Company H's facility that limit its ability reasonably to extract, isolate, and sell the paper pulp independently, the first useful products within the meaning of paragraph (e) of this section from Company H's recycling process are the industrial-sized rolls of paper. The portion of Company H's facility that processes the discarded magazines and produces industrial-sized rolls of paper is a qualified solid waste disposal facility, and the portion of Company H's facility that further processes the industrial-sized rolls of paper into retail paper towels is not a qualified solid waste facility.

(ii) The facts are the same as in paragraph (i) of this *Example 8*, except that Company H is able reasonably to extract the cleaned paper pulp from the process without degradation of the pulp and to sell the cleaned paper pulp at its dock for a price that exceeds its costs of extracting the pulp from the process. Therefore, the paper pulp is the first useful product within the meaning of paragraph (e) of this section. As a result, the portion of Company H's facility that processes the discarded magazines is a qualified solid waste disposal facility, and the portion of Company H's facility that produces industrial-sized rolls of paper is not a qualified solid waste disposal facility. If, however, the only reasonable way Company H could sell the pulp was to transport the pulp to a distant market, then the costs of storing and transporting the pulp to the market may be taken into account in determining whether the pulp is the first useful product.

Example 9. Preliminary Function—Energy Conversion Process. (i) Company I owns a paper mill. At the mill, logs from nearby timber operations are processed through a machine that removes bark. The stripped logs are used to manufacture paper. The stripped bark has the lowest fair market value of any product produced from the paper mill. The stripped bark falls onto a conveyor belt that transports the bark to a storage bin that is used to store the bark briefly until Company I feeds the bark into a boiler. The conveyor belt and storage bin are used only for these purposes. The boiler is used only to create steam by burning the bark, and the steam is used to generate electricity. The stripped bark is solid waste because it is residual material within the meaning of paragraph (c)(1)(i)(B) of this section and Company I expects to introduce the bark into an energy conversion process within a reasonable period of time. The creation of steam from the stripped bark is an energy conversion process that starts with the incineration of the stripped bark. The energy conversion process is a qualified solid waste disposal process. The conveyor belt performs a collection activity that is preliminary and that is directly related to the solid waste disposal function. The storage bin performs a storage function that is preliminary and that is directly related to the solid waste disposal function. Thus, the conveyor belt and storage bin are solid waste disposal facilities. The bark removal process is not a preliminary function because it is not directly related to the energy conversion process and it does not become so related merely because it results in material that is solid waste.

(ii) The facts are the same as in paragraph (i) of this *Example 9*, except that the stripped bark represents only 55 percent by weight and volume of the materials that are transported by the conveyor belt. The remaining 45 percent of the materials transported by the conveyor belt are not solid waste and these other materials are sorted from the conveyor belt by a sorting machine immediately before the stripped bark arrives at the storage bin. Fifty-five percent of the costs of the conveyor belt and the sorting machine are allocable to solid waste disposal functions.

Example 10. Preliminary Function—Final Disposal Process. Company J owns a waste transfer station and uses it to collect, sort, and process solid waste. Company J uses its trucks to haul the solid waste to the nearest landfill. At least 65 percent by weight and volume of the material brought to the transfer station is solid waste. The waste transfer station and the trucks perform functions that are preliminary and directly related to the solid waste disposal function of the landfill. Thus, the waste transfer station and the trucks qualify as solid waste disposal facilities.

Example 11. Mixed-Input Facility. Company K owns an incinerator financed by an issue and uses the incinerator exclusively to burn coal and other solid material to create steam. Each year while the issue is outstanding, 40 percent by volume and 45 percent by weight of the solid material that Company K processes in the conversion process is coal. The remainder of the solid material is either used material or residual material within the meaning of paragraph (c)(1)(i) of this section. Sixty percent of the costs of the property used to perform the energy conversion process are allocable to a solid waste disposal function.

(i) *Effective/Applicability Dates*—(1) *In general*. Except as otherwise provided in this paragraph (i), this section applies to bonds to which section 142 applies that are sold on or after October 18, 2011.

(2) *Elective retroactive application*. Issuers may apply this section, in whole, but not in part, to outstanding bonds to which section 142 applies and which were sold before October 18, 2011.

(3) *Certain refunding bonds*. An issuer need not apply this section to bonds that are issued in a current refunding to refund bonds to which this section does not apply if the weighted average maturity of the refunding bonds is no longer than the remaining weighted average maturity of the refunded bonds.

[T.D. 9546, 76 FR 51881, Aug. 19, 2011; 76 FR 55255, Sept. 7, 2011]

§ 1.142(f)(4)–1 Manner of making election to terminate tax-exempt bond financing.

(a) *Overview*. Section 142(f)(4) permits a person engaged in the local furnishing of electric energy or gas (a local furnisher) that uses facilities financed with exempt facility bonds under section 142(a)(8) and that expands its service area in a manner inconsistent with the requirements of sections 142(a)(8) and (f) to make an election to ensure that those bonds will continue to be treated as exempt facility bonds. The election must meet the requirements of paragraphs (b) and (c) of this section.

(b) *Time for making election*—(1) *In general*. An election under section 142(f)(4)(B) must be filed with the Internal Revenue Service on or before 90 days after the date of the service area expansion that causes bonds to cease to meet the requirements of sections 142(a)(8) and (f).

(2) *Date of service area expansion*. For the purposes of this section, the date of the service area expansion is the first date on which the local furnisher is authorized to collect revenue for the provision of service in the expanded area.

(c) *Manner of making election*. An election under section 142(f)(4)(B) must be captioned ''ELECTION TO TERMINATE TAX-EXEMPT BOND FINANCING'', must be signed under penalties of perjury by a person who has authority to sign on behalf of the local furnisher, and must contain the following information—

(1) The name of the local furnisher;

(2) The tax identification number of the local furnisher;

(3) The complete address of the local furnisher;

(4) The date of the service area expansion;

(5) Identification of each bond issue subject to the election, including the complete name of each issue, the tax identification number of each issuer, the report number of the information return filed under section 149(e) for each issue, the issue date of each issue,

the CUSIP number (if any) of the bond with the latest maturity of each issue, the issue price of each issue, the adjusted issue price of each issue as of the date of the election, the earliest date on which the bonds of each issue may be redeemed, and the principal amount of bonds of each issue to be redeemed on the earliest redemption date;

(6) A statement that the local furnisher making the election agrees to the conditions stated in section 142(f)(4)(B); and

(7) A statement that each issuer of the bonds subject to the election has received written notice of the election.

(d) *Effect on section 150(b).* Except as provided in paragraph (e) of this section, if a local furnisher files an election within the period specified in paragraph (b) of this section, section 150(b) does not apply to bonds identified in the election during and after that period.

(e) *Effect of failure to meet agreements.* If a local furnisher fails to meet any of the conditions stated in an election pursuant to paragraph (c)(6) of this section, the election is invalid.

(f) *Corresponding provisions of the Internal Revenue Code of 1954.* Section 103(b)(4)(E) of the Internal Revenue Code of 1954 set forth corresponding requirements for the exclusion from gross income of the interest on bonds issued for facilities for the local furnishing of electric energy or gas. For the purposes of this section any reference to sections 142(a)(8) and (f) of the Internal Revenue Code of 1986 includes a reference to the corresponding portion of section 103(b)(4)(E) of the Internal Revenue Code of 1954.

(g) *Effective dates.* This section applies to elections made on or after January 19, 2001.

[T.D. 8941, 66 FR 4671, Jan. 18, 2001]

§ 1.143(g)–1 Requirements related to arbitrage.

(a) *In general.* Under section 143, for an issue to be an issue of qualified mortgage bonds or qualified veterans' mortgage bonds (together, mortgage revenue bonds), the requirements of section 143(g) must be satisfied. An issue satisfies the requirements of section 143(g) only if such issue meets the requirements of paragraph (b) of this section and, in the case of an issue 95 percent or more of the net proceeds of which are to be used to provide residences for veterans, such issue also meets the requirements of paragraph (c) of this section. The requirements of section 143(g) and this section are applicable in addition to the requirements of section 148 and §§ 1.148–0 through 1.148–11.

(b) *Effective rate of mortgage interest not to exceed bond yield by more than 1.125 percentage points*—(1) *Maximum yield.* An issue shall be treated as meeting the requirements of this paragraph (b) only if the excess of the effective rate of interest on the mortgages financed by the issue, over the yield on the issue, is not greater over the term of the issue than 1.125 percentage points.

(2) *Effective rate of interest.* (i) In determining the effective rate of interest on any mortgage for purposes of this paragraph (b), there shall be taken into account all fees, charges, and other amounts borne by the mortgagor that are attributable to the mortgage or to the bond issue. Such amounts include points, commitment fees, origination fees, servicing fees, and prepayment penalties paid by the mortgagor.

(ii) Items that shall be treated as borne by the mortgagor and shall be taken into account in calculating the effective rate of interest also include—

(A) All points, commitment fees, origination fees, or similar charges borne by the seller of the property; and

(B) The excess of any amounts received from any person other than the mortgagor by any person in connection with the acquisition of the mortgagor's interest in the property over the usual and reasonable acquisition costs of a person acquiring like property when owner-financing is not provided through the use of mortgage revenue bonds.

(iii) The following items shall not be treated as borne by the mortgagor and shall not be taken into account in calculating the effective rate of interest—

(A) Any expected rebate of arbitrage profit under paragraph (c) of this section; and

(B) Any application fee, survey fee, credit report fee, insurance charge or similar settlement or financing cost to the extent such amount does not exceed amounts charged in the area in cases when owner-financing is not provided through the use of mortgage revenue bonds. For example, amounts paid for Federal Housing Administration, Veterans' Administration, or similar private mortgage insurance on an individual's mortgage, or amounts paid for pool mortgage insurance on a pool of mortgages, are not taken into account so long as such amounts do not exceed the amounts charged in the area with respect to a similar mortgage, or pool of mortgages, that is not financed with mortgage revenue bonds. For this purpose, amounts paid for pool mortgage insurance include amounts paid to an entity (for example, the Government National Mortgage Association, the Federal National Mortgage Association (FNMA), the Federal Home Loan Mortgage Corporation, or other mortgage insurer) to directly guarantee the pool of mortgages financed with the bonds, or to guarantee a pass-through security backed by the pool of mortgages financed with the bonds.

(C) The following example illustrates the provisions of this paragraph (b)(2)(iii):

Example. Housing Authority X issues bonds intended to be qualified mortgage bonds under section 143(a). At the time the bonds are issued, X enters into an agreement with a group of mortgage lending institutions (lenders) under which the lenders agree to originate and service mortgages that meet certain specified requirements. After originating a specified amount of mortgages, each lender issues a ''pass-though security'' (each, a PTS) backed by the mortgages and sells the PTS to X. Under the terms of the PTS, the lender pays X an amount equal to the regular monthly payments on the mortgages (less certain fees), whether or not received by the lender (plus any prepayments and liquidation proceeds in the event of a foreclosure or other disposition of any mortgages). FNMA guarantees the timely payment of principal and interest on each PTS. From the payments received from each mortgagor, the lender pays a fee to FNMA for its guarantee of the PTS. The amounts paid to FNMA do not exceed the amounts charged in the area with respect to a similar pool of mortgages that is not financed with mortgage revenue bonds. Under this paragraph (b)(2)(iii), the fees for the guarantee provided by FNMA are an insurance charge because the guarantee is pool mortgage insurance. Because the amounts charged for the guarantee do not exceed the amounts charged in the area with respect to a similar pool of mortgages that is not financed with mortgage revenue bonds, the amounts charged for the guarantee are not taken into account in computing the effective rate of interest on the mortgages financed with X's bonds.

(3) *Additional rules.* To the extent not inconsistent with the Tax Reform Act of 1986, Public Law 99–514 (the 1986 Act), or subsequent law, §6a.103A–2(i)(2) (other than paragraphs (i)(2)(i) and (i)(2)(ii)(A) through (C)) of this chapter applies to provide additional rules relating to compliance with the requirement that the effective rate of mortgage interest not exceed the bond yield by more than 1.125 percentage points.

(c) *Arbitrage and investment gains to be used to reduce costs of owner-financing.* As provided in section 143(g)(3), certain earnings on nonpurpose investments must either be paid or credited to mortgagors, or paid to the United States, in certain circumstances. To the extent not inconsistent with the 1986 Act or subsequent law, §6a.103A–2(i)(4) of this chapter applies to provide guidance relating to compliance with this requirement.

(d) *Effective dates*—(1) *In general.* Except as otherwise provided in this section, §1.143(g)–1 applies to bonds sold on or after May 23, 2005, that are subject to section 143.

(2) *Permissive retroactive application in whole.* Except as provided in paragraph (d)(4) of this section, issuers may apply §1.143(g)–1, in whole, but not in part, to bonds sold before May 23, 2005, that are subject to section 143.

(3) *Bonds subject to the Internal Revenue Code of 1954.* Except as provided in paragraph (d)(4) of this section and subject to the applicable effective dates for the corresponding statutory provisions, an issuer may apply §1.143(g)–1, in whole, but not in part, to bonds that are subject to section 103A(i) of the Internal Revenue Code of 1954.

(4) *Special rule for pre-July 1, 1993 bonds.* To the extent that an issuer applies this section to bonds issued before July 1, 1993, §6a.103A–2(i)(3) of this chapter also applies to the bonds.

[T.D. 9204, 70 FR 29449, May 23, 2005]

§ 1.144–0 Table of contents.

This section lists the captioned paragraphs contained in §§ 1.144–1 and 1.144–2.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§ 1.144–1 Qualified small issue bonds, qualified student loan bonds, and qualified redevelopment bonds.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 141(e)(1)(D), a qualified small issue bond issued under section 144(a) may be a qualified bond. Under section 144(a), any qualified small issue bond is any bond issued as a part of an issue 95 percent or more of the proceeds of which are to be used to provide certain manufacturing facilities or certain depreciable farm property and which meets other requirements. Under section 141(e)(1)(F) a qualified redevelopment bond issued under section 144(c) is a qualified bond. Under section 144(c), a qualified redevelopment bond is any bond issued as a part of an issue 95 percent or more of the net proceeds of which are to be used for one or more redevelopment purposes and which meets certain other requirements.

(b) *Scope.* Sections 1.144–0 through 1.144–2 apply for purposes of the rules for small issue bonds under section 144(a) and qualified redevelopment bonds under section 144(c), except that § 1.144–2 does not apply to the requirements for qualified small issue bonds under section 144(a)(4) (relating to the limitation on capital expenditures) or under section 144(a)(10) (relating to the aggregate limit of tax-exempt bonds per taxpayer).

(c) *Effective dates.* For effective dates of §§ 1.144–0 through 1.144–2, see § 1.141–16.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§ 1.144–2 Remedial actions.

The remedial action rules of § 1.142–2 apply to qualified small issue bonds issued under section 144(a) and to qualified redevelopment bonds issued under section 144(c), for this purpose treating those bonds as exempt facility bonds and the qualifying purposes for those bonds as exempt facilities.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§ 1.145–0 Table of contents.

This section lists the captioned paragraphs contained in §§ 1.145–1 and 1.145–2.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997, as amended by T.D. 9234, 70 FR 75035, Dec. 19, 2005]

§ 1.145–1 Qualified 501(c)(3) bonds.

(a) *Overview.* Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 141(e)(1)(G), a qualified 501(c)(3) bond issued under section 145 is a qualified bond. Under section 145, a qualified 501(c)(3) bond is any bond issued as a part of an issue that satisfies the requirements of sections 145(a) through (d).

(b) *Scope.* Sections 1.145–0 through 1.145–2 apply for purposes of section 145(a).

(c) *Effective dates.* For effective dates of §§ 1.145–0 through 1.145–2, see § 1.141–15.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997]

§ 1.145–2 Application of private activity bond regulations.

(a) *In general.* Except as provided in this section, §§ 1.141–0 through 1.141–15 apply to section 145(a). For example, under this section, § 1.141–1, and § 1.141–

2, an issue ceases to be an issue of qualified 501(c)(3) bonds if the issuer or a conduit borrower 501(c)(3) organization takes a deliberate action, subsequent to the issue date, that causes the issue to fail to comply with the requirements of sections 141(e) and 145 (such as an action that results in revocation of exempt status of the 501(c)(3) organization).

(b) *Modification of private business tests*. In applying §§1.141–0 through 1.141–15 to section 145(a)—

(1) References to governmental persons include 501(c)(3) organizations with respect to their activities that do not constitute unrelated trades or businesses under section 513(a);

(2) References to ''10 percent'' and ''proceeds'' in the context of the private business use test and the private security or payment test mean ''5 percent'' and ''net proceeds''; and

(3) References to the private business use test in §§1.141–2 and 1.141–12 include the ownership test of section 145(a)(1).

(4) References to *governmental bonds* in §1.141–6 mean qualified 501(c)(3) bonds.

(5) References to *ownership by governmental persons* in §1.141–6 mean ownership by governmental persons or 501(c)(3) organizations.

(c) *Exceptions*—(1) *Certain provisions relating to governmental programs*. The following provisions do not apply to section 145: §1.141–2(d)(4) (relating to the special rule for dispositions of personal property in the ordinary course of an established governmental program) and §1.141–2(d)(5) (relating to the special rule for general obligation bond programs that finance a large number of separate purposes).

(2) *Costs of issuance*. Sections 1.141–3(g)(6) and 1.141–6(d) do not apply to the extent costs of issuance are allocated among the other purposes for which the proceeds are used or to portions of a project. For purposes of section 145(a)(2), costs of issuance are treated as private business use.

(d) *Issuance costs financed by prior issue*. Solely for purposes of applying the private business use test to a refunding issue under §1.141–13, the use of proceeds of the prior issue (or any earlier issue in a series of refundings) to pay issuance costs of the prior issue (or the earlier issue) is treated as a government use.

[T.D. 8712, 62 FR 2303, Jan. 16, 1997, as amended by T.D. 9234, 70 FR 75035, Dec. 19, 2005; T.D. 9741, 80 FR 65646, Oct. 27, 2015]

§ 1.147–0 Table of contents.

This section lists the captioned paragraphs contained in §§1.147–1 and 1.147–2.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.147–1 Other requirements applicable to certain private activity bonds.

(a) *Overview*. Interest on a private activity bond is not excludable from gross income under section 103(a) unless the bond is a qualified bond. Under section 147, certain requirements must be met for a private activity bond to qualify as a qualified bond.

(b) *Scope*. Sections 1.147–0 through 1.147–2 apply for purposes of the rules in section 147 for qualified private activity bonds that permit use of proceeds to acquire land for environmental purposes (section 147(c)(3)), permit use of proceeds for certain rehabilitations (section 147(d) (2) and (3)), prohibit use of proceeds to finance skyboxes, airplanes, gambling establishments and similar facilities (section 147(e)), and require public approval (section 147(f)), but not for the rules limiting use of proceeds to acquire land or existing property under sections 147(c) (1) and (2), and (d)(1).

(c) *Effective dates*. For effective dates of §§1.147–0 through 1.147–2, see §1.141–16.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.147–2 Remedial actions.

The remedial action rules of §1.142–2 apply to the rules in section 147 for qualified private activity bonds that permit use of proceeds to acquire land for environmental purposes (section 147(c)(3)), permit use of proceeds for certain rehabilitations (section 147(d)

(2) and (3)), prohibit use of proceeds to finance skyboxes, airplanes, gambling establishments and similar facilities (section 147(e)), and require public approval (section 147(f)), for this purpose treating those private activity bonds subject to the rules under section 147 as exempt facility bonds and the qualifying purposes for those bonds as exempt facilities.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.147(b)–1 Bond maturity limitation-treatment of working capital.

Section 147(b) does not apply to proceeds of a private activity bond issue used to finance working capital expenditures.

[T.D. 8476, 58 FR 33515, June 18, 1993]

§ 1.147(f)–1 Public approval of private activity bonds.

(a) *In general.* Interest on a private activity bond is excludable from gross income under section 103(a) only if the bond meets the requirements for a qualified bond as defined in section 141(e) and other applicable requirements provided in section 103. In order to be a qualified bond as defined in section 141(e), among other requirements, a private activity bond must meet the requirements of section 147(f). A private activity bond meets the requirements of section 147(f) only if the bond is publicly approved pursuant to paragraph (b) of this section or the bond qualifies for the exception for refunding bonds in section 147(f)(2)(D).

(b) *Public approval requirement*—(1) *In general.* Except as otherwise provided in this section, a bond meets the requirements of section 147(f) if, before the issue date, the issue of which the bond is a part receives issuer approval and host approval (each a *public approval*) as defined in paragraphs (b)(2) and (3) of this section in accordance with the method and process set forth in paragraphs (c) through (f) of this section.

(2) *Issuer approval.* Except as otherwise provided in this section, *issuer approval* means an approval that meets the requirements of this paragraph (b)(2). Either the governmental unit that issues the issue or the governmental unit on behalf of which the issue is issued must approve the issue. For this purpose, § 1.103–1 applies to the determination of whether an issuer issues bonds on behalf of another governmental unit. If an issuer issues bonds on behalf of more than one governmental unit (for example, in the case of an authority that acts for two counties), any one of those governmental units may provide the issuer approval.

(3) *Host approval.* Except as otherwise provided in this section, *host approval* means an approval that meets the requirements of this paragraph (b)(3). Each governmental unit the geographic jurisdiction of which contains the site of a project to be financed by the issue must approve the issue. If, however, the entire site of a project to be financed by the issue is within the geographic jurisdiction of more than one governmental unit within a State (counting the State as a governmental unit within such State), then any one of those governmental units may provide host approval for the issue for that project. For purposes of the host approval, if a project to be financed by the issue is located within the geographic jurisdiction of two or more governmental units but not entirely within any one of those governmental units, each portion of the project that is located entirely within the geographic jurisdiction of the respective governmental units may be treated as a separate project. The issuer approval provided pursuant to paragraph (b)(2) of this section may be treated as a host approval if the governmental unit providing the issuer approval is also a governmental unit eligible to provide the host approval pursuant to this section.

(4) *Special rule for host approval of airports or high-speed intercity rail facilities.* Pursuant to a special rule in section 147(f)(3), if the proceeds of an issue are to be used to finance a project that consists of either facilities located at an airport (within the meaning of section 142(a)(1)) or high-speed intercity rail facilities (within the meaning of section 142(a)(11)) and the issuer of that issue is the owner or operator of the airport or high-speed intercity rail facilities, the issuer is the only governmental unit that is required to provide the host approval for that project.

(5) *Special rule for issuer approval of scholarship funding bond issues and volunteer fire department bond issues.* In the case of a qualified scholarship funding bond as defined in section 150(d)(2), the governmental unit that made a request described in section 150(d)(2)(B) with respect to the issuer of the bond is the governmental unit on behalf of which the bond was issued for purposes of the issuer approval. If more than one governmental unit within a State made a request described in section 150(d)(2)(B), the State or any such requesting governmental unit may be treated as the governmental unit on behalf of which the bond was issued for purposes of the issuer approval. In the case of a bond of a volunteer fire department treated as a bond of a political subdivision of a State under section 150(e), the political subdivision described in section 150(e)(2)(B) with respect to that volunteer fire department is the governmental unit on behalf of which the bond is issued for purposes of the issuer approval.

(6) *Special rules for host approval of mortgage revenue bonds, student loan bonds, and certain qualified 501(c)(3) bonds.* In the case of a mortgage revenue bond (as defined in paragraph (g)(5) of this section), a qualified student loan bond as defined in section 144(b), and the portion of an issue of qualified 501(c)(3) bonds as defined in section 145 that finances working capital expenditures, the issue or portion of the issue must receive an issuer approval but no host approval is necessary. See also paragraph (f)(5) of this section, providing certain optional alternative special rules for certain qualified 501(c)(3) bonds for pooled loan financings described in section 147(b)(4)(B).

(c) *Method of public approval.* The method of public approval of an issue must satisfy either paragraph (c)(1) or (2) of this section. An approval may satisfy the requirements of this paragraph (c) without regard to the authority under State or local law for the acts constituting that approval.

(1) *Applicable elected representative.* An applicable elected representative of the approving governmental unit approves the issue following a public hearing for which there was reasonable public notice.

(2) *Voter referendum.* A voter referendum of the approving governmental unit approves the issue.

(d) *Public hearing and reasonable public notice*—(1) *Public hearing. Public hearing* means a forum providing a reasonable opportunity for interested individuals to express their views, orally or in writing, on the proposed issue of bonds and the location and nature of the proposed project to be financed.

(2) *Location of the public hearing.* The public hearing must be held in a location that, based on the facts and circumstances, is convenient for residents of the approving governmental unit. The location of the public hearing is presumed convenient for residents of the unit if the public hearing is located in the approving governmental unit's capital or seat of government. If more than one governmental unit is required to hold a public hearing, the hearings may be combined as long as the combined hearing affords the residents of all of the participating governmental units a reasonable opportunity to be heard. The location of any combined hearing is presumed convenient for residents of each participating governmental unit if it is no farther than 100 miles from the seat of government of each participating governmental unit beyond whose geographic jurisdiction the hearing is conducted.

(3) *Procedures for conducting the public hearing.* In general, a governmental unit may select its own procedure for a public hearing, provided that interested individuals have a reasonable opportunity to express their views. Thus, a governmental unit may impose reasonable requirements on persons who wish to participate in the hearing, such as a requirement that persons desiring to speak at the hearing make a written request to speak at least 24 hours before the hearing or that they limit their oral remarks to a prescribed time. For this purpose, it is unnecessary, for example, that the applicable elected representative of the approving governmental unit be present at the hearing, that a report on the hearing be submitted to that applicable elected representative, or that State administrative procedural requirements for

public hearings be observed. Except to the extent State procedural requirements for public hearings are in conflict with a specific requirement of this section, a public hearing performed in compliance with State procedural requirements satisfies the requirements for a public hearing in this paragraph (d). A public hearing may be conducted by an individual appointed or employed to perform such function by the governmental unit or its agencies, or by the issuer. Thus, for example, for bonds to be issued by an authority that acts on behalf of a county, the hearing may be conducted by the authority, the county, or an appointee of either.

(4) *Reasonable public notice. Reasonable public notice* means notice that is reasonably designed to inform residents of an approving governmental unit, including the issuing governmental unit and the governmental unit in whose geographic jurisdiction a project is to be located, of the proposed issue. The notice must state the time and place for the public hearing and contain the information required by paragraph (f)(2) of this section. Notice is presumed to be reasonably designed to inform residents of an approving governmental unit if it satisfies the requirements of this paragraph (d)(4) and is given no fewer than seven (7) calendar days before the public hearing in one or more of the ways set forth in paragraphs (d)(4)(i) through (iv) of this section.

(i) *Newspaper publication.* Public notice may be given by publication in one or more newspapers of general circulation available to the residents of the governmental unit.

(ii) *Radio or television broadcast.* Public notice may be given by radio or television broadcast to the residents of the governmental unit.

(iii) *Governmental unit website posting.* Public notice may be given by electronic posting on the approving governmental unit's primary public website in an area of that website used to inform its residents about events affecting the residents (for example, notice of public meetings of the governmental unit). In the case of an issuer approval of an issue issued by an on-behalf-of issuer that acts on behalf of a governmental unit, such notice may be posted on the public website of the on-behalf-of issuer as an alternative to the public website of the approving governmental unit.

(iv) *Alternative State law public notice procedures.* Public notice may be given in a way that is permitted under a general State law for public notices for public hearings for the approving governmental unit, provided that the public notice is reasonably accessible.

(e) *Applicable elected representative*—(1) *In general*—(i) *Definition of applicable elected representative.* The *applicable elected representative* of a governmental unit means—

(A) The governmental unit's elected legislative body;

(B) The governmental unit's chief elected executive officer;

(C) In the case of a State, the chief elected legal officer of the State's executive branch of government; or

(D) Any official elected by the voters of the governmental unit and designated for purposes of this section by the governmental unit's chief elected executive officer or by State or local law to approve issues for the governmental unit.

(ii) *Elected officials.* For purposes of paragraphs (e)(1)(i)(B), (C), and (D) of this section, an official is considered elected only if that official is popularly elected at-large by the voters of the governmental unit. If an official popularly elected at-large by the voters of a governmental unit is appointed or selected pursuant to State or local law to be the chief executive officer of the unit, that official is deemed to be an elected chief executive officer for purposes of this section but for no longer than the official's tenure as an official popularly elected at-large.

(iii) *Legislative bodies.* In the case of a bicameral legislature that is popularly elected, both chambers together constitute an applicable elected representative. Absent designation under paragraph (e)(1)(i)(D) of this section, however, neither such chamber independently constitutes an applicable elected representative. If multiple elected legislative bodies of a governmental unit have independent legislative authority, the body with the more specific authority relating to the issue is the only legislative body that is treated as an elected legislative body under paragraph (e)(1)(i)(A) of this section.

(2) *Governmental unit with no applicable elected representative*—(i) *In general.* The applicable elected representatives of a governmental unit with no applicable elected representative (but for this paragraph (e)(2) and section 147(f)(2)(E)(ii)) are the applicable elected representatives of the next higher governmental unit (with an applicable elected representative) from which the governmental unit derives its authority. Except as otherwise provided in this section, any governmental unit from which the governmental unit with no applicable elected representative derives its authority may be treated as the next higher governmental unit without regard to the relative status of such higher governmental unit under State law. A governmental unit derives its authority from another governmental unit that—

(A) Enacts a specific law (for example, a provision in a State constitution, charter, or statute) by or under which the governmental unit is created;

(B) Otherwise empowers or approves the creation of the governmental unit; or

(C) Appoints members to the governing body of the governmental unit.

(ii) *Host approval.* For purposes of a host approval, a governmental unit may be treated as the next higher governmental unit only if the project is located within its geographic jurisdiction and eligible residents of the unit are entitled to vote for its applicable elected representatives.

(3) *On behalf of issuers.* In the case of an issuer that issues bonds on behalf of a governmental unit, the applicable elected representative is any applicable elected representative of the governmental unit on behalf of which the bonds are issued.

(f) *Public approval process*—(1) *In general.* The public approval process for an issue, including scope, content, and timing of the public approval, must meet the requirements of this paragraph (f). A governmental unit must timely approve either each project to be financed with proceeds of the issue or a plan of financing for each project to be financed with proceeds of the issue.

(2) *General rule on information required for a reasonable public notice and public approval.* Except as otherwise provided in this section, a project to be financed with proceeds of an issue is within the scope of a public approval under section 147(f) if the reasonable public notice of the public hearing, if applicable, and the public approval (together the notice and approval) include the information set forth in paragraphs (f)(2)(i) through (iv) of this section.

(i) *The project.* The notice and approval must include a general functional description of the type and use of the project to be financed with the issue. For this purpose, a project description is sufficient if it identifies the project by reference to a particular category of exempt facility bond to be issued (for example, an exempt facility bond for an airport pursuant to section 142(a)(1)) or by reference to another general category of private activity bond together with information on the type and use of the project to be financed with the issue (for example, a qualified small issue bond as defined in section 144(a) for a manufacturing facility or a qualified 501(c)(3) bond as defined in section 145 for a hospital facility and working capital expenditures).

(ii) *The maximum stated principal amount of the issue.* The notice and approval must include the maximum stated principal amount of the issue of private activity bonds to be issued to finance the project or projects. If an issue finances multiple projects (for example, facilities at different locations on non-proximate sites that are not treated as part of the same project), the notice and approval must specify separately the maximum stated principal amount of bonds to be issued to finance each separate project to be financed as part of the issue. The maximum stated principal amount of bonds to be issued to finance a project may be determined on any reasonable basis and may take into account contingencies, without regard to whether the occurrence of any such contingency is reasonably expected at the time of the notice.

(iii) *The name of the initial legal owner or principal user of the project.* The notice and approval must include the name of either the expected initial legal owner or principal user (within the meaning of section 144(a)) of the project or, alternatively, the name of a significant true beneficial party of interest for such legal owner or user (for example, the name of a section 501(c)(3) organization that is the sole member of a limited liability company that is the legal owner or the name of a general partner of a partnership that owns the project).

(iv) *The location of the project.* The notice and approval must include a general description of the prospective location of the project by street address, reference to boundary streets or other geographic boundaries, or other description of the specific geographic location that is reasonably designed to inform readers of the location. For a project involving multiple capital projects or facilities located on the same site, or on adjacent or reasonably proximate sites with similar uses, a consolidated description of the location of those capital projects or facilities provides a sufficient description of the location of the project. For example, a project for a section 501(c)(3) educational entity involving multiple buildings on the entity's main urban college campus may describe the location of the project by reference to the outside street boundaries of that campus with a reference to any noncontiguous features of that campus.

(3) *Special rule for mortgage revenue bonds.* Mortgage loans financed by mortgage revenue bonds are within the scope of a public approval if the notice and approval state that the bonds are to be issued to finance residential mortgages, provide the maximum stated principal amount of mortgage revenue bonds expected to be issued, and provide a general description of the geographic jurisdiction in which the residences to be financed with the proceeds of the mortgage revenue bonds are expected to be located (for example, residences located throughout a State for an issuer with a statewide jurisdiction or residences within a particular local geographic jurisdiction, such as within a city or county, for a local issuer). For this purpose, in the case of mortgage revenue bonds, no information is required on specific names of mortgage loan borrowers or specific locations of individual residences to be financed.

(4) *Special rule for qualified student loan bonds.* Qualified student loans financed by qualified student loan bonds as defined in section 144(b) are within the scope of a public approval if the notice and approval state that the bonds will be issued to finance student loans and state the maximum stated principal amount of qualified student loan bonds expected to be issued for qualified student loans. For this purpose, in the case of qualified student loan bonds, no information is required with respect to names of specific student loan borrowers.

(5) *Special rule for certain qualified 501(c)(3) bonds.* Qualified 501(c)(3) bonds issued pursuant to section 145 for pooled loan financings that are described in section 147(b)(4)(B) (without regard to any election under section 147(b)(4)(A)) are within the scope of a public approval if the public approval either meets the general requirements of paragraph (b) of this section or, alternatively, at the issuer's option, meets the special requirements of paragraphs (f)(5)(i) and (ii) of this section.

(i) *Pre-issuance issuer approval.* Within the time period required by paragraph (f)(7) of this section, an issuer approval is obtained after reasonable public notice of a public hearing is provided and a public hearing is held. For this purpose, a project is treated as described in the notice and approval if the notice and approval provide that the bonds will be qualified 501(c)(3) bonds to be used to finance loans described in section 147(b)(4)(B), state the maximum stated principal amount of bonds expected to be issued to finance loans to section 501(c)(3) organizations or governmental units as described in section 147(b)(4)(B), provide a general description of the type of project to be financed with such loans (for example, loans for hospital facilities or college facilities), and state that an additional public approval that includes specific project information will be obtained before any such loans are originated.

(ii) *Post-issuance public approval for specific loans.* Before a loan described in section 147(b)(4)(B) is originated, a supplemental public approval, including issuer approval and host approval, for the bonds to be used to finance that loan is obtained that meets all the requirements of section 147(f) and the requirements for a public approval in paragraph (b) of this section. This post-issuance supplemental public approval requirement applies by treating the bonds to be used to finance such loan as if they were reissued for purposes of section 147(f) (without regard to paragraph (f)(5) of this section). For this purpose, proceeds to be used to finance such loan do not include the portion of the issue used to finance a common reserve fund or common costs of issuance.

(6) *Deviations in public approval information*—(i) *In general.* Except as otherwise provided in this section, a substantial deviation between the stated use or amount of proceeds of an issue included in the information required to be provided in the notice and approval (*public approval information*) and the actual use or amount of proceeds of the issue causes that issue to fail to meet the public approval requirement. Conversely, insubstantial deviations between the stated use or amount of proceeds of an issue included in the public approval information and the actual use or amount of proceeds of the issue do not cause such a failure. In general, the determination of whether a deviation is substantial is based on all the facts and circumstances. In all events, however, a change in the fundamental nature or type of a project is a substantial deviation.

(ii) *Certain insubstantial deviations in public approval information.* The following deviations from the public approval information in the notice and approval are treated as insubstantial deviations:

(A) *Size of bond issue and use of proceeds.* A deviation between the maximum stated principal amount of a proposed issuance of bonds to finance a project that is specified in public approval information and the actual stated principal amount of bonds issued and used to finance that project is an insubstantial deviation if that actual stated principal amount is no more than ten percent (10%) greater than that maximum stated principal amount or is any amount less than that maximum stated principal amount. In addition, the use of proceeds to pay working capital expenditures directly associated with any project specified in the public approval information is an insubstantial deviation.

(B) *Initial legal owner or principal user.* A deviation between the initial legal owner or principal user of the project named in the notice and approval and the actual initial legal owner or principal user of the project is an insubstantial deviation if such parties are related parties on the issue date of the issue.

(iii) *Supplemental public approval to cure certain substantial deviations in public approval information.* A substantial deviation between the stated use or amount of proceeds of an issue included in the public approval information and the actual use or amount of the proceeds of the issue does not cause that issue to fail to meet the public approval requirement if all of the following requirements are met:

(A) *Original public approval and reasonable expectations.* The issue met the requirements for a public approval in paragraph (b) of this section. In addition, on the issue date of the issue, the issuer reasonably expected there would be no substantial deviations between the stated use or amount of proceeds of an issue included in the public approval information and the actual use or amount of the proceeds of the issue.

(B) *Unexpected events or unforeseen changes in circumstances.* As a result of unexpected events or unforeseen changes in circumstances that occur after the issue date of the issue, the issuer determines to use proceeds of the issue in a manner or amount not provided in a public approval.

(C) *Supplemental public approval.* Before using proceeds of the bonds in a manner or amount not provided in a public approval, the issuer obtains a supplemental public approval for those bonds that meets the public approval requirement in paragraph (b) of this section. This supplemental public approval requirement applies by treating those bonds as if they were reissued for purposes of section 147(f).

(7) *Certain timing requirements.* Public approval of an issue is timely only if the issuer obtains the public approval

within one year before the issue date of the issue. Public approval of a plan of financing is timely only if the issuer obtains public approval for the plan of financing within one year before the issue date of the first issue issued under the plan of financing and the issuer issues all issues under the plan of financing within three years after the issue date of such first issue.

(g) *Definitions.* The definitions in this paragraph (g) apply for purposes of this section. In addition, the general definitions in § 1.150–1 apply for purposes of this section.

(1) *Geographic jurisdiction* means the area encompassed by the boundaries prescribed by State or local law for a governmental unit or, if there are no such boundaries, the area in which a unit may exercise such sovereign powers that make that unit a governmental unit for purposes of § 1.103–1 and this section.

(2) *Governmental unit* has the meaning of ''State or local governmental unit'' as defined in § 1.103–1. Thus, a governmental unit is a State, territory, a possession of the United States, the District of Columbia, or any political subdivision thereof.

(3) *Host approval* is defined in paragraph (b)(3) of this section.

(4) *Issuer approval* is defined in paragraph (b)(2) of this section.

(5) *Mortgage revenue bonds* mean qualified mortgage bonds as defined in section 143(a), qualified veterans' mortgage bonds as defined in section 143(b), or refunding bonds issued to finance mortgages of owner-occupied residences pursuant to applicable law in effect prior to enactment of section 143(a) or section 143(b).

(6) *Proceeds* means ''proceeds'' as defined in § 1.141–1(b), except that it does not include disposition proceeds.

(7) *Project* generally means one or more capital projects or facilities, including land, buildings, equipment, and other property, to be financed with an issue, that are located on the same site, or adjacent or proximate sites used for similar purposes, and that are subject to the public approval requirement of section 147(f). Capital projects or facilities that are not located on the same site or adjacent or proximate sites may be treated as one project if those capital projects or facilities are used in an integrated operation. For an issue of mortgage revenue bonds or an issue of qualified student loan bonds as defined in section 144(b), the term project means the mortgage loans or qualified student loans to be financed with the proceeds of the issue. For an issue of qualified 501(c)(3) bonds as defined in section 145, the term project means a project as defined in the first sentence of this definition, and also is deemed to include working capital expenditures to be financed with proceeds of the issue.

(8) *Public approval information* is defined in paragraph (f)(6)(i) of this section.

(9) *Public hearing* is defined in paragraph (d)(1) of this section.

(10) *Reasonable public notice* is defined in paragraph (d)(4) of this section.

(11) *Voter referendum* means a vote by the voters of the affected governmental unit conducted in the same manner and time as voter referenda on matters relating to governmental spending or bond issuances by the governmental unit under applicable State and local law.

(h) *Applicability date.* This section applies to bonds issued pursuant to a public approval occurring on or after April 1, 2019. For bonds issued pursuant to a public approval occurring before April 1, 2019, see § 5f.103–2 as contained in 26 CFR part 5f, revised as of April 1, 2018. In addition, an issuer may apply the provisions of paragraph (f)(6) of this section in whole, but not in part, to bonds issued pursuant to a public approval occurring before April 1, 2019.

[T.D. 9845, 83 FR 67690, Dec. 31, 2018]

§ 1.148–0 Scope and table of contents.

(a) *Overview.* Under section 103(a), interest on certain obligations issued by States and local governments is excludable from the gross income of the owners. Section 148 was enacted to minimize the arbitrage benefits from investing gross proceeds of tax-exempt bonds in higher yielding investments and to remove the arbitrage incentives to issue more bonds, to issue bonds earlier, or to leave bonds outstanding longer than is otherwise reasonably necessary to accomplish the governmental purposes for which the bonds were issued. To accomplish these purposes, section 148 restricts the direct and indirect investment of bond proceeds in higher yielding investments and requires that certain earnings on higher yielding investments be rebated to the United States. Violation of these provisions causes the bonds in the issue to become *arbitrage bonds,* the interest on which is not excludable from the gross income of the owners under section 103(a). The regulations in §§ 1.148–1 through 1.148–11 apply in a manner consistent with these purposes.

(b) *Scope.* Sections 1.148–1 through 1.148–11 apply generally for purposes of the arbitrage restrictions on State and local bonds under section 148.

(c) *Table of contents.* This paragraph (c) lists the table of contents for §§ 1.148–1, 1.148–2, 1.148–3, 1.148–4, 1.148–5, 1.148–6, 1.148–7, 1.148–8, 1.148–9, 1.148–10 and 1.148–11.

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§ 1.148–10 Anti-abuse rules and authority of Commissioner.

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§ 1.148–11 Effective/applicability dates.

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[T.D. 8476, 58 FR 33515, June 18, 1993, as amended by T.D. 8538, 59 FR 24041, May 10, 1994; T.D. 8718, 62 FR 25506, May 9, 1997; T.D. 9085, 68 FR 45775, Aug. 4, 2003; T.D. 9097, 68 FR 69022, Dec. 11, 2003; T.D. 9701, 79 FR 67351, Nov. 13, 2014; T.D. 9777, 81 FR 46592, July 18, 2016; T.D. 9801, 81 FR 89003, Dec. 9, 2016; T.D. 9854, 84 FR 14007, Apr. 9, 2019]

§ 1.148–1 Definitions and elections.

(a) *In general.* The definitions in this section and the definitions under section 150 apply for purposes of section 148 and §§ 1.148–1 through 1.148–11.

(b) *Certain definitions.* The following definitions apply:

Accounting method means both the overall method used to account for gross proceeds of an issue (e.g., the cash method or a modified accrual method) and the method used to account for or allocate any particular item within that overall accounting method (e.g., accounting for investments, expenditures, allocations to and from different sources, and particular items of the foregoing).

Annuity contract means annuity contract as defined in section 72.

Available amount means available amount as defined in § 1.148–6(d)(3)(iii).

Bona fide debt service fund means a fund, which may include proceeds of an issue, that—

(1) Is used primarily to achieve a proper matching of revenues with principal and interest payments within each bond year; and

(2) Is depleted at least once each bond year, except for a reasonable carryover amount not to exceed the greater of:

(i) the earnings on the fund for the immediately preceding bond year; or

(ii) one-twelfth of the principal and interest payments on the issue for the immediately preceding bond year.

Bond year means, in reference to an issue, each 1-year period that ends on the day selected by the issuer. The first and last bond years may be short periods. If no day is selected by the issuer before the earlier of the final maturity date of the issue or the date that is 5 years after the issue date, bond years end on each anniversary of the issue date and on the final maturity date.

Capital project or capital projects means all capital expenditures, plus related working capital expenditures to which the de minimis rule under § 1.148–6(d)(3)(ii)(A) applies, that carry out the governmental purposes of an issue. For example, a capital project may include capital expenditures for one or more buildings, plus related start-up operating costs.

Commingled fund means any fund or account containing both gross proceeds of an issue and amounts in excess of $25,000 that are not gross proceeds of that issue if the amounts in the fund or account are invested and accounted for collectively, without regard to the source of funds deposited in the fund or account. An open-end regulated investment company under section 851, however, is not a commingled fund.

Computation date means each date on which the rebate amount for an issue is computed under § 1.148–3(e).

Computation period means the period between computation dates. The first computation period begins on the issue date and ends on the first computation date. Each succeeding computation period begins on the date immediately following the computation date and ends on the next computation date.

Consistently applied means applied uniformly within a fiscal period and between fiscal periods to account for gross proceeds of an issue and any amounts that are in a commingled fund.

De minimis amount means—

(1) In reference to original issue discount (as defined in section 1273(a)(1)) or premium on an obligation—

(i) An amount that does not exceed 2 percent multiplied by the stated redemption price at maturity; plus

(ii) Any original issue premium that is attributable exclusively to reasonable underwriters' compensation; and

(2) In reference to market discount (as defined in section 1278(a)(2)(A)) or premium on an obligation, an amount that does not exceed 2 percent multiplied by the stated redemption price at maturity.

Economic accrual method (also known as the *constant interest method* or *actuarial method*) means the method of computing yield that is based on the compounding of interest at the end of each compounding period.

Fair market value means fair market value as defined in § 1.148–5(d)(6).

Fixed rate investment means any investment whose yield is fixed and determinable on the issue date.

Fixed yield bond means any bond whose yield is fixed and determinable on the issue date using the assumptions and rules provided in § 1.148–4(b).

Fixed yield issue means any issue if each bond that is part of the issue is a fixed yield bond.

Gross proceeds means any proceeds and replacement proceeds of an issue.

Guaranteed investment contract includes any nonpurpose investment that has specifically negotiated withdrawal or reinvestment provisions and a specifically negotiated interest rate, and also includes any agreement to supply investments on two or more future dates (e.g., a forward supply contract).

Higher yielding investments means higher yielding investments as defined in section 148(b)(1).

Investment means any investment property as defined in sections 148(b)(2) and 148(b)(3), and any other tax-exempt bond.

Investment proceeds means any amounts actually or constructively received from investing proceeds of an issue.

Investment-type property is defined in paragraph (e) of this section.

Issue price means issue price as defined in paragraph (f) of this section.

Issuer generally means the entity that actually issues the issue, and, unless the context or a provision clearly requires otherwise, each conduit borrower of the issue. For example, rules imposed on issuers to account for gross proceeds of an issue apply to a conduit borrower to account for any gross proceeds received under a purpose investment. Provisions regarding elections, filings, liability for the rebate amount, and certifications of reasonable expectations apply only to the actual issuer.

Multipurpose issue means an issue the proceeds of which are used for two or more separate purposes determined in accordance with § 1.148–9(h).

Net sale proceeds means sale proceeds, less the portion of those sale proceeds invested in a reasonably required reserve or replacement fund under section 148(d) and as part of a minor portion under section 148(e).

Nonpurpose investment means any investment property, as defined in section 148(b), that is not a purpose investment.

Payment means a payment as defined in § 1.148–3(d) for purposes of computing the rebate amount, and a payment as defined in § 1.148–5(b) for purposes of computing the yield on an investment.

Plain par bond means a qualified tender bond or a bond—

(1) Issued with not more than a de minimis amount of original issue discount or premium;

(2) Issued for a price that does not include accrued interest other than pre-issuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

Plain par investment means an investment that is an obligation—

(1) Issued with not more than a de minimis amount of original issue discount or premium, or, if acquired on a date other than the issue date, acquired with not more than a de minimis amount of market discount or premium;

(2) Issued for a price that does not include accrued interest other than pre-issuance accrued interest;

(3) That bears interest from the issue date at a single, stated, fixed rate or that is a variable rate debt instrument under section 1275, in each case with interest unconditionally payable at least annually; and

(4) That has a lowest stated redemption price that is not less than its outstanding stated principal amount.

Pre-issuance accrued interest means amounts representing interest that accrued on an obligation for a period not greater than one year before its issue date but only if those amounts are paid within one year after the issue date.

Proceeds means any sale proceeds, investment proceeds, and transferred proceeds of an issue. Proceeds do not include, however, amounts actually or constructively received with respect to a purpose investment that are properly allocable to the immaterially higher yield under §1.148–2(d) or section 143(g) or to qualified administrative costs recoverable under §1.148–5(e).

Program investment means a purpose investment that is part of a governmental program in which—

(1) The program involves the origination or acquisition of purpose investments;

(2) At least 95 percent (90 percent for qualified student loans under section 144(b)(1)(A)) of the cost of the purpose investments acquired under the program represents one or more loans to a substantial number of persons representing the general public, States or political subdivisions, 501(c)(3) organizations, persons who provide housing and related facilities, or any combination of the foregoing;

(3) At least 95 percent of the receipts from the purpose investments are used to pay principal, interest, or redemption prices on issues that financed the program, to pay or reimburse administrative costs of those issues or of the program, to pay or reimburse anticipated future losses directly related to the program, to finance additional purpose investments for the same general purposes of the program, or to redeem and retire governmental obligations at the next earliest possible date of redemption;

(4) The program documents prohibit any obligor on a purpose investment financed by the program or any related party to that obligor from purchasing bonds of an issue that finance the program in an amount related to the amount of the purpose investment acquired from that obligor; and

(5) The issuer has not waived the right to treat the investment as a program investment.

Purpose investment means an investment that is acquired to carry out the governmental purpose of an issue.

Qualified administrative costs means qualified administrative costs as defined in §1.148–5(e).

Qualified guarantee means a qualified guarantee as defined in §1.148–4(f).

Qualified hedge means a qualified hedge as defined in §1.148–4(h)(2).

Reasonable expectations or reasonableness. An issuer's expectations or actions are reasonable only if a prudent person in the same circumstances as the issuer would have those same expectations or take those same actions, based on all the objective facts and circumstances. Factors relevant to a determination of reasonableness include the issuer's history of conduct concerning stated expectations made in connection with the issuance of obligations, the level of inquiry by the issuer into factual matters, and the existence of covenants, enforceable by bondholders, that require implementation of specific expectations. For a conduit financing issue, factors relevant to a determination of reasonableness include the reasonable expectations of the conduit borrower, but only if, under the circumstances, it is reasonable and prudent for the issuer to rely on those expectations.

Rebate amount means 100 percent of the amount owed to the United States under section 148(f)(2), as further described in §1.148–3.

Receipt means a receipt as defined in §1.148–3(d) for purposes of computing the rebate amount, and a receipt as defined in §1.148–5(b) for purposes of computing yield on an investment.

Refunding escrow means one or more funds established as part of a single transaction or a series of related transactions, containing proceeds of a refunding issue and any other amounts to provide for payment of principal or interest on one or more prior issues. For this purpose, funds are generally not so established solely because of—

(1) The deposit of proceeds of an issue and replacement proceeds of the prior issue in an escrow more than 6 months apart, or

(2) The deposit of proceeds of completely separate issues in an escrow.

Replacement proceeds is defined in paragraph (c) of this section.

Restricted working capital expenditures means working capital expenditures that are subject to the proceeds-spent-last rule in §1.148–6(d)(3)(i) and are ineligible for any exception to that rule.

Sale proceeds means any amounts actually or constructively received from the sale of the issue, including amounts used to pay underwriters' discount or compensation and accrued interest other than pre-issuance accrued interest. Sale proceeds also include, but are not limited to, amounts derived from the sale of a right that is associated with a bond, and that is described in §1.148–4(b)(4). See also §1.148–4(h)(5) treating amounts received upon the termination of certain hedges as sale proceeds.

Stated redemption price means the redemption price of an obligation under the terms of that obligation, including any call premium.

Transferred proceeds means transferred proceeds as defined in §1.148–9 (or the applicable corresponding provision of prior law).

Unconditionally payable means payable under terms in which—

(1) Late payment or nonpayment results in a significant penalty to the borrower or reasonable remedies to the lender, and

(2) It is reasonably certain on the issue date that the payment will actually be made.

Value means value determined under §1.148–4(e) for a bond, and value determined under §1.148–5(d) for an investment.

Variable yield bond means any bond that is not a fixed yield bond.

Variable yield issue means any issue that is not a fixed yield issue.

Yield means yield computed under §1.148–4 for an issue, and yield computed under §1.148–5 for an investment.

Yield restricted means required to be invested at a yield that is not materially higher than the yield on the issue under section 148(a) and §1.148–2.

(c) *Definition of replacement proceeds*—(1) *In general*. Amounts are replacement proceeds of an issue if the amounts have a sufficiently direct nexus to the issue or to the governmental purpose of the issue to conclude that the amounts would have been used for that governmental purpose if the proceeds of the issue were not used or to be used for that governmental purpose. For this purpose, governmental purposes include the expected use of amounts for the payment of debt service on a particular date. The mere availability or preliminary earmarking of amounts for a governmental purpose, however, does not in itself establish a sufficient nexus to cause those amounts to be replacement proceeds. Replacement proceeds include, but are not limited to, sinking funds, pledged funds, and other replacement proceeds described in paragraph (c)(4) of this section, to the extent that those funds or amounts are held by or derived from a substantial beneficiary of the issue. A substantial beneficiary of an issue includes the issuer and any related party to the issuer, and, if the issuer is not a state, the state in which the issuer is located. A person is not a substantial beneficiary of an issue solely because it is a guarantor under a qualified guarantee.

(2) *Sinking fund. Sinking fund* includes a debt service fund, redemption fund, reserve fund, replacement fund, or any similar fund, to the extent reasonably expected to be used directly or indirectly to pay principal or interest on the issue.

(3) *Pledged fund*—(i) *In general.* A *pledged fund* is any amount that is directly or indirectly pledged to pay principal or interest on the issue. A pledge need not be cast in any particular form but, in substance, must provide reasonable assurance that the amount will be available to pay principal or interest on the issue, even if the issuer encounters financial difficulties. A pledge to a guarantor of an issue is an indirect pledge to secure payment of principal or interest on the issue. A pledge of more than 50 percent of the outstanding stock of a corporation that is a conduit borrower of the issue is not treated as a pledge for this purpose, unless the corporation is formed or availed of to avoid the creation of replacement proceeds.

(ii) *Negative pledges.* An amount is treated as pledged to pay principal or interest on an issue if it is held under an agreement to maintain the amount at a particular level for the direct or indirect benefit of the bondholders or a guarantor of the bonds. An amount is not treated as pledged under this paragraph (c)(3)(ii), however, if—

(A) The issuer or a substantial beneficiary may grant rights in the amount that are superior to the rights of the bondholders or the guarantor; or

(B) The amount does not exceed reasonable needs for which it is maintained, the required level is tested no more frequently than every 6 months, and the amount may be spent without any substantial restriction other than a requirement to replenish the amount by the next testing date.

(4) *Other replacement proceeds*—(i) *Bonds outstanding longer than necessary*—(A) *In general.* Replacement proceeds arise to the extent that the issuer reasonably expects as of the issue date that—

(*1*) The term of an issue will be longer than is reasonably necessary for the governmental purposes of the issue, and

(*2*) There will be available amounts during the period that the issue remains outstanding longer than necessary. Whether an issue is outstanding longer than necessary is determined under §1.148–10. Replacement proceeds are created under this paragraph (c)(4)(i)(A) at the beginning of each fiscal year during which an issue remains outstanding longer than necessary in an amount equal to available amounts of the issuer as of that date.

(B) *Safe harbor against creation of replacement proceeds.* As a safe harbor, replacement proceeds do not arise under paragraph (c)(4)(i)(A) of this section—

(*1*) For the portion of an issue that is to be used to finance working capital expenditures, if that portion is not outstanding longer than the temporary period under §1.148–2(e)(3) for which the proceeds qualify;

(*2*) For the portion of an issue (including a refunding issue) that is to be used to finance or refinance capital projects, if that portion has a weighted average maturity that does not exceed 120 percent of the average reasonably expected economic life of the financed capital projects, determined in the same manner as under section 147(b);

(*3*) For the portion of an issue that is a refunding issue, if that portion has a weighted average maturity that does not exceed the remaining weighted average maturity of the prior issue, and the issue of which the prior issue is a part satisfies paragraph (c)(4)(i)(B) (*1*) or (*2*) of this section; or

(*4*) For the portion of an issue (including a refunding issue) that is to be used to finance working capital expenditures, if that portion satisfies paragraph (c)(4)(ii) of this section.

(ii) *Safe harbor for longer-term working capital financings.* A portion of an issue used to finance working capital expenditures satisfies this paragraph (c)(4)(ii) if the issuer meets the requirements of paragraphs (c)(4)(ii)(A) through (E) of this section.

(A) *Determine first testing year.* On the issue date, the issuer must determine the first fiscal year following the applicable temporary period under §1.148–

2(e) in which it reasonably expects to have available amounts (first testing year), but in no event can the first day of the first testing year be later than five years after the issue date.

(B) *Application of available amount to reduce burden on tax-exempt bond market.* Beginning with the first testing year and for each subsequent fiscal year for which the portion of the issue that is the subject of this safe harbor remains outstanding, the issuer must determine the available amount as of the first day of each fiscal year. Then, except as provided in paragraph (c)(4)(ii)(D) of this section, within the first 90 days of that fiscal year, the issuer must apply that amount (or if less, the available amount on the date of the required redemption or investment) to redeem or to invest in eligible tax-exempt bonds (as defined in paragraph (c)(4)(ii)(E) of this section). For this purpose, available amounts in a bona fide debt service fund are not treated as available amounts.

(C) *Continuous investment requirement.* Except as provided in this paragraph (c)(4)(ii)(C), any amounts invested in eligible tax-exempt bonds under paragraph (c)(4)(ii)(B) of this section must be invested continuously in such tax-exempt bonds to the extent provided in paragraph (c)(4)(ii)(D) of this section.

(*1*) *Exception for reinvestment period.* Amounts previously invested in eligible tax-exempt bonds under paragraph (c)(4)(ii)(B) of this section that are held for not more than 30 days in a fiscal year pending reinvestment in eligible tax-exempt bonds are treated as invested in eligible tax-exempt bonds.

(*2*) *Limited use of invested amounts.* An issuer may spend amounts previously invested in eligible tax-exempt bonds under paragraph (c)(4)(ii)(B) of this section within 30 days of the date on which they cease to be so invested to make expenditures for a governmental purpose on any date on which the issuer has no other available amounts for such purpose, or to redeem eligible tax-exempt bonds.

(D) *Cap on applied or invested amounts.* The maximum amount that an issuer is required to apply under paragraph (c)(4)(ii)(B) of this section or to invest continuously under paragraph (c)(4)(ii)(C) of this section with respect to the portion of an issue that is the subject of this safe harbor is the outstanding principal amount of such portion. For purposes of this cap, an issuer receives credit towards its requirement to invest available amounts in eligible tax-exempt bonds for amounts previously invested under paragraph (c)(4)(ii)(B) of this section that remain continuously invested under paragraph (c)(4)(ii)(C) of this section.

(E) *Definition of eligible tax-exempt bonds.* For purposes of paragraph (c)(4)(ii) of this section, *eligible tax-exempt bonds* means any of the following:

(*1*) A bond the interest on which is excludable from gross income under section 103 and that is not a specified private activity bond (as defined in section 57(a)(5)(C)) subject to the alternative minimum tax;

(*2*) An interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest on a bond that is excludable from gross income under section 103 and that is not interest on a specified private activity bond (as defined in section 57(a)(5)(C)) subject to the alternative minimum tax; or

(*3*) A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

(d) *Elections.* Except as otherwise provided, any required elections must be made in writing, and, once made, may not be revoked without the permission of the Commissioner.

(e) *Investment-type property*—(1) *In general.* Except as otherwise provided in this paragraph (e), investment-type property includes any property, other than property described in section 148(b)(2)(A), (B), (C), or (E), that is held principally as a passive vehicle for the production of income. For this purpose, production of income includes any benefit based on the time value of money.

(2) *Prepayments*—(i) *In general*—(A) *Generally.* Except as otherwise provided in this paragraph (e)(2), a prepayment for property or services, including a prepayment for property or services that is made after the date that the contract to buy the property or services is entered into, also gives rise to

investment-type property if a principal purpose for prepaying is to receive an investment return from the time the prepayment is made until the time payment otherwise would be made. A prepayment does not give rise to investment-type property if—

(*1*) Prepayments on substantially the same terms are made by a substantial percentage of persons who are similarly situated to the issuer but who are not beneficiaries of tax-exempt financing;

(*2*) The prepayment is made within 90 days of the reasonably expected date of delivery to the issuer of all of the property or services for which the prepayment is made; or

(*3*) The prepayment meets the requirements of paragraph (e)(2)(iii)(A) or (B) of this section.

(B) *Example.* The following example illustrates an application of this paragraph (e)(2)(i):

Example. Prepayment after contract is executed. In 1998, City A enters into a ten-year contract with Company Y. Under the contract, Company Y is to provide services to City A over the term of the contract and in return City A will pay Company Y for its services as they are provided. In 2004, City A issues bonds to finance a lump sum payment to Company Y in satisfaction of City A's obligation to pay for Company Y's services to be provided over the remaining term of the contract. The use of bond proceeds to make the lump sum payment constitutes a prepayment for services under paragraph (e)(2)(i) of this section, even though the payment is made after the date that the contract is executed.

(ii) *Customary prepayments.* The determination of whether a prepayment satisfies paragraph (e)(2)(i)(A)(*1*) of this section is generally made based on all the facts and circumstances. In addition, a prepayment is deemed to satisfy paragraph (e)(2)(i)(A)(*1*) of this section if—

(A) The prepayment is made for—

(*1*) Maintenance, repair, or an extended warranty with respect to personal property (for example, automobiles or electronic equipment); or

(*2*) Updates or maintenance or support services with respect to computer software; and

(B) The same maintenance, repair, extended warranty, updates or maintenance or support services, as applicable, are regularly provided to nongovernmental persons on the same terms.

(iii) *Certain prepayments to acquire a supply of natural gas or electricity*—(A) *Natural gas prepayments.* A prepayment meets the requirements of this paragraph (e)(2)(iii)(A) if—

(*1*) It is made by or for one or more utilities that are owned by a governmental person, as defined in §1.141–1(b) (each of which is referred to in this paragraph (e)(2)(iii)(A) as the issuing municipal utility), to purchase a supply of natural gas; and

(*2*) At least 90 percent of the prepaid natural gas financed by the issue is used for a qualifying use. Natural gas is used for a qualifying use if it is to be—

(*i*) Furnished to retail gas customers of the issuing municipal utility who are located in the natural gas service area of the issuing municipal utility, provided, however, that gas used to produce electricity for sale shall not be included under this paragraph (e)(2)(iii)(A)(*2*)(*i*);

(*ii*) Used by the issuing municipal utility to produce electricity that will be furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility;

(*iii*) Used by the issuing municipal utility to produce electricity that will be sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser;

(*iv*) Sold to a utility that is owned by a governmental person if the requirements of paragraph (e)(2)(iii)(A)(*2*)(*i*), (*ii*) or (*iii*) of this section are satisfied by the purchaser (treating the purchaser as the issuing municipal utility); or

(*v*) Used to fuel the pipeline transportation of the prepaid gas supply acquired in accordance with this paragraph (e)(2)(iii)(A).

(B) *Electricity prepayments.* A prepayment meets the requirements of this paragraph (e)(2)(iii)(B) if—

(*1*) It is made by or for one or more utilities that are owned by a governmental person (each of which is referred to in this paragraph (e)(2)(iii)(B) as the issuing municipal utility) to purchase a supply of electricity; and

(*2*) At least 90 percent of the prepaid electricity financed by the issue is used for a qualifying use. Electricity is used for a qualifying use if it is to be—

(*i*) Furnished to retail electric customers of the issuing municipal utility who are located in the electricity service area of the issuing municipal utility; or

(*ii*) Sold to a utility that is owned by a governmental person and furnished to retail electric customers of the purchaser who are located in the electricity service area of the purchaser.

(C) *Service area.* For purposes of this paragraph (e)(2)(iii), the service area of a utility owned by a governmental person consists of—

(*1*) Any area throughout which the utility provided, at all times during the 5-year period ending on the issue date—

(*i*) In the case of a natural gas utility, natural gas transmission or distribution service; and

(*ii*) In the case of an electric utility, electricity distribution service; and

(*2*) Any area recognized as the service area of the utility under state or Federal law.

(D) *Retail customer.* For purposes of this paragraph (e)(2)(iii), a retail customer is a customer that purchases natural gas or electricity, as applicable, other than for resale.

(E) *Commodity swaps.* A prepayment does not fail to meet the requirements of this paragraph (e)(2)(iii) by reason of any commodity swap contract that may be entered into between the issuer and an unrelated party (other than the gas or electricity supplier), or between the gas or electricity supplier and an unrelated party (other than the issuer), so long as each swap contract is an independent contract. A swap contract is an independent contract if the obligation of each party to perform under the swap contract is not dependent on performance by any person (other than the other party to the swap contract) under another contract (for example, a gas or electricity supply contract or another swap contract); provided, however, that a commodity swap contract will not fail to be an independent contract solely because the swap contract may terminate in the event of a failure of a gas or electricity supplier to deliver gas or electricity for which the swap contract is a hedge.

(F) *Remedial action.* Issuers may apply principles similar to the rules of §1.141–12, including §1.141–12(d) (relating to redemption or defeasance of nonqualified bonds) and §1.141–12(e) (relating to alternative use of disposition proceeds), to cure a violation of paragraph (e)(2)(iii)(A)(*2*) or (e)(2)(iii)(B)(*2*) of this section. For this purpose, the amount of nonqualified bonds is determined in the same manner as for output contracts taken into account under the private business tests, including the principles of §1.141–7(d), treating nonqualified sales of gas or electricity under this paragraph (e)(2)(iii) as satisfying the benefits and burdens test under §1.141–7(c)(1).

(iv) *Additional prepayments as permitted by the Commissioner.* The Commissioner may, by published guidance, set forth additional circumstances in which a prepayment does not give rise to investment-type property.

(3) *Certain hedges.* Investment-type property also includes the investment element of a contract that is a hedge (within the meaning of §1.148–4(h)(2)(i)(A)) and that contains a significant investment element because a payment by the issuer relates to a conditional or unconditional obligation by the hedge provider to make a payment on a later date. See §1.148–4(h)(2)(ii) relating to hedges with a significant investment element.

(4) *Exception for certain capital projects.* Investment-type property does not include real property or tangible personal property (for example, land, buildings, and equipment) that is used in furtherance of the public purposes for which the tax-exempt bonds are issued. For example, investment-type property does not include a courthouse financed with governmental bonds or an eligible exempt facility under section 142, such as a public road, financed with private activity bonds.

(f) *Definition of issue price*—(1) *In general.* Except as otherwise provided in this paragraph (f), ''issue price'' is defined in sections 1273 and 1274 and the regulations under those sections.

(2) *Bonds issued for money*—(i) *General rule*. Except as otherwise provided in this paragraph (f)(2), the issue price of bonds issued for money is the first price at which a substantial amount of the bonds is sold to the public. If a bond is issued for money in a private placement to a single buyer that is not an underwriter or a related party (as defined in §1.150–1(b)) to an underwriter, the issue price of the bond is the price paid by that buyer. Issue price is not reduced by any issuance costs (as defined in §1.150–1(b)).

(ii) *Special rule for use of initial offering price to the public*. The issuer may treat the initial offering price to the public as of the sale date as the issue price of the bonds if the requirements of paragraphs (f)(2)(ii)(A) and (B) of this section are met.

(A) The underwriters offered the bonds to the public for purchase at a specified initial offering price on or before the sale date, and the lead underwriter in the underwriting syndicate or selling group (or, if applicable, the sole underwriter) provides, on or before the issue date, a certification to that effect to the issuer, together with reasonable supporting documentation for that certification, such as a copy of the pricing wire or equivalent communication.

(B) Each underwriter agrees in writing that it will neither offer nor sell the bonds to any person at a price that is higher than the initial offering price to the public during the period starting on the sale date and ending on the earlier of the following:

(*1*) The close of the fifth (5th) business day after the sale date; or

(*2*) The date on which the underwriters have sold a substantial amount of the bonds to the public at a price that is no higher than the initial offering price to the public.

(iii) *Special rule for competitive sales*. For bonds issued for money in a competitive sale, an issuer may treat the reasonably expected initial offering price to the public as of the sale date as the issue price of the bonds if the issuer obtains from the winning bidder a certification of the bonds' reasonably expected initial offering price to the public as of the sale date upon which the price in the winning bid is based.

(iv) *Choice of rule for determining issue price*. If more than one rule for determining the issue price of the bonds is available under this paragraph (f)(2), at any time on or before the issue date, the issuer may select the rule it will use to determine the issue price of the bonds. On or before the issue date of the bonds, the issuer must identify the rule selected in its books and records maintained for the bonds.

(3) *Definitions*. For purposes of this paragraph (f), the following definitions apply:

(i) *Competitive sale* means a sale of bonds by an issuer to an underwriter that is the winning bidder in a bidding process in which the issuer offers the bonds for sale to underwriters at specified written terms, if that process meets the following requirements:

(A) The issuer disseminates the notice of sale to potential underwriters in a manner that is reasonably designed to reach potential underwriters (for example, through electronic communication that is widely circulated to potential underwriters by a recognized publisher of municipal bond offering documents or by posting on an Internet-based Web site or other electronic medium that is regularly used for such purpose and is widely available to potential underwriters);

(B) All bidders have an equal opportunity to bid (within the meaning of §1.148–5(d)(6)(iii)(A)(*6*));

(C) The issuer receives bids from at least three underwriters of municipal bonds who have established industry reputations for underwriting new issuances of municipal bonds; and

(D) The issuer awards the sale to the bidder who submits a firm offer to purchase the bonds at the highest price (or lowest interest cost).

(ii) *Public* means any person (as defined in section 7701(a)(1)) other than an underwriter or a related party (as defined in §1.150–1(b)) to an underwriter.

(iii) *Underwriter* means:

(A) Any person (as defined in section 7701(a)(1)) that agrees pursuant to a written contract with the issuer (or with the lead underwriter to form an underwriting syndicate) to participate in the initial sale of the bonds to the public; and

(B) Any person that agrees pursuant to a written contract directly or indirectly with a person described in paragraph (f)(3)(iii)(A) of this section to participate in the initial sale of the bonds to the public (for example, a retail distribution agreement between a national lead underwriter and a regional firm under which the regional firm participates in the initial sale of the bonds to the public).

(4) *Other special rules.* For purposes of this paragraph (f), the following special rules apply:

(i) *Separate determinations.* The issue price of bonds in an issue that do not have the same credit and payment terms is determined separately. The issuer need not apply the same rule to determine issue price for all of the bonds in the issue.

(ii) *Substantial amount.* Ten percent is a substantial amount.

(iii) *Bonds issued for property.* If a bond is issued for property, the adjusted applicable Federal rate, as determined under section 1288 and §1.1288–1, is used in lieu of the applicable Federal rate to determine the bond's issue price under section 1274.

[T.D. 8476, 58 FR 33517, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24041, May 10, 1994; T.D. 8718, 62 FR 25507, May 9, 1997; T.D. 9085, 68 FR 45775, Aug. 4, 2003; T.D. 9777, 81 FR 46592, July 18, 2016; T.D. 9801, 81 FR 89003, Dec. 9, 2016; T.D. 9854, 84 FR 14007, Apr. 9, 2019]

§ 1.148–2 General arbitrage yield restriction rules.

(a) *In general.* Under section 148(a), the direct or indirect investment of the gross proceeds of an issue in higher yielding investments causes the bonds of the issue to be arbitrage bonds. The investment of proceeds in higher yielding investments, however, during a temporary period described in paragraph (e) of this section, as part of a reasonably required reserve or replacement fund described in paragraph (f) of this section, or as part of a minor portion described in paragraph (g) of this section does not cause the bonds of the issue to be arbitrage bonds. Bonds are not arbitrage bonds under this section as a result of an inadvertent, insubstantial error.

(b) *Reasonable expectations*—(1) *In general.* Except as provided in paragraph (c) of this section, the determination of whether an issue consists of arbitrage bonds under section 148(a) is based on the issuer's reasonable expectations as of the issue date regarding the amount and use of the gross proceeds of the issue.

(2) *Certification of expectations*—(i) *In general.* An officer of the issuer responsible for issuing the bonds must, in good faith, certify the issuer's expectations as of the issue date. The certification must state the facts and estimates that form the basis for the issuer's expectations. The certification is evidence of the issuer's expectations, but does not establish any conclusions of law or any presumptions regarding either the issuer's actual expectations or their reasonableness.

(ii) *Exceptions to certification requirement.* An issuer is not required to make a certification for an issue under paragraph (b)(2)(i) of this section if—

(A) The issuer reasonably expects as of the issue date that there will be no unspent gross proceeds after the issue date, other than gross proceeds in a bona fide debt service fund (e.g., equipment lease financings in which the issuer purchases equipment in exchange for an installment payment note); or

(B) The issue price of the issue does not exceed $1,000,000.

(c) *Intentional acts.* The taking of any deliberate, intentional action by the issuer or person acting on its behalf after the issue date in order to earn arbitrage causes the bonds of the issue to be arbitrage bonds if that action, had it been expected on the issue date, would have caused the bonds to be arbitrage bonds. An intent to violate the requirements of section 148 is not necessary for an action to be intentional.

(d) *Materially higher yielding investments*—(1) *In general.* The yield on investments is materially higher than the yield on the issue to which the investments are allocated if the yield on the investments over the term of the issue exceeds the yield on the issue by an amount in excess of the applicable definition of *materially higher* set forth in paragraph (d)(2) of this section. If yield restricted investments in the same class are subject to different definitions of *materially higher*, the applicable definition of *materially higher* that produces the lowest permitted yield applies to all the investments in the class. The yield on the issue is determined under §1.148–4. The yield on investments is determined under §1.148–5.

(2) *Definitions of materially higher yield*—(i) *General rule for purpose and nonpurpose investments*. For investments that are not otherwise described in this paragraph (d)(2), materially higher means one-eighth of 1 percentage point.

(ii) *Refunding escrows and replacement proceeds*. For investments in a refunding escrow or for investments allocable to replacement proceeds, materially higher means one-thousandth of 1 percentage point.

(iii) *Program investments*. For program investments that are not described in paragraph (d)(2)(iv) of this section, materially higher means 1 and one-half percentage points.

(iv) *Student loans*. For qualified student loans that are program investments, materially higher means 2 percentage points.

(v) *Tax-exempt investments*. For investments that are tax-exempt bonds and are not investment property under section 148(b)(3), no yield limitation applies.

(3) *Mortgage loans*. Qualified mortgage loans that satisfy the requirements of section 143(g) are treated as meeting the requirements of this paragraph (d).

(e) *Temporary periods*—(1) *In general*. During the temporary periods set forth in this paragraph (e), the proceeds and replacement proceeds of an issue may be invested in higher yielding investments without causing bonds in the issue to be arbitrage bonds. This paragraph (e) does not apply to refunding issues (see §1.148–9).

(2) *General 3-year temporary period for capital projects and qualified mortgage loans*—(i) *In general*. The net sale proceeds and investment proceeds of an issue reasonably expected to be allocated to expenditures for capital projects qualify for a temporary period of 3 years beginning on the issue date (the *3-year temporary period)*. The 3-year temporary period also applies to the proceeds of qualified mortgage bonds and qualified veterans' mortgage bonds by substituting *qualified mortgage loans* in each place that *capital projects* appears in this paragraph (e)(2). The 3-year temporary period applies only if the issuer reasonably expects to satisfy the expenditure test, the time test, and the due diligence test. These rules apply separately to each conduit loan financed by an issue (other than qualified mortgage loans), with the expenditure and time tests measured from the issue date of the issue.

(A) *Expenditure test*. The expenditure test is met if at least 85 percent of the net sale proceeds of the issue are allocated to expenditures on the capital projects by the end of the 3-year temporary period.

(B) *Time test*. The time test is met if the issuer incurs within 6 months of the issue date a substantial binding obligation to a third party to expend at least 5 percent of the net sale proceeds of the issue on the capital projects. An obligation is not binding if it is subject to contingencies within the issuer's or a related party's control.

(C) *Due diligence test*. The due diligence test is met if completion of the capital projects and the allocation of the net sale proceeds of the issue to expenditures proceed with due diligence.

(ii) *5-year temporary period*. In the case of proceeds expected to be allocated to a capital project involving a substantial amount of construction expenditures (as defined in §1.148–7), a 5-year temporary period applies in lieu of the 3-year temporary period if the issuer satisfies the requirements of paragraph (e)(2)(i) of this section applied by substituting ''5 years'' in each place that ''3 years'' appears, and both the issuer and a licensed architect or engineer certify that the longer period is necessary to complete the capital project.

(3) *Temporary period for working capital expenditures*—(i) *General rule*. The proceeds of an issue that are reasonably expected to be allocated to working capital expenditures within 13 months after the issue date qualify for a temporary period of 13 months beginning on the issue date. Paragraph (e)(2)

of this section contains additional temporary period rules for certain working capital expenditures that are treated as part of a capital project.

(ii) *Longer temporary period for certain tax anticipation issues.* If an issuer reasonably expects to use tax revenues arising from tax levies for a single fiscal year to redeem or retire an issue, and the issue matures by the earlier of 2 years after the issue date or 60 days after the last date for payment of those taxes without interest or penalty, the temporary period under paragraph (e)(3)(i) of this section is extended until the maturity date of the issue.

(4) *Temporary period for pooled financings*—(i) *In general.* Proceeds of a pooled financing issue reasonably expected to be used to finance purpose investments qualify for a temporary period of 6 months while held by the issuer before being loaned to a conduit borrower. Any otherwise available temporary period for proceeds held by a conduit borrower, however, is reduced by the period of time during which those proceeds were held by the issuer before being loaned. For example, if the proceeds of a pooled financing issue loaned to a conduit borrower would qualify for a 3-year temporary period, and the proceeds are held by the issuer for 5 months before being loaned to the conduit borrower, the proceeds qualify for only an additional 31-month temporary period after being loaned to the conduit borrower. Except as provided in paragraph (e)(4)(iv) of this section, this paragraph (e)(4) does not apply to any qualified mortgage bond or qualified veterans' mortgage bond under section 143.

(ii) *Loan repayments*—(A) *Amount held by the issuer.* The temporary period under this paragraph (e)(4) for proceeds from the sale or repayment of any loan that are reasonably expected to be used to make or finance new loans is 3 months.

(B) *Amounts re-loaned to conduit borrowers.* Any temporary period for proceeds held by a conduit borrower under a new loan from amounts described in paragraph (e)(4)(ii)(A) of this section is determined by treating the date the new loan is made as the issue date and by reducing the temporary period by the period the amounts were held by the issuer following the last repayment.

(iii) *Construction issues.* If all or a portion of a pooled financing issue qualifies as a construction issue under §1.148–7(b)(6), paragraph (e)(4)(i) of this section is applied by substituting ''2 years'' for ''6 months.''

(iv) *Amounts re-loaned for qualified mortgage loans.* The temporary period under this paragraph (e)(4) for proceeds from the sale, prepayment, or repayment of any qualified mortgage loan that are reasonably expected to be used to make or finance new qualified mortgage loans is 3 years.

(5) *Temporary period for replacement proceeds*—(i) *In general.* Except as otherwise provided, replacement proceeds qualify for a temporary period of 30 days beginning on the date that the amounts are first treated as replacement proceeds.

(ii) *Temporary period for bona fide debt service funds.* Amounts in a bona fide debt service fund for an issue qualify for a temporary period of 13 months. If only a portion of a fund qualifies as a bona fide debt service fund, only that portion qualifies for this temporary period.

(6) *Temporary period for investment proceeds.* Except as otherwise provided in this paragraph (e), investment proceeds qualify for a temporary period of 1 year beginning on the date of receipt.

(7) *Other amounts.* Gross proceeds not otherwise eligible for a temporary period described in this paragraph (e) qualify for a temporary period of 30 days beginning on the date of receipt.

(f) *Reserve or replacement funds*—(1) *General 10 percent limitation on funding with sale proceeds.* An issue consists of arbitrage bonds if sale proceeds of the issue in excess of 10 percent of the stated principal amount of the issue are used to finance any reserve or replacement fund, without regard to whether those sale proceeds are invested in higher yielding investments. If an issue has more than a de minimis amount of original issue discount or premium, the issue price (net of pre-issuance accrued interest) is used to measure the 10-percent limitation in lieu of stated principal amount. This rule does not limit the use of amounts other than sale proceeds of an issue to fund a reserve or replacement fund.

(2) *Exception from yield restriction for reasonably required reserve or replacement funds*—(i) *In general*. The investment of amounts that are part of a reasonably required reserve or replacement fund in higher yielding investments will not cause an issue to consist of arbitrage bonds. A reasonably required reserve or replacement fund may consist of all or a portion of one or more funds, however labelled, derived from one or more sources. Amounts in a reserve or replacement fund in excess of the amount that is reasonably required are not part of a reasonably required reserve or replacement fund.

(ii) *Size limitation*. The amount of gross proceeds of an issue that qualifies as a reasonably required reserve or replacement fund may not exceed an amount equal to the least of 10 percent of the stated principal amount of the issue, the maximum annual principal and interest requirements on the issue, or 125 percent of the average annual principal and interest requirements on the issue. If an issue has more than a de minimis amount of original issue discount or premium, the issue price of the issue (net of pre-issuance accrued interest) is used to measure the 10 percent limitation in lieu of its stated principal amount. For a reserve or replacement fund that secures more than one issue (e.g. a parity reserve fund), the size limitation may be measured on an aggregate basis.

(iii) *Valuation of investments*. Investments in a reasonably required reserve or replacement fund may be valued in any reasonable, consistently applied manner that is permitted under §1.148–5.

(iv) *150 percent debt service limitation on investment in nonpurpose investments for certain private activity bonds*. Section 148(d)(3) contains additional limits on the amount of gross proceeds of an issue of private activity bonds, other than qualified 501(c)(3) bonds, that may be invested in higher yielding nonpurpose investments without causing the bonds to be arbitrage bonds. For purposes of these rules, *initial temporary period* means the temporary periods under paragraphs (e)(2), (e)(3), and (e)(4) of this section and under §1.148–9(d)(2)(i), (ii), and (iii).

(3) *Certain parity reserve funds*. The limitation contained in paragraph (f)(1) of this section does not apply to an issue if the master legal document authorizing the issuance of the bonds (e.g., a master indenture) was adopted before August 16, 1986, and that document—

(i) Requires a reserve or replacement fund in excess of 10 percent of the sale proceeds, but not more than maximum annual principal and interest requirements;

(ii) Is not amended after August 31, 1986 (other than to permit the issuance of additional bonds as contemplated in the master legal document); and

(iii) Provides that bonds having a parity of security may not be issued by or on behalf of the issuer for the purposes provided under the document without satisfying the reserve fund requirements of the indenture.

(g) *Minor portion*. Under section 148(e), a bond of an issue is not an arbitrage bond solely because of the investment in higher yielding investments of gross proceeds of the issue in an amount not exceeding the lesser of—

(1) 5 percent of the sale proceeds of the issue; or

(2) $100,000.

(h) *Certain waivers permitted*. On or before the issue date, an issuer may elect to waive the right to invest in higher yielding investments during any temporary period under paragraph (e) of this section or as part of a reasonably required reserve or replacement fund under paragraph (f) of this section. At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion under paragraph (g) of this section.

[T.D. 8476, 58 FR 33520, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24042, May 10, 1994; T.D. 8718, 62 FR 25507, May 9, 1997; T.D. 9777, 81 FR 46593, July 18, 2016]

§ 1.148–3 General arbitrage rebate rules.

(a) *In general*. Section 148(f) requires that certain earnings on nonpurpose investments allocable to the gross proceeds of an issue be paid to the United

States to prevent the bonds in the issue from being arbitrage bonds. The arbitrage that must be rebated is based on the difference between the amount actually earned on nonpurpose investments and the amount that would have been earned if those investments had a yield equal to the yield on the issue.

(b) *Definition of rebate amount.* As of any date, the rebate amount for an issue is the excess of the future value, as of that date, of all receipts on nonpurpose investments over the future value, as of that date, of all payments on nonpurpose investments.

(c) *Computation of future value of a payment or receipt.* The future value of a payment or receipt at the end of any period is determined using the economic accrual method and equals the value of that payment or receipt when it is paid or received (or treated as paid or received), plus interest assumed to be earned and compounded over the period at a rate equal to the yield on the issue, using the same compounding interval and financial conventions used to compute that yield.

(d) *Payments and receipts*—(1) *Definition of payments.* For purposes of this section, payments are—

(i) Amounts actually or constructively paid to acquire a nonpurpose investment (or treated as paid to a commingled fund);

(ii) For a nonpurpose investment that is first allocated to an issue on a date after it is actually acquired (e.g., an investment that becomes allocable to transferred proceeds or to replacement proceeds) or that becomes subject to the rebate requirement on a date after it is actually acquired (e.g., an investment allocated to a reasonably required reserve or replacement fund for a construction issue at the end of the 2-year spending period), the value of that investment on that date;

(iii) For a nonpurpose investment that was allocated to an issue at the end of the preceding computation period, the value of that investment at the beginning of the computation period;

(iv) On the last day of each bond year during which there are amounts allocated to gross proceeds of an issue that are subject to the rebate requirement, and on the final maturity date, a computation credit of $1,400 for any bond year ending in 2007 and, for bond years ending after 2007, a computation credit in the amount determined under paragraph (d)(4) of this section; and

(v) Yield reduction payments on nonpurpose investments made pursuant to §1.148–5(c).

(2) *Definition of receipts.* For purposes of this section, receipts are—

(i) Amounts actually or constructively received from a nonpurpose investment (including amounts treated as received from a commingled fund), such as earnings and return of principal;

(ii) For a nonpurpose investment that ceases to be allocated to an issue before its disposition or redemption date (e.g., an investment that becomes allocable to transferred proceeds of another issue or that ceases to be allocable to the issue pursuant to the universal cap under §1.148–6) or that ceases to be subject to the rebate requirement on a date earlier than its disposition or redemption date (e.g., an investment allocated to a fund initially subject to the rebate requirement but that subsequently qualifies as a bona fide debt service fund), the value of that nonpurpose investment on that date; and

(iii) For a nonpurpose investment that is held at the end of a computation period, the value of that investment at the end of that period.

(3) *Special rules for commingled funds.* Section 1.148–6(e) provides special rules to limit certain of the required determinations of payments and receipts for investments of a commingled fund.

(4) *Cost-of-living adjustment.* For any calendar year after 2007, the $1,400 computation credit set forth in paragraph (d)(1)(iv) of this section shall be increased by an amount equal to such dollar amount multiplied by the cost-of-living adjustment determined under section 1(f)(3) for such year, as modified by this paragraph (d)(4). In applying section 1(f)(3) to determine this cost-of-living adjustment, the reference to ''calendar year 1992'' in section 1(f)(3)(B) shall be changed to ''calendar year 2006.'' If any such increase determined under this paragraph (d)(4) is not a multiple of $10, such increase

shall be rounded to the nearest multiple thereof.

(e) *Computation dates*—(1) *In general.* For a fixed yield issue, an issuer may treat any date as a computation date. For a variable yield issue, an issuer:

(i) May treat the last day of any bond year ending on or before the latest date on which the first rebate amount is required to be paid under paragraph (f) of this section (the *first required payment date*) as a computation date but may not change that treatment after the first payment date; and

(ii) After the first required payment date, must consistently treat either the end of each bond year or the end of each fifth bond year as computation dates and may not change these computation dates after the first required payment date.

(2) *Final computation date.* The date that an issue is discharged is the final computation date. For an issue retired within 3 years of the issue date, however, the final computation date need not occur before the end of 8 months after the issue date or during the period in which the issuer reasonably expects that any of the spending exceptions under §1.148–7 will apply to the issue.

(f) *Amount of required rebate installment payment*—(1) *Amount of interim rebate payments.* The first rebate installment payment must be made for a computation date that is not later than 5 years after the issue date. Subsequent rebate installment payments must be made for a computation date that is not later than 5 years after the previous computation date for which an installment payment was made. A rebate installment payment must be in an amount that, when added to the future value, as of the computation date, of previous rebate payments made for the issue, equals at least 90 percent of the rebate amount as of that date.

(2) *Amount of final rebate payment.* For the final computation date, a final rebate payment must be paid in an amount that, when added to the future value of previous rebate payments made for the issue, equals 100 percent of the rebate amount as of that date.

(3) *Future value of rebate payments.* The future value of a rebate payment is determined under paragraph (c) of this section. This value is computed by taking into account recoveries of overpayments.

(g) *Time and manner of payment.* Each rebate payment must be paid no later than 60 days after the computation date to which the payment relates. Any rebate payment paid within this 60-day period may be treated as paid on the computation date to which it relates. A rebate payment is paid when it is filed with the Internal Revenue Service at the place or places designated by the Commissioner. A payment must be accompanied by the form provided by the Commissioner for this purpose.

(h) *Penalty in lieu of loss of tax exemption*—(1) *In general.* The failure to pay the correct rebate amount when required will cause the bonds of the issue to be arbitrage bonds, unless the Commissioner determines that the failure was not caused by willful neglect and the issuer promptly pays a penalty to the United States. If no bond of the issue is a private activity bond (other than a qualified 501(c)(3) bond), the penalty equals 50 percent of the rebate amount not paid when required to be paid, plus interest on that amount. Otherwise, the penalty equals 100 percent of the rebate amount not paid when required to be paid, plus interest on that amount.

(2) *Interest on underpayments.* Interest accrues at the underpayment rate under section 6621, beginning on the date the correct rebate amount is due and ending on the date 10 days before it is paid.

(3) *Waivers of the penalty.* The penalty is automatically waived if the rebate amount that the issuer failed to pay plus interest is paid within 180 days after discovery of the failure, unless, the Commissioner determines that the failure was due to willful neglect, or the issue is under examination by the Commissioner at any time during the period beginning on the date the failure first occurred and ending on the date 90 days after the receipt of the rebate amount. Generally, extensions of this 180-day period and waivers of the penalty in other cases will be granted by the Commissioner only in unusual circumstances. For purposes of this paragraph (h)(3), willful neglect does

not include a failure that is attributable solely to the permissible retroactive selection of a short first bond year if the rebate amount that the issuer failed to pay is paid within 60 days of the selection of that bond year.

(4) *Application to alternative penalty under §1.148–7.* Paragraphs (h) (1), (2), and (3) of this section apply to failures to pay penalty payments under §1.148–7 (*alternative penalty amounts*) by substituting *alternative penalty amounts* for *rebate amount* and *the last day of each spending period* for *computation date.*

(i) *Recovery of overpayment of rebate*—(1) *In general.* An issuer may recover an overpayment for an issue of tax-exempt bonds by establishing to the satisfaction of the Commissioner that the overpayment occurred. An overpayment is the excess of the amount paid to the United States for an issue under section 148 over the sum of the rebate amount for the issue as of the most recent computation date and all amounts that are otherwise required to be paid under section 148 as of the date the recovery is requested.

(2) *Limitations on recovery.* (i) An overpayment may be recovered only to the extent that a recovery on the date that it is first requested would not result in an additional rebate amount if that date were treated as a computation date.

(ii) Except for overpayments of penalty in lieu of rebate under section 148(f)(4)(C)(vii) and §1.148–7(k), an overpayment of less than $5,000 may not be recovered before the final computation date.

(3) *Time and manner for requesting refund.* (i) An issuer must request a refund of an overpayment (claim) no later than the date that is two years after the final computation date for the issue to which the overpayment relates (the filing deadline). The claim must be made using the form provided by the Commissioner for this purpose.

(ii) The Commissioner may request additional information to support a claim. The issuer must file the additional information by the date specified in the Commissioner's request, which date may be extended by the Commissioner if unusual circumstances warrant. An issuer will be given at least 21 calendar days to respond to a request for additional information.

(iii) A claim described in either paragraph (i)(3)(iii)(A) or (B) of this section that has been denied by the Commissioner may be appealed to the Office of Appeals under this paragraph (i)(3)(iii). Upon a determination in favor of the issuer, the Office of Appeals must return the undeveloped case to the Commissioner for further consideration of the substance of the claim.

(A) A claim is described in this paragraph (i)(3)(iii)(A) if the Commissioner asserts that the claim was filed after the filing deadline.

(B) A claim is described in this paragraph (i)(3)(iii)(B) if the Commissioner asserts that additional information to support the claim was not submitted within the time specified in the request for information or in any extension of such specified time period.

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

Example 1. Calculation and payment of rebate for a fixed yield issue. (i) *Facts.* On January 1, 1994, City *A* issues a fixed yield issue and invests all the sale proceeds of the issue ($49 million). There are no other gross proceeds. The issue has a yield of 7.0000 percent per year compounded semiannually (computed on a 30 day month/360 day year basis). City *A* receives amounts from the investment and immediately expends them for the governmental purpose of the issue as follows:

Date	Amount
2/1/94	$3,000,000
5/1/94	5,000,000
1/1/95	5,000,000
9/1/95	20,000,000
3/1/96	22,000,000

(ii) *First computation date.* (A) City *A* chooses January 1, 1999, as its first computation date. This date is the latest date that may be used to compute the first required rebate installment payment. The rebate amount as of this date is computed by determining the future value of the receipts and the payments for the investment. The compounding interval is each 6-month (or shorter) period and the 30 day month/360 day year basis is used because these conventions were used to compute yield on the issue. The future value of these amounts, plus the computation credit, as of January 1, 1999, is:

Date	Receipts (payments)	FV (7.0000 percent)
1/1/94	($49,000,000)	($69,119,339)

Date	Receipts (payments)	FV (7.0000 percent)
2/1/94	3,000,000	4,207,602
5/1/94	5,000,000	6,893,079
1/1/95	5,000,000	6,584,045
1/1/95	(1,000)	(1,317)
9/1/95	20,000,000	25,155,464
1/1/96	(1,000)	1,229)
3/1/96	22,000,000	26,735,275
1/1/97	(1,000)	(1,148)
Rebate amount (1/01/99)		452,432

(B) City *A* pays 90 percent of the rebate amount ($407,189) to the United States within 60 days of January 1, 1999.

(iii) *Second computation date.* (A) On the next required computation date, January 1, 2004, the future value of the payments and receipts is:

Date	Receipts (payments)	FV (7.0000 percent)
1/1/99	$452,432	$638,200
Rebate amount (1/01/04)		638,200

(B) As of this computation date, the future value of the payment treated as made on January 1, 1999, is $574,380, which equals at least 90 percent of the rebate amount as of this computation date ($638,200 × 0.9), and thus no additional rebate payment is due as of this date.

(iv) *Final computation date.* (A) On January 1, 2009, City *A* redeems all the bonds, and thus this date is the final computation date. The future value of the receipts and payments as of this date is:

Date	Receipts (payments)	FV (7.0000 percent)
1/1/04	$638,200	$900,244
1/1/09	(1,000)	(1,000)
Rebate amount (1/01/09)		899,244

(B) As of this computation date, the future value of the payment made on January 1, 1999, is $810,220 and thus an additional rebate payment of $89,024 is due. This payment reflects the future value of the 10 percent unpaid portion, and thus would not be owed had the issuer paid the full rebate amount as of any prior computation date.

Example 2. Calculation and payment of rebate for a variable yield issue. (i) *Facts.* On July 1, 1994, City *B* issues a variable yield issue and invests all of the sale proceeds of the issue ($30 million). There are no other gross proceeds. As of July 1, 1999, there are nonpurpose investments allocated to the issue. Prior to July 1, 1999, City *B* receives amounts from nonpurpose investments and immediately expends them for the governmental purpose of the issue as follows:

Date	Amount
8/1/1994	$5,000,000
7/1/1995	8,000,000
12/1/1995	17,000,000
7/1/1999	650,000

(ii) *First computation date.* (A) City *B* treats the last day of the fifth bond year (July 1, 1999) as a computation date. The yield on the variable yield issue during the first computation period (the period beginning on the issue date and ending on the first computation date) is 6.0000 percent per year compounded semiannually. The value of the nonpurpose investments allocated to the issue as of July 1, 1999, is $3 million. The rebate amount as of July 1, 1999, is computed by determining the future value of the receipts and the payments for the nonpurpose investments. The compounding interval is each 6-month (or shorter) period and the 30 day month/360 day year basis is used because these conventions were used to compute yield on the issue. The future value of these amounts and of the computation date credits as of July 1, 1999, is:

Date	Receipts (payments)	FV (6.0000 percent)
7/1/1994	($30,000,000)	($40,317,491)
8/1/1994	5,000,000	6,686,560
7/1/1995	(1,000)	(1,267)
7/1/1995	8,000,000	10,134,161
12/1/1995	17,000,000	21,011,112
7/1/1996	(1,000)	(1,194)
7/1/1997	(1,000)	(1,126)
7/1/1998	(1,000)	(1,061)
7/1/1999	3,000,000	3,000,000
7/1/1999	650,000	650,000
7/1/1999	(1,000)	(1,000)
Rebate amount (7/01/1999)		1,158,694

(B) City *B* pays 90 percent of the rebate amount ($1,042,824.60) to the United States within 60 days of July 1, 1999.

(iii) *Next computation date.* (A) On July 1, 2004, City *B* redeems all of the bonds. Thus, the next computation date is July 1, 2004. On July 30, 1999, City *B* chose to compute rebate for periods following the first computation period by treating the end of each fifth bond year as a computation date. The yield during the second computation period is 5.0000 percent per year compounded semiannually. The computation of the rebate amount as of this date reflects the value of the nonpurpose investments allocated to the issue at the end of the prior computation period. On July 1, 2004, City *B* sells those nonpurpose investments for $3,925,000 and expends that amount for the governmental purpose of the issue.

(B) As of July 1, 2004, the future value of the rebate amount computed as of July 1, 1999, and of all other payments and receipts is:

Date	Receipts (payments)	FV (5.0000 percent)
7/1/1999	$1,158,694	$1,483,226
7/1/1999	(3,000,000)	(3,840,254)
7/1/2000	(1,000)	(1,218)
7/1/2001	(1,000)	(1,160)
7/1/2002	(1,000)	(1,104)
7/1/2003	(1,000)	(1,051)
7/1/2004	(2,000)	(2,000)
7/1/2004	3,925,000	3,925,000
		1,561,439

(C) As of this computation date, the future value of the payment made on July 1, 1999, is $1,334,904 and thus an additional rebate payment of $226,535 is due.

(D) If the yield during the second computation period were, instead, 7.0000 percent, the rebate amount computed as of July 1, 2004, would be $1,320,891. The future value of the payment made on July 1, 1999, would be $1,471,007. Although the future value of the payment made on July 1, 1999 ($1,471,007), exceeds the rebate amount computed as of July 1, 2004 ($1,320,891), §1.148–3(i) limits the amount recoverable as a defined overpayment of rebate under section 148 to the excess of the total ''amount paid'' over the sum of the amount determined under the future value method to be the ''rebate amount'' as of the most recent computation date and all other amounts that are otherwise required to be paid under section 148 as of the date the recovery is requested. Because the total amount that the issuer paid on July 1, 1999 ($1,042,824.60), does not exceed the rebate amount as of July 1, 2004 ($1,320,891), the issuer would not be entitled to recover any overpayment of rebate in this case.

(k) *Bona fide debt service fund exception.* Under section 148(f)(4)(A), the rebate requirement does not apply to amounts in certain bona fide debt service funds. An issue with an average annual debt service that is not in excess of $2,500,000 may be treated as satisfying the $100,000 limitation in section 148(f)(4)(A)(ii).

[T.D. 8476, 58 FR 33522, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24042, May 10, 1994; T.D. 8476, 59 FR 24350, May 11, 1994; T.D. 8718, 62 FR 25507, May 9, 1997; T.D. 9701, 79 FR 67351, Nov. 13, 2014; T.D. 9777, 81 FR 46593, July 18, 2016]

§ 1.148–4 Yield on an issue of bonds.

(a) *In general.* The yield on an issue of bonds is used to apply investment yield restrictions under section 148(a) and to compute rebate liability under section 148(f). Yield is computed under the economic accrual method using any consistently applied compounding interval of not more than one year. A short first compounding interval and a short last compounding interval may be used. Yield is expressed as an annual percentage rate that is calculated to at least four decimal places (for example, 5.2525 percent). Other reasonable, standard financial conventions, such as the 30 days per month/360 days per year convention, may be used in computing yield but must be consistently applied. The yield on an issue that would be a purpose investment (absent section 148(b)(3)(A)) is equal to the yield on the conduit financing issue that financed that purpose investment.

(b) *Computing yield on a fixed yield issue*—(1) *In general*—(i) *Yield on an issue.* The yield on a fixed yield issue is the discount rate that, when used in computing the present value as of the issue date of all unconditionally payable payments of principal, interest, and fees for qualified guarantees on the issue and amounts reasonably expected to be paid as fees for qualified guarantees on the issue, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price of bonds of the issue as of the issue date. Further, payments include certain amounts properly allocable to a qualified hedge. Yield on a fixed yield issue is computed as of the issue date and is not affected by subsequent unexpected events, except to the extent provided in paragraphs (b)(4) and (h)(3) of this section.

(ii) *Yield on a bond.* Yield on a fixed yield bond is computed in the same manner as yield on a fixed yield issue.

(2) *Yield on certain fixed yield bonds subject to mandatory or contingent early redemption*—(i) *In general.* The yield on a fixed yield issue that includes a bond subject to mandatory early redemption or expected contingent redemption is computed by treating that bond as redeemed on its reasonably expected early redemption date for an amount equal to its value on that date. Reasonable expectations are determined on the issue date. A bond is subject to mandatory early redemption if it is unconditionally payable in full before its final maturity date. A bond is subject to a contingent redemption if it must be, or is reasonably expected to be, redeemed prior to final maturity upon

the occurrence of a contingency. A contingent redemption is taken into account only if the contingency is reasonably expected to occur, in which case the date of occurrence of the contingency must be reasonably estimated. For example, if bonds are reasonably expected to be redeemed early using excess revenues from general or special property taxes or benefit assessments or similar amounts, the reasonably expected redemption schedule is used to determine yield. For purposes of this paragraph (b)(2)(i), excess proceeds calls for issues for which the requirements of §1.148–2(e) (2) or (3) are satisfied, calamity calls, and refundings do not cause a bond to be subject to early redemption. The value of a bond is determined under paragraph (e) of this section.

(ii) *Substantially identical bonds subject to mandatory early redemption.* If substantially identical bonds of an issue are subject to specified mandatory redemptions prior to final maturity (e.g., a mandatory sinking fund redemption requirement), yield on that issue is computed by treating those bonds as redeemed in accordance with the redemption schedule for an amount equal to their value. Generally, bonds are substantially identical if the stated interest rate, maturity, and payment dates are the same. In computing the yield on an issue containing bonds described in this paragraph (b)(2)(ii), each of those bonds must be treated as redeemed at its present value, unless the stated redemption price at maturity of the bond does not exceed the issue price of the bond by more than one-fourth of one percent multiplied by the product of the stated redemption price at maturity and the number of years to the weighted average maturity date of the substantially identical bonds, in which case each of those bonds must be treated as redeemed at its outstanding stated principal amount, plus accrued, unpaid interest. Weighted average maturity is determined by taking into account the mandatory redemption schedule.

(3) *Yield on certain fixed yield bonds subject to optional early redemption*—(i) *In general.* If a fixed yield bond is subject to optional early redemption and is described in paragraph (b)(3)(ii) of this section, the yield on the issue containing the bond is computed by treating the bond as redeemed at its stated redemption price on the optional redemption date that would produce the lowest yield on that bond.

(ii) *Fixed yield bonds subject to special yield calculation rule.* A fixed yield bond is described in this paragraph (b)(3)(ii) only if it—

(A) Is subject to optional redemption within five years of the issue date, but only if the yield on the issue computed by assuming all bonds in the issue subject to redemption within 5 years of the issue date are redeemed at maturity is more than one-eighth of one percentage point higher than the yield on that issue computed by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at the earliest date for their redemption;

(B) Is issued at an issue price that exceeds the stated redemption price at maturity by more than one-fourth of one percent multiplied by the product of the stated redemption price at maturity and the number of complete years to the first optional redemption date for the bond; or

(C) Bears interest at increasing interest rates (*i.e.*, a *stepped coupon bond*).

(4) *Yield recomputed upon transfer of certain rights associated with the bond.* For purposes of §1.148–3, as of the date of any transfer, waiver, modification, or similar transaction (collectively, a *transfer*) of any right that is part of the terms of a bond or is otherwise associated with a bond (e.g., a redemption right), in a transaction that is separate and apart from the original sale of the bond, the issue is treated as if it were retired and a new issue issued on the date of the transfer (*reissued*). The redemption price of the retired issue and the issue price of the new issue equal the aggregate values of all the bonds of the issue on the date of the transfer. In computing yield on the new issue, any amounts received by the issuer as consideration for the transfer are taken into account.

(5) *Special aggregation rule treating certain bonds as a single fixed yield bond.* Two variable yield bonds of an issue are treated in the aggregate as a single fixed yield bond if—

(i) Aggregate treatment would result in the single bond being a fixed yield bond; and

(ii) The terms of the bonds do not contain any features that could distort the aggregate fixed yield from what the yield would be if a single fixed yield bond were issued. For example, if an issue contains a bond bearing interest at a floating rate and a related bond bearing interest at a rate equal to a fixed rate minus that floating rate, those two bonds are treated as a single fixed yield bond only if neither bond may be redeemed unless the other bond is also redeemed at the same time.

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

Example 1. No early call—(i) *Facts.* On January 1, 1994, City *A* issues an issue consisting of four identical fixed yield bonds. The stated final maturity date of each bond is January 1, 2004, and no bond is subject to redemption before this date. Interest is payable on January 1 of each year at a rate of 6.0000 percent per year on the outstanding principal amount. The total stated principal amount of the bonds is $20 million. The issue price of the bonds $20,060,000.

(ii) *Computation.* The yield on the issue is computed by treating the bonds as retired at the stated maturity under the general rule of §1.148–4(b)(1). The bonds are treated as redeemed for their stated redemption prices. The yield on the issue is 5.8731 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (5.8731 percent)
1/1/1995	$1,200,000	$1,132,510
1/1/1996	1,200,000	1,068,816
1/1/1997	1,200,000	1,008,704
1/1/1998	1,200,000	951,973
1/1/1999	1,200,000	898,433
1/1/2000	1,200,000	847,903
1/1/2001	1,200,000	800,216
1/1/2002	1,200,000	755,210
1/1/2003	1,200,000	712,736
1/1/2004	21,200,000	11,883,498
		20,060,000

Example 2. Mandatory calls. (i) *Facts.* The facts are the same as in *Example 1.* In this case, however, the bonds are subject to mandatory sinking fund redemption on January 1 of each year, beginning January 1, 2001. On each sinking fund redemption date, one of the bonds is chosen by lottery and is required to be redeemed at par plus accrued interest.

(ii) *Computation.* Because the bonds are subject to specified redemptions, yield on the issue is computed by treating the bonds as redeemed in accordance with the redemption schedule under §1.148–4(b)(2)(ii). Because the bonds are not sold at a discount, the bonds are treated as retired at their stated redemption prices. The yield on the issue is 5.8678 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (5.8678 percent)
1/1/1995	$1,200,000	$1,132,569
1/1/1996	1,200,000	1,068,926
1/1/1997	1,200,000	1,008,860
1/1/1998	1,200,000	952,169
1/1/1999	1,200,000	898,664
1/1/2000	1,200,000	848,166
1/1/2001	6,200,000	4,135,942
1/1/2002	5,900,000	3,714,650
1/1/2003	5,600,000	3,327,647
1/1/2004	5,300,000	2,972,407
		$20,060,000

Example 3. Optional early call. (i) *Facts.* On January 1, 1994, City *C* issues an issue consisting of three bonds. Each bond has a stated principal amount of $10 million dollars and is issued for par. Bond *X* bears interest at 5 percent per year and matures on January 1, 1999. Bond *Y* bears interest at 6 percent per year and matures on January 1, 2002. Bond *Z* bears interest at 7 percent per year and matures on January 1, 2004. Bonds *Y* and *Z* are callable by the issuer at par plus accrued interest after December 31, 1998.

(ii) *Computation.* (A) The yield on the issue computed as if each bond is outstanding to its maturity is 6.0834 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (6.0834 percent)
1/1/1995	$1,800,000	$1,695,299
1/1/1996	1,800,000	1,596,689
1/1/1997	1,800,000	1,503,814
1/1/1998	1,800,000	1,416,342
1/1/1999	11,800,000	8,744,830
1/1/2000	1,300,000	907,374
1/1/2001	1,300,000	854,595
1/1/2002	11,300,000	6,996,316
1/1/2003	700,000	408,190
1/1/2004	10,700,000	5,876,551
		30,000,000

(B) The yield on the issue computed as if all bonds are called at the earliest date for redemption is 5.9126 percent per year compounded semiannually, computed as follows:

Date	Payments	PV (5.9126 percent)
1/1/1995	$1,800,000	$1,698,113
1/1/1996	1,800,000	1,601,994
1/1/1997	1,800,000	1,511,315
1/1/1998	1,800,000	1,425,769
1/1/1999	31,800,000	23,762,809

Date	Payments	PV (5.9126 percent)
		30,000,000

(C) Because the yield on the issue computed by assuming all bonds in the issue subject to redemption within 5 years of the issue date are redeemed at maturity is more than one-eighth of one percentage point higher than the yield on the issue computed by assuming all bonds subject to optional redemption within 5 years of the issue date are redeemed at the earliest date for their redemption, each bond is treated as redeemed on the date that would produce the lowest yield for the issue. The lowest yield on the issue would result from a redemption of all the bonds on January 1, 1999. Thus, the yield on the issue is 5.9126 percent per year compounded semiannually.

(c) *Computing yield on a variable yield issue*—(1) *In general.* The yield on a variable yield issue is computed separately for each computation period. The yield for each computation period is the discount rate that, when used in computing the present value as of the first day of the computation period of all the payments of principal and interest and fees for qualified guarantees that are attributable to the computation period, produces an amount equal to the present value, using the same discount rate, of the aggregate issue price (or deemed issue price, as determined in paragraph (c)(2)(iv) of this section) of the bonds of the issue as of the first day of the computation period. The yield on a variable yield bond is computed in the same manner as the yield on a variable yield issue. Except as provided in paragraph (c)(2) of this section, yield on any fixed yield bond in a variable yield issue is computed in the same manner as the yield on a fixed yield issue as provided in paragraph (b) of this section.

(2) *Payments on bonds included in yield for a computation period*—(i) *Payments in general.* The payments on a bond that are attributable to a computation period include any amounts actually paid during the period for principal on the bond. Payments also include any amounts paid during the current period both for interest accruing on the bond during the current period and for interest accruing during the prior period that was included in the deemed issue price of the bond as accrued unpaid interest at the start of the current period under this paragraph (c)(2). Further, payments include any amounts properly allocable to fees for a qualified guarantee of the bond for the period and to any amounts properly allocable to a qualified hedge for the period.

(ii) *Payments at actual redemption.* If a bond is actually redeemed during a computation period, an amount equal to the greater of its value on the redemption date or the actual redemption price is a payment on the actual redemption date.

(iii) *Payments for bonds outstanding at end of computation period.* If a bond is outstanding at the end of a computation period, a payment equal to the bond's value is taken into account on the last day of that period.

(iv) *Issue price for bonds outstanding at beginning of next computation period.* A bond outstanding at the end of a computation period is treated as if it were immediately reissued on the next day for a deemed issue price equal to the value from the day before as determined under paragraph (c)(2)(iii) of this section.

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

Example. On January 1, 1994, City *A* issues an issue of identical plain par bonds in an aggregate principal amount of $1,000,000. The bonds pay interest at a variable rate on each June 1 throughout the term of the issue. The entire principal amount of the bonds plus accrued, unpaid interest is payable on the final maturity date of January 1, 2000. No bond year is selected. On June 1, 1994, 1995, 1996, 1997, and 1998, interest in the amounts of $30,000, $55,000, $57,000, $56,000, and $45,000 is paid on the bonds. From June 1, 1998, to January 1, 1999, $30,000 of interest accrues on the bonds. From January 1, 1999, to June 1, 1999, another $35,000 of interest accrues. On June 1, 1999, the issuer actually pays $65,000 of interest. On January 1, 2000, $1,000,000 of principal and $38,000 of accrued interest are paid. The payments for the computation period starting on the issue date and ending on January 1, 1999, include all annual interest payments paid from the issue date to June 1, 1998. Because the issue is outstanding on January 1, 1999, it is treated as redeemed on that date for amount equal to its value ($1,000,000 plus accrued, unpaid interest of $30,000 under paragraph (e)(1) of this section). Thus, $1,030,000 is treated as paid on January 1, 1999. The issue is then treated as reissued on January 1, 1999, for $1,030,000. The payments for the next computation period starting on January 1, 1999, and ending on January 1, 2000, include the interest actually paid on the bonds during that period ($65,000 on June 1, 1999, plus $38,000 paid on January 1, 2000). Because the issue was actually redeemed on January 1, 2000, an amount equal to its stated redemption price is also treated as paid on January 1, 2000.

(d) *Conversion from variable yield issue to fixed yield issue.* For purposes of determining yield under this section, as of the first day on which a variable yield issue would qualify as a fixed yield issue if it were newly issued on that date (a *conversion date*), that issue is treated as if it were reissued as a fixed yield issue on the conversion date. The redemption price of the variable yield issue and the issue price of the fixed yield issue equal the aggregate values of all the bonds on the conversion date. Thus, for example, for plain par bonds (e.g., tender bonds), the deemed issue price would be the outstanding principal amount, plus accrued unpaid interest. If the conversion date occurs on a date other than a computation date, the issuer may continue to treat the issue as a variable yield issue until the next computation date, at which time it must be treated as converted to a fixed yield issue.

(e) *Value of bonds*—(1) *Plain par bonds.* Except as otherwise provided, the value of a plain par bond is its outstanding stated principal amount, plus accrued unpaid interest. The value of a plain par bond that is actually redeemed or treated as redeemed is its stated redemption price on the redemption date, plus accrued, unpaid interest.

(2) *Other bonds.* The value of a bond other than a plain par bond on a date is its present value on that date. The present value of a bond is computed under the economic accrual method taking into account all the unconditionally payable payments of principal, interest, and fees for a qualified guarantee to be paid on or after that date and using the yield on the bond as the discount rate, except that for purposes of §1.148–6(b)(2) (relating to the universal cap), these values may be determined by consistently using the yield on the issue of which the bonds are a part. To determine yield on fixed yield bonds, see paragraph (b)(1) of this section. The rules contained in paragraphs (b)(2) and (b)(3) of this section apply for this purpose. In the case of bonds described in paragraph (b)(2)(ii) of this section, the present value of those bonds on any date is computed using the yield to the final maturity date of those bonds as the discount rate. In determining the present value of a variable yield bond under this paragraph (e)(2), the initial interest rate on the bond established by the interest index or other interest rate setting mechanism is used to determine the interest payments on that bond.

(f) *Qualified guarantees*—(1) *In general.* Fees properly allocable to payments for a qualified guarantee for an issue (as determined under paragraph (f)(6) of this section) are treated as additional interest on that issue under section 148. A guarantee is a qualified guarantee if it satisfies each of the requirements of paragraphs (f)(2) through (f)(4) of this section.

(2) *Interest savings.* As of the date the guarantee is obtained, the issuer must reasonably expect that the present value of the fees for the guarantee will be less than the present value of the expected interest savings on the issue as a result of the guarantee. For this purpose, present value is computed using the yield on the issue, determined with regard to guarantee payments, as the discount rate.

(3) *Guarantee in substance.* The arrangement must create a guarantee in substance. The arrangement must impose a secondary liability that unconditionally shifts substantially all of the credit risk for all or part of the payments, such as payments for principal and interest, redemption prices, or tender prices, on the guaranteed bonds. Reasonable procedural or administrative requirements of the guarantee do not cause the guarantee to be conditional. In the case of a guarantee against failure to remarket a qualified tender bond, commercially reasonable limitations based on credit risk, such as limitations on payment in the event of default by the primary obligor or the bankruptcy of a long-term credit guarantor, do not cause the guarantee to be conditional. The guarantee may be in any form. The guarantor may not be a co-obligor. Thus, the guarantor must

not expect to make any payments other than under a direct-pay letter of credit or similar arrangement for which the guarantor will be reimbursed immediately. The guarantor and any related parties together must not use more than 10 percent of the proceeds of the portion of the issue allocable to the guaranteed bonds.

(4) *Reasonable charge*—(i) *In general.* Fees for a guarantee must not exceed a reasonable, arm's-length charge for the transfer of credit risk. In complying with this requirement, the issuer may not rely on the representations of the guarantor.

(ii) *Fees for services other than transfer of credit risk must be separately stated.* A fee for a guarantee must not include any payment for any direct or indirect services other than the transfer of credit risk, unless the compensation for those other services is separately stated, reasonable, and excluded from the guarantee fee. Fees for the transfer of credit risk include fees for the guarantor's overhead and other costs relating to the transfer of credit risk. For example, a fee includes payment for services other than transfer of credit risk if—

(A) It includes payment for the cost of underwriting or remarketing bonds or for the cost of insurance for casualty to bond-financed property;

(B) It is refundable upon redemption of the guaranteed bond before the final maturity date and the amount of the refund would exceed the portion of the fee that had not been earned; or

(C) The requirements of §1.148–2(e)(2) (relating to temporary periods for capital projects) are not satisfied, and the guarantor is not reasonably assured that the bonds will be repaid if the project to be financed is not completed.

(5) *Guarantee of purpose investments.* Except for guarantees of qualified mortgage loans and qualified student loans, a guarantee of payments on a purpose investment is a qualified guarantee of the issue if all payments on the purpose investment reasonably coincide with payments on the related bonds and the payments on the purpose investment are unconditionally payable no more than 6 months before the corresponding interest payment and 12 months before the corresponding principal payments on the bonds. This paragraph (f)(5) only applies if, in addition to satisfying the other requirements of this paragraph (f), the guarantee is, in substance, a guarantee of the bonds allocable to that purpose investment and to no other bonds except for bonds that are equally and ratably secured by purpose investments of the same conduit borrower.

(6) *Allocation of qualified guarantee payments*—(i) *In general.* Payments for a qualified guarantee must be allocated to bonds and to computation periods in a manner that properly reflects the proportionate credit risk for which the guarantor is compensated. Proportionate credit risk for bonds that are not substantially identical may be determined using any reasonable, consistently applied method. For example, this risk may be based on the ratio of the total principal and interest paid and to be paid on a guaranteed bond to the total principal and interest paid and to be paid on all bonds of the guaranteed issue. An allocation method generally is not reasonable, for example, if a substantial portion of the fee is allocated to the construction portion of the issue and a correspondingly insubstantial portion is allocated to the later years covered by the guarantee. Reasonable letter of credit *set up* fees may be allocated ratably during the initial term of the letter of credit. Upon an early redemption of a variable yield bond, fees otherwise allocable to the period after the redemption are allocated to remaining outstanding bonds of the issue or, if none remain outstanding, to the period before the redemption.

(ii) *Safe harbor for allocation of qualified guarantee fees for variable yield issues.* An allocation of non-level payments for a qualified guarantee for variable yield bonds is treated as meeting the requirements of paragraph (f)(6)(i) of this section if, for each bond year for which the guarantee is in effect, an equal amount (or for any short bond year, a proportionate amount of the equal amount) is treated as paid as of the beginning of that bond year. The present value of the annual amounts must equal the fee for the guarantee allocated to that bond, with present value computed as of the first day the guarantee is in effect by using as the discount rate the yield on the variable yield bonds covered by the guarantee, determined without regard to any fee allocated under this paragraph (f)(6)(ii).

(7) *Refund or reduction of guarantee payments.* If as a result of an investment of proceeds of a refunding issue in a refunding escrow, there will be a reduction in, or refund of, payments for a guarantee (*savings*), the savings must be treated as a reduction in the payments on the refunding issue.

(g) *Yield on certain mortgage revenue and student loan bonds.* For purposes of section 148 and this section, section 143(g)(2)(C)(ii) applies to the computation of yield on an issue of qualified mortgage bonds or qualified veterans' mortgage bonds. For purposes of applying section 148 and section 143(g) with respect to purpose investments allocable to a variable yield issue of qualified mortgage bonds, qualified veterans' mortgage bonds, or qualified student loan bonds that is reasonably expected as of the issue date to convert to a fixed yield issue, the yield may be computed over the term of the issue, and, if the yield is so computed, paragraph (d) of this section does not apply to the issue. As of any date, the yield over the term of the issue is based on—

(1) With respect to any bond of the issue that has not converted to a fixed and determinable yield on or before that date, the actual amounts paid or received to that date and the amounts that are reasonably expected (as of that date) to be paid or received with respect to that bond over the remaining term of the issue (taking into account prepayment assumptions under section 143(g)(2)(B)(iv), if applicable); and

(2) With respect to any bond of the issue that has converted to a fixed and determinable yield on or before that date, the actual amounts paid or received before that bond converted, if any, and the amount that was reasonably expected (on the date that bond converted) to be paid or received with respect to that bond over the remaining term of the issue (taking into account prepayment assumptions under section 143(g)(2)(B)(iv), if applicable).

(h) *Qualified hedging transactions*—(1) *In general.* Payments made or received by an issuer under a qualified hedge (as defined in paragraph (h)(2) of this section) relating to bonds of an issue are taken into account (as provided in paragraph (h)(3) of this section) to determine the yield on the issue. Except as provided in paragraphs (h)(4) and (h)(5)(ii)(E) of this section, the bonds to which a qualified hedge relates are treated as variable yield bonds from the issue date of the bonds. This paragraph (h) applies solely for purposes of sections 143(g), 148, and 149(d).

(2) *Qualified hedge defined.* Except as provided in paragraph (h)(5) of this section, the term *qualified hedge* means a contract that satisfies each of the following requirements:

(i) *Hedge*—(A) *In general.* The contract is entered into primarily to modify the issuer's risk of interest rate changes with respect to a bond (a hedge). For example, the contract may be an interest rate swap, an interest rate cap, a futures contract, a forward contract, or an option.

(B) *Special rule for fixed rate issues.* If the contract modifies the issuer's risk of interest rate changes with respect to a bond that is part of an issue that, absent the contract, would be a fixed rate issue, the contract must be entered into—

(*1*) No later than 15 days after the issue date (or the deemed issue date under paragraph (d) of this section) of the issue; or

(*2*) No later than the expiration of a qualified hedge with respect to bonds of that issue that satisfies paragraph (h)(2)(i)(B)(*1*) of this section; or

(*3*) No later than the expiration of a qualified hedge with respect to bonds of that issue that satisfies either paragraph (h)(2)(i)(B)(*2*) of this section or this paragraph (h)(2)(i)(B)(*3*).

(C) *Contracts with certain acquisition payments.* If a hedge provider makes a single payment to the issuer (e.g., a payment for an off-market swap) in connection with the acquisition of a contract, the issuer may treat a portion of that contract as a hedge provided—

(*1*) The hedge provider's payment to the issuer and the issuer's payments under the contract in excess of those that it would make if the contract bore rates equal to the on-market rates for the contract (determined as of the date the parties enter into the contract) are separately identified in a certification of the hedge provider; and

(*2*) The payments described in paragraph (h)(2)(i)(C)(*1*) of this section are not treated as payments on the hedge.

(ii) *No significant investment element*—(A) *In general.* The contract does not contain a significant investment element. Except as provided in paragraph (h)(2)(ii)(B) of this section, a contract contains a significant investment element if a significant portion of any payment by one party relates to a conditional or unconditional obligation by the other party to make a payment on a different date. Examples of contracts that contain a significant investment element are a debt instrument held by the issuer; an interest rate swap requiring any payments other than periodic payments, within the meaning of §1.446–3 (periodic payments) (e.g., a payment for an off-market swap or prepayment of part or all of one leg of a swap); and an interest rate cap requiring the issuer's premium for the cap to be paid in a single, up-front payment. Solely for purposes of determining if a hedge is a qualified hedge under this section, payments that an issuer receives pursuant to the terms of a hedge that are equal to the issuer's cost of funds are treated as periodic payments under §1.446–3 without regard to whether the payments are calculated by reference to a ''specified index'' described in §1.446–3(c)(2). Accordingly, a hedge does not have a significant investment element under this paragraph (h)(2)(ii)(A) solely because an issuer receives payments pursuant to the terms of a hedge that are computed to be equal to the issuer's cost of funds, such as the issuer's actual market-based tax-exempt variable interest rate on its bonds.

(B) *Special level payment rule for interest rate caps.* An interest rate cap does not contain a significant investment element if—

(*1*) All payments to the issuer by the hedge provider are periodic payments;

(*2*) The issuer makes payments for the cap at the same time as periodic payments by the hedge provider must be made if the specified index (within the meaning of §1.446–3) of the cap is above the strike price of the cap; and

(*3*) Each payment by the issuer bears the same ratio to the notional principal amount (within the meaning of §1.446–3) that is used to compute the hedge provider's payment, if any, on that date.

(iii) *Parties.* The contract is entered into between the issuer or the political subdivision on behalf of which the issuer issues the bonds (collectively referred to in this paragraph (h) as the *issuer*) and a provider that is not a related party (the *hedge provider*).

(iv) *Hedged bonds.* The contract covers, in whole or in part, all of one or more groups of substantially identical bonds in the issue (*i.e.*, all of the bonds having the same interest rate, maturity, and terms). Thus, for example, a qualified hedge may include a hedge of all or a pro rata portion of each interest payment on the variable rate bonds in an issue for the first 5 years following their issuance. For purposes of this paragraph (h), unless the context clearly requires otherwise, *hedged bonds* means the specific bonds or portions thereof covered by a hedge.

(v) *Interest-based contract and size and scope of hedge.* The contract is primarily interest-based (for example, a hedge based on a debt index, including a tax-exempt debt index or a taxable debt index, rather than an equity index). In addition, the size and scope of the hedge under the contract is limited to that which is reasonably necessary to hedge the issuer's risk with respect to interest rate changes on the hedged bonds. For example, a contract is limited to hedging an issuer's risk with respect to interest rate changes on the hedged bonds if the hedge is based on the principal amount and the reasonably expected interest payments of the hedged bonds. For anticipatory hedges under paragraph (h)(5) of this section, the size and scope limitation applies based on the reasonably expected terms of the hedged bonds to be issued. A contract is not primarily interest based unless—

(A) The hedged bond, without regard to the contract, is either a fixed rate bond, a variable rate debt instrument within the meaning of §1.1275–5 provided the rate is not based on an objective rate other than a qualified inverse floating rate or a qualified inflation rate, a tax-exempt obligation described in §1.1275–4(d)(2), or an inflation-indexed debt instrument within the meaning of §1.1275–7; and

(B) As a result of treating all payments on (and receipts from) the contract as additional payments on (and receipts from) the hedged bond, the resulting bond would be substantially similar to either a fixed rate bond, a variable rate debt instrument within the meaning of §1.1275–5 provided the rate is not based on an objective rate other than a qualified inverse floating rate or a qualified inflation rate, a tax-exempt obligation described in §1.1275–4(d)(2), or an inflation-indexed debt instrument within the meaning of §1.1275–7. For this purpose, differences that would not prevent the resulting bond from being substantially similar to another type of bond include: a difference between the interest rate used to compute payments on the hedged bond and the interest rate used to compute payments on the hedge where one interest rate is substantially similar to the other; the difference resulting from the payment of a fixed premium for a cap (for example, payments for a cap that are made in other than level installments); and the difference resulting from the allocation of a termination payment where the termination was not expected as of the date the contract was entered into.

(vi) *Payments closely correspond.* The payments received by the issuer from the hedge provider under the contract correspond closely in time to either the specific payments being hedged on the hedged bonds or specific payments required to be made pursuant to the bond documents, regardless of the hedge, to a sinking fund, debt service fund, or similar fund maintained for the issue of which the hedged bond is a part. For this purpose, such payments will be treated as corresponding closely in time under this paragraph (h)(2)(vi) if they are made within 90 calendar days of each other.

(vii) *Source of payments.* Payments to the hedge provider are reasonably expected to be made from the same source of funds that, absent the hedge, would be reasonably expected to be used to pay principal and interest on the hedged bonds.

(viii) *Identification*—(A) *In general.* The actual issuer must identify the contract on its books and records maintained for the hedged bonds not later than 15 calendar days after the date on which there is a binding agreement to enter into a hedge contract (for example, the date of a hedge pricing confirmation, as distinguished from the closing date for the hedge or start date for payments on the hedge, if different). The identification must specify the name of the hedge provider, the terms of the contract, the hedged bonds, and include a hedge provider's certification as described in paragraph (h)(2)(viii)(B) of this section. The identification must contain sufficient detail to establish that the requirements of this paragraph (h)(2) and, if applicable, paragraph (h)(4) of this section are satisfied. In addition, the existence of the hedge must be noted on the first form relating to the issue of which the hedged bonds are a part that is filed with the Internal Revenue Service on or after the date on which the contract is identified pursuant to this paragraph (h)(2)(viii).

(B) *Hedge provider's certification.* The hedge provider's certification must—

(*1*) Provide that the terms of the hedge were agreed to between a willing buyer and willing seller in a bona fide, arm's-length transaction;

(*2*) Provide that the hedge provider has not made, and does not expect to make, any payment to any third party for the benefit of the issuer in connection with the hedge, except for any such third-party payment that the hedge provider expressly identifies in the documents for the hedge;

(*3*) Provide that the amounts payable to the hedge provider pursuant to the hedge do not include any payments for underwriting or other services unrelated to the hedge provider's obligations under the hedge, except for any such payment that the hedge provider expressly identifies in the documents for the hedge; and

(*4*) Contain any other statements that the Commissioner may provide in guidance published in the Internal Revenue Bulletin. See §601.601(d)(2)(ii) of this chapter.

(3) *Accounting for qualified hedges*—(i) *In general.* Except as otherwise provided in paragraph (h)(4) of this section, payments made or received by the issuer under a qualified hedge are treated as payments made or received, as appropriate, on the hedged bonds that are taken into account in determining the yield on those bonds. These payments are reasonably allocated to the hedged bonds in the period to which the payments relate, as determined under paragraph (h)(3)(iii) of this section. Payments made or received by the issuer include payments deemed made or received when a contract is terminated or deemed terminated under this paragraph (h)(3). Payments reasonably allocable to the modification of risk of interest rate changes and to the hedge provider's overhead under this paragraph (h) are included as payments made or received under a qualified hedge.

(ii) *Exclusions from hedge.* If any payment for services or other items under the contract is not expressly treated by paragraph (h)(3)(i) of this section as a payment under the qualified hedge, the payment is not a payment with respect to a qualified hedge.

(iii) *Timing and allocation of payments.* Except as provided in paragraphs (h)(3)(iv) and (h)(5) of this section, payments made or received by the issuer under a qualified hedge are taken into account in the same period in which those amounts would be treated as income or deductions under §1.446–4 (without regard to §1.446–4(a)(2)(iv)) and are adjusted as necessary to reflect the end of a computation period and the start of a new computation period.

(iv) *Accounting for modifications and terminations*—(A) *Modification defined.* A modification of a qualified hedge includes, without limitation, a change in the terms of the hedge or an issuer's acquisition of another hedge with terms that have the effect of modifying an issuer's risk of interest rate changes or other terms of an existing qualified hedge. For example, if the issuer enters into a qualified hedge that is an interest rate swap under which it receives payments based on the Securities Industry and Financial Market Association (SIFMA) Municipal Swap Index and subsequently enters a second hedge (with the same or different provider) that limits the issuer's exposure under the existing qualified hedge to variations in the SIFMA Municipal Swap Index, the new hedge modifies the qualified hedge.

(B) *Termination defined.* A termination means either an actual termination or a deemed termination of a qualified hedge. Except as otherwise provided, an actual termination of a qualified hedge occurs to the extent that the issuer sells, disposes of, or otherwise actually terminates all or a portion of the hedge. A deemed termination of a qualified hedge occurs if the hedge ceases to meet the requirements for a qualified hedge; the issuer makes a modification (as defined in paragraph (h)(3)(iv)(A) of this section) that is material either in kind or in extent and, therefore, results in a deemed exchange of the hedge and a realization event to the issuer under section 1001; or the issuer redeems all or a portion of the hedged bonds.

(C) *Special rules for certain modifications when the hedge remains qualified.* A modification of a qualified hedge that otherwise would result in a deemed termination under paragraph (h)(3)(iv)(B) of this section does not result in such a termination if the modified hedge is retested for qualification as a qualified hedge as of the date of the modification, the modified hedge meets the requirements for a qualified hedge as of such date, and the modified hedge is treated as a qualified hedge prospectively in determining the yield on the hedged bonds. For purposes of this paragraph (h)(3)(iv)(C), when determining whether the modified hedge is qualified, the fact that the existing qualified hedge is off-market as of the date of the modification is disregarded and the identification requirement in paragraph (h)(2)(viii) of this section applies by measuring the time period for identification from the date of the modification and without regard to the requirement for a hedge provider's certification.

(D) *Continuations of certain qualified hedges in refundings.* If hedged bonds are redeemed using proceeds of a refunding issue, the qualified hedge for the refunded bonds is not actually terminated, and the hedge meets the requirements for a qualified hedge for the refunding bonds as of the issue date of the refunding bonds, then no termination of the hedge occurs and the hedge instead is treated as a qualified hedge for the refunding bonds. For purposes of this paragraph (h)(3)(iv)(D), when determining whether the hedge is a qualified hedge for the refunding bonds, the fact that the hedge is off-market with respect to the refunding bonds as of the issue date of the refunding bonds is disregarded and the identification requirement in paragraph (h)(2)(viii) of this section applies by measuring the time period for identification from the issue date of the refunding bonds and without regard to the requirement for a hedge provider's certification.

(E) *General allocation rules for hedge termination payments.* Except as otherwise provided in paragraphs (h)(3)(iv)(F), (G), and (H) of this section, a payment made or received by an issuer to terminate a qualified hedge, or a payment deemed made or received for a deemed termination, is treated as a payment made or received, as appropriate, on the hedged bonds. Upon an actual termination or a deemed termination of a qualified hedge, the amount that an issuer may treat as a termination payment made or received on the hedged bonds is the fair market value of the qualified hedge on its termination date, based on all of the facts and circumstances. Except as otherwise provided, a termination payment is reasonably allocated to the remaining periods originally covered by the terminated hedge in a manner that reflects the economic substance of the hedge.

(F) *Special rule for terminations when bonds are redeemed.* Except as otherwise provided in this paragraph (h)(3)(iv)(F) and in paragraph (h)(3)(iv)(G) of this section, when a qualified hedge is deemed terminated because the hedged bonds are redeemed, the termination payment as determined under paragraph (h)(3)(iv)(E) of this section is treated as made or received on that date. When hedged bonds are redeemed, any payment received by the issuer on termination of a hedge, including a termination payment or a deemed termination payment, reduces, but not below zero, the interest payments made by the issuer on the hedged bonds in the computation period ending on the termination date. The remainder of the payment, if any, is reasonably allocated over the bond years in the immediately preceding computation period or periods to the extent necessary to eliminate the excess.

(G) *Special rules for refundings.* When there is a termination of a qualified hedge because there is a refunding of the hedged bonds, to the extent that the hedged bonds are redeemed using the proceeds of a refunding issue, the termination payment is accounted for under paragraph (h)(3)(iv)(E) of this section by treating it as a payment on the refunding issue, rather than the hedged bonds. In addition, to the extent that the refunding issue is redeemed during the period to which the termination payment has been allocated to that issue, paragraph (h)(3)(iv)(F) of this section applies to the termination payment by treating it as a payment on the redeemed refunding issue.

(H) *Safe harbor for allocation of certain termination payments.* A payment to terminate a qualified hedge does not result in that hedge failing to satisfy the applicable provisions of paragraph (h)(3)(iv)(E) of this section if that payment is allocated in accordance with this paragraph (h)(3)(iv)(H). For an issue that is a variable yield issue after termination of a qualified hedge, an amount must be allocated to each date on which the hedge provider's payment, if any, would have been made had the hedge not been terminated. The amounts allocated to each date must bear the same ratio to the notional principal amount (within the meaning of §1.446–3) that would have been used to compute the hedge provider's payment, if any, on that date, and the sum of the present values of those amounts must equal the present value of the termination payment. Present value is computed as of the day the qualified hedge is terminated, using the yield on the hedged bonds, determined without regard to the termination payment. The yield used for this purpose is computed for the period beginning on the first date the qualified hedge is in effect and ending on the date the qualified hedge is terminated. On the other hand, for an issue that is a fixed yield issue after termination of a qualified hedge, the termination payment is taken into account as a single payment on the date it is paid.

(4) *Certain variable yield bonds treated as fixed yield bonds*—(i) *In general.* Except as otherwise provided in this paragraph (h)(4), if the issuer of variable yield bonds enters into a qualified hedge, the hedged bonds are treated as fixed yield bonds paying a fixed interest rate if:

(A) *Maturity.* The term of the hedge is equal to the entire period during which the hedged bonds bear interest at variable interest rates, and the issuer does not reasonably expect that the hedge will be terminated before the end of that period.

(B) *Payments closely correspond.* Payments to be received under the hedge correspond closely in time to the hedged portion of payments on the hedged bonds. Hedge payments received within 15 days of the related payments on the hedged bonds generally so correspond.

(C) *Aggregate payments fixed.* Taking into account all payments made and received under the hedge and all payments on the hedged bonds (*i.e.*, after netting all payments), the issuer's aggregate payments are fixed and determinable as of a date not later than 15 days after the issue date of the hedged bonds. Payments on bonds are treated as fixed for purposes of this paragraph (h)(4)(i)(C) if payments on the bonds are based, in whole or in part, on one interest rate, payments on the hedge are based, in whole or in part, on a second interest rate that is substantially the same as, but not identical to, the first interest rate and payments on the bonds would be fixed if the two rates were identical. Rates are treated as substantially the same if they are reasonably expected to be substantially the same throughout the term of the hedge. For example, an objective 30-day tax-exempt variable rate index or other objective index may be substantially the same as an issuer's individual 30-day interest rate. A hedge based on a taxable interest rate or taxable interest index cannot meet the requirements of this paragraph (h)(4)(i)(C) unless either—

(*1*) The hedge is an anticipatory hedge that is terminated or otherwise closed substantially contemporaneously with the issuance of the hedged bond in accordance with paragraph (h)(5)(ii) or (iii) of this section; or

(*2*) The issuer's payments on the hedged bonds and the hedge provider's payments on the hedge are based on identical interest rates.

(ii) *Accounting.* Except as otherwise provided in this paragraph (h)(4)(ii), in determining yield on the hedged bonds, all the issuer's payments on the hedged bonds and all payments made and received on a hedge described in paragraph (h)(4)(i) of this section are taken into account. If payments on the bonds and payments on the hedge are based, in whole or in part, on variable interest rates that are substantially the same within the meaning of paragraph (h)(4)(i)(C) of this section (but not identical), yield on the issue is determined by treating the variable interest rates as identical. For example, if variable rate bonds bearing interest at a weekly rate equal to the rate necessary to remarket the bonds at par are hedged with an interest rate swap under which the issuer receives payments based on a short-term floating rate index that is substantially the same as, but not identical to, the weekly rate on the bonds, the interest payments on the bonds are treated as equal to the payments received by the issuer under the swap for purposes of computing the yield on the bonds.

(iii) *Effect of termination*—(A) *In general.* Except as otherwise provided in this paragraph (h)(4)(iii) and paragraph (h)(5) of this section, the issue of which the hedged bonds are a part is treated as if it were reissued as of the termination date of the qualified hedge covered by paragraph (h)(4)(i) of this section in determining yield on the hedged bonds for purposes of §1.148–3. The redemption price of the retired issue and the issue price of the new issue equal the aggregate values of all the bonds of the issue on the termination date. In computing the yield on the new issue for this purpose, any termination payment is accounted for under paragraph (h)(3)(iv) of this section, applied by treating the termination payment as made or received on the new issue under this paragraph (h)(4)(iii).

(B) *Effect of early termination.* Except as otherwise provided in this paragraph (h)(4)(iii), the general rules of paragraph (h)(4)(i) of this section do not apply in determining the yield on the hedged bonds for purposes of §1.148–3 if the hedge is terminated or deemed terminated within 5 years after the issue date of the issue of which the hedged bonds are a part. Thus, the hedged bonds are treated as variable yield bonds for purposes of §1.148–3 from the issue date.

(C) *Certain terminations disregarded.* This paragraph (h)(4)(iii) does not apply to a termination if, based on the facts and circumstances (e.g., taking into account both the termination and any qualified hedge that immediately replaces the terminated hedge), there is no change in the yield.

(iv) *Consequences of certain modifications.* The special rules under paragraph (h)(4)(iii) of this section regarding the effects of termination of a qualified hedge of fixed yield hedged bonds apply to a modification described in paragraph (h)(3)(iv)(C) of this section. Thus, such a modification is treated as a termination for purposes of paragraph (h)(4)(iii) of this section unless the rule in paragraph (h)(4)(iii)(C) applies.

(5) *Contracts entered into before issue date of hedged bond*—(i) *In general.* A contract does not fail to be a hedge under paragraph (h)(2)(i) of this section solely because it is entered into before the issue date of the hedged bond. However, that contract must be one to which either paragraph (h)(5)(ii) or (h)(5)(iii) of this section applies.

(ii) *Contracts expected to be closed substantially contemporaneously with the issue date of hedged bond*—(A) *Application.* This paragraph (h)(5)(ii) applies to a contract if, on the date the contract is identified, the issuer reasonably expects to terminate or otherwise close (terminate) the contract substantially contemporaneously with the issue date of the hedged bond.

(B) *Contract terminated.* If a contract to which this paragraph (h)(5)(ii) applies is terminated substantially contemporaneously with the issue date of the hedged bond, the amount paid or received, or deemed to be paid or received, by the issuer in connection with the issuance of the hedged bond to terminate the contract is treated as an adjustment to the issue price of the hedged bond and as an adjustment to the sale proceeds of the hedged bond for purposes of section 148. Amounts paid or received, or deemed to be paid or received, before the issue date of the hedged bond are treated as paid or received on the issue date in an amount equal to the future value of the payment or receipt on that date. For this purpose, future value is computed using yield on the hedged bond without taking into account amounts paid or received (or deemed paid or received) on the contract.

(C) *Contract not terminated.* If a contract to which this paragraph (h)(5)(ii) applies is not terminated substantially contemporaneously with the issue date of the hedged bond, the contract is deemed terminated for its fair market value as of the issue date of the hedged bond. Once a contract has been deemed terminated pursuant to this paragraph (h)(5)(ii)(C), payments on and receipts from the contract are no longer taken into account under this paragraph (h) for purposes of determining yield on the hedged bond.

(D) *Relation to other requirements of a qualified hedge.* Payments made in connection with the issuance of a bond to terminate a contract to which this paragraph (h)(5)(ii) applies do not prevent the contract from satisfying the requirements of paragraph (h)(2)(vi) of this section.

(E) *Fixed yield treatment.* A bond that is hedged with a contract to which this paragraph (h)(5)(ii) applies does not fail to be a fixed yield bond if, taking into account payments on the contract and the payments to be made on the bond, the bond satisfies the definition of fixed yield bond. See also paragraph (h)(4) of this section.

(iii) *Contracts expected not to be closed substantially contemporaneously with the* *issue date of hedged bond*—(A) *Application.* This paragraph (h)(5)(iii) applies to a contract if, on the date the contract is identified, the issuer does not reasonably expect to terminate the contract substantially contemporaneously with the issue date of the hedge bond.

(B) *Contract terminated.* If a contract to which this paragraph (h)(5)(iii) applies is terminated in connection with the issuance of the hedged bond, the amount paid or received, or deemed to be paid or received, by the issuer to terminate the contract is treated as an adjustment to the issue price of the hedged bond and as an adjustment to the sale proceeds of the hedged bond for purposes of section 148.

(C) *Contract not terminated.* If a contract to which this paragraph (h)(5)(iii) applies is not terminated substantially contemporaneously with the issue date of the hedged bond, no payments with respect to the hedge made by the issuer before the issue date of the hedged bond are taken into account under this section.

(iv) *Identification.* The identification required under paragraph (h)(2)(viii) of this section must specify the reasonably expected governmental purpose, issue price, maturity, and issue date of the hedged bond, the manner in which interest is reasonably expected to be computed, and whether paragraph (h)(5)(ii) or (h)(5)(iii) of this section applies to the contract. If an issuer identifies a contract under this paragraph (h)(5)(iv) that would be a qualified hedge with respect to the anticipated bond, but does not issue the anticipated bond on the identified issue date, the contract is taken into account as a qualified hedge of any bond of the issuer that is issued for the identified governmental purpose within a reasonable interval around the identified issue date of the anticipated bond.

(6) *Authority of the Commissioner.* The Commissioner, by publication of a revenue ruling or revenue procedure (see §601.601(d)(2) of this chapter), may specify contracts that, although they do not meet the requirements of paragraph (h)(2) of this section, are qualified hedges or, although they do not meet the requirements of paragraph (h)(4) of this section, cause the hedged bonds to be treated as fixed yield bonds.

[T.D. 8476, 58 FR 33524, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24042, May 10, 1994; T.D. 8718, 62 FR 25507, May 9, 1997; T.D. 8838, 64 FR 48547, Sept. 7, 1999; T.D. 9777, 81 FR 46593, July 18, 2016; 83 FR 14175, Apr. 3, 2018]

§ 1.148–5 Yield and valuation of investments.

(a) *In general.* This section provides rules for computing the yield and value of investments allocated to an issue for various purposes under section 148.

(b) *Yield on an investment*—(1) *In general.* Except as otherwise provided, the yield on an investment allocated to an issue is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue. The yield on an investment allocated to an issue is the discount rate that, when used in computing the present value as of the date the investment is first allocated to the issue of all unconditionally payable receipts from the investment, produces an amount equal to the present value of all unconditionally payable payments for the investment. For this purpose, *payments* means amounts to be actually or constructively paid to acquire the investment, and *receipts* means amounts to be actually or constructively received from the investment, such as earnings and return of principal. The yield on a variable rate investment is determined in a manner comparable to the determination of the yield on a variable rate issue. For an issue of qualified mortgage bonds, qualified veterans' mortgage bonds, or qualified student loan bonds on which interest is paid semiannually, all regular monthly loan payments to be received during a semiannual debt service period may be treated as received at the end of that period. In addition, for any conduit financing issue, payments made by the conduit borrower are not treated as paid until the conduit borrower ceases to receive the benefit of earnings on those amounts.

(2) *Yield on a separate class of investments*—(i) *In general.* For purposes of the yield restriction rules of section 148(a) and §1.148–2, yield is computed

separately for each class of investments. For this purpose, in determining the yield on a separate class of investments, the yield on each individual investment within the class is blended with the yield on other individual investments within the class, whether or not held concurrently, by treating those investments as a single investment. The yields on investments that are not within the same class are not blended.

(ii) *Separate classes of investments*. Each of the following is a separate class of investments—

(A) Each category of yield restricted purpose investment and program investment that is subject to a different definition of *materially higher* under § 1.148–2(d)(2);

(B) Yield-restricted nonpurpose investments; and

(C) All other nonpurpose investments;

(iii) *Permissive application of single investment rules to certain yield restricted investments for all purposes of section 148*. For all purposes of section 148, if an issuer reasonably expects as of the issue date to establish and maintain a sinking fund solely to reduce the yield on the investments in a refunding escrow, then the issuer may treat all of the yield restricted nonpurpose investments in the refunding escrow and that sinking fund as a single investment having a single yield, determined under this paragraph (b)(2). Thus, an issuer may not treat the nonpurpose investments in a reasonably required reserve fund and a refunding escrow as a single investment having a single yield under this paragraph (b)(2)(iii).

(iv) *Mandatory application of single investment rules for refunding escrows for all purposes of section 148*. For all purposes of section 148, in computing the yield on yield restricted investments allocable to proceeds (*i.e.*, sale proceeds, investment proceeds, and transferred proceeds) of a refunding issue that are held in one or more refunding escrows, the individual investments are treated as a single investment having a single yield, whether or not held concurrently. For example, this single investment includes both the individual investments allocable to sale and investment proceeds of a refunding issue that are held in one refunding escrow for a prior issue and the investments allocable to transferred proceeds of that refunding issue that are held in another refunding escrow.

(3) *Investments to be held beyond issue's maturity or beyond temporary period*. In computing the yield on investments allocable to an issue that are to be held beyond the reasonably expected redemption date of the issue, those investments are treated as sold for an amount equal to their value on that date. In computing the yield on investments that are held beyond an applicable temporary period under § 1.148–2, for purposes of § 1.148–2 those investments may be treated as purchased for an amount equal to their fair market value as of the end of the temporary period.

(4) *Consistent redemption assumptions on purpose investments*. The yield on purpose investments allocable to an issue is computed using the same redemption assumptions used to compute the yield on the issue. Yield on purpose investments allocable to an issue of qualified mortgage bonds and qualified veterans' mortgage bonds must be determined in a manner that is consistent with, and using the assumptions required by, section 143(g)(2)(B).

(5) *Student loan special allowance payments included in yield*. Except as provided in § 1.148–11(e), the yield on qualified student loans is computed by including as receipts any special allowance payments made by the Secretary of Education pursuant to section 438 of the Higher Education Act of 1965.

(c) *Yield reduction payments to the United States*—(1) *In general*. In determining the yield on an investment to which this paragraph (c) applies, any amount paid to the United States in accordance with this paragraph (c), including a rebate amount, is treated as a payment for that investment that reduces the yield on that investment.

(2) *Manner of payment*—(i) *In general*. Except as otherwise provided in paragraph (c)(2)(ii) of this section, an amount is paid under this paragraph (c) if it is paid to the United States at the same time and in the same manner as rebate amounts are required to be paid

or at such other time or in such manner as the Commissioner may prescribe. For example, yield reduction payments must be made on or before the date of required rebate installment payments as described in §§1.148–3(f), (g), and (h). The provisions of §1.148–3(i) apply to payments made under this paragraph (c).

(ii) *Special rule for purpose investments.* For purpose investments allocable to an issue—

(A) No amounts are required to be paid to satisfy this paragraph (c) until the earlier of the end of the tenth bond year after the issue date of the issue or 60 days after the date on which the issue is no longer outstanding; and

(B) For payments made prior to the date on which the issue is retired, the issuer need not pay more than 75 percent of the amount otherwise required to be paid as of the date to which the payment relates.

(3) *Applicability of special yield reduction rule.* Paragraph (c) applies only to investments that are described in at least one of paragraphs (c)(3)(i) through (ix) of this section and, except as otherwise expressly provided in paragraphs (c)(3)(i) through (ix) of this section, that are allocated to proceeds of an issue other than gross proceeds of an advance refunding issue.

(i) *Nonpurpose investments allocated to proceeds of an issue that qualified for certain temporary periods.* Nonpurpose investments allocable to proceeds of an issue that qualified for one of the temporary periods available for capital projects, working capital expenditures, pooled financings, or investment proceeds under §1.148–2(e)(2), (3), (4), or (6), respectively.

(ii) *Investments allocable to certain variable yield issues.* Investments allocable to a variable yield issue during any computation period in which at least 5 percent of the value of the issue is represented by variable yield bonds, unless the issue is an issue of hedge bonds (as defined in section 149(g)(3)(A)).

(iii) *Nonpurpose investments allocable to certain transferred proceeds.* Nonpurpose investments allocable to transferred proceeds of—

(A) A current refunding issue to the extent necessary to reduce the yield on those investments to satisfy yield restrictions under section 148(a); or

(B) An advance refunding issue to the extent that investment of the refunding escrows allocable to the proceeds, other than transferred proceeds, of the refunding issue in zero-yielding nonpurpose investments is insufficient to satisfy yield restrictions under section 148(a).

(iv) *Purpose investments allocable to qualified student loans and qualified mortgage loans.* Purpose investments allocable to qualified student loans and qualified mortgage loans.

(v) *Nonpurpose investments allocable to gross proceeds in certain reserve funds.* Nonpurpose investments allocable to gross proceeds of an issue in a reasonably required reserve or replacement fund or a fund that, except for its failure to satisfy the size limitation in §1.148–2(f)(2)(ii), would qualify as a reasonably required reserve or replacement fund, but only to the extent the requirements in paragraphs (c)(3)(v)(A) or (B) of this section are met. This paragraph (c)(3)(v) includes nonpurpose investments described in this paragraph that are allocable to transferred proceeds of an advance refunding issue, but only to the extent necessary to satisfy yield restriction under section 148(a) on those proceeds treating all investments allocable to those proceeds as a separate class.

(A) The value of the nonpurpose investments in the fund is not greater than 15 percent of the stated principal amount of the issue, as computed under §1.148–2(f)(2)(ii).

(B) The amounts in the fund (other than investment earnings) are not reasonably expected to be used to pay debt service on the issue other than in connection with reductions in the amount required to be in that fund (for example, a reserve fund for a revolving fund loan program).

(vi) *Nonpurpose investments allocable to certain replacement proceeds of refunded issues.* Nonpurpose investments allocated to replacement proceeds of a refunded issue, including a refunded issue that is an advance refunding issue, as a result of the application of the universal cap to amounts in a refunding escrow.

(vii) *Investments allocable to replacement proceeds under a certain transition rule*. Investments described in §1.148–11(f).

(viii) *Nonpurpose investments allocable to proceeds when State and Local Government Series Securities are unavailable*. Nonpurpose investments allocable to proceeds of an issue, including an advance refunding issue, that an issuer purchases if, on the date the issuer enters into the agreement to purchase such investments, the issuer is unable to subscribe for State and Local Government Series Securities because the U.S. Department of the Treasury, Bureau of the Fiscal Service, has suspended sales of those securities.

(ix) *Nonpurpose investments allocable to proceeds of certain variable yield advance refunding issues*. Nonpurpose investments allocable to proceeds of the portion of a variable yield issue used for advance refunding purposes that are deposited in a yield restricted defeasance escrow if—

(A) The issuer has entered into a qualified hedge under §1.148–4(h)(2) with respect to all of the variable yield bonds of the issue allocable to the yield restricted defeasance escrow and that hedge is in the form of a variable-to-fixed interest rate swap under which the issuer pays the hedge provider a fixed interest rate and receives from the hedge provider a floating interest rate;

(B) Such qualified hedge covers a period beginning on the issue date of the hedged bonds and ending on or after the date on which the final payment is to be made from the yield restricted defeasance escrow; and

(C) The issuer restricts the yield on the yield restricted defeasance escrow to a yield that is not greater than the yield on the issue, determined by taking into account the issuer's fixed payments to be made under the hedge and by assuming that the issuer's variable yield payments to be paid on the hedged bonds are equal to the floating payments to be received by the issuer under the qualified hedge and are paid on the same dates (that is, such yield reduction payments can only be made to address basis risk differences between the variable yield payments on the hedged bonds and the floating payments received on the hedge).

(d) *Value of investments*—(1) *In general*. Except as otherwise provided, the value of an investment (including a payment or receipt on the investment) on a date must be determined using one of the following valuation methods consistently for all purposes of section 148 to that investment on that date:

(i) *Plain par investment—outstanding principal amount*. A plain par investment may be valued at its outstanding stated principal amount, plus any accrued unpaid interest on that date.

(ii) *Fixed rate investment—present value*. A fixed rate investment may be valued at its present value on that date.

(iii) *Any investment—fair market value*. An investment may be valued at its fair market value on that date.

(2) *Mandatory valuation of certain yield restricted investments at present value*. A purpose investment must be valued at present value, and except as otherwise provided in paragraphs (b)(3) and (d)(3) of this section, a yield restricted nonpurpose investment must be valued at present value.

(3) *Mandatory valuation of certain investments at fair market value*—(i) *In general*. Except as otherwise provided in paragraphs (d)(3)(ii) and (d)(4) of this section, a nonpurpose investment must be valued at fair market value on the date that it is first allocated to an issue or first ceases to be allocated to an issue as a consequence of a deemed acquisition or deemed disposition. For example, if an issuer deposits existing nonpurpose investments into a sinking fund for an issue, those investments must be valued at fair market value as of the date first deposited into the fund.

(ii) *Exception to fair market value requirement for transferred proceeds allocations, certain universal cap allocations, and commingled funds*. Paragraph (d)(3)(i) of this section does not apply if the investment is allocated from one issue to another as a result of the transferred proceeds allocation rule under §1.148–9(b) or is deallocated from one issue as a result of the universal cap rule under §1.148–6(b)(2) and reallocated to another issue as a result of a preexisting pledge of the investment to secure that other issue, provided that, in either circumstance (that is, transferred proceeds allocations or universal cap deallocations), the issue from which the investment is allocated (that is, the first issue in an allocation from one issue to another issue) consists of tax-exempt bonds. In addition, paragraph (d)(3)(i) of this section does not apply to investments in a commingled fund (other than a bona fide debt service fund) unless it is an investment being initially deposited in or withdrawn from a commingled fund described in §1.148–6(e)(5)(iii).

(4) *Special transition rule for transferred proceeds.* The value of a nonpurpose investment that is allocated to transferred proceeds of a refunding issue on a transfer date may not exceed the value of that investment on the transfer date used for purposes of applying the arbitrage restrictions to the refunded issue.

(5) *Definition of present value of an investment.* Except as otherwise provided, present value of an investment is computed under the economic accrual method, using the same compounding interval and financial conventions used to compute the yield on the issue. The present value of an investment on a date is equal to the present value of all unconditionally payable receipts to be received from and payments to be paid for the investment after that date, using the yield on the investment as the discount rate.

(6) *Definition of fair market value*—(i) *In general.* The fair market value of an investment is the price at which a willing buyer would purchase the investment from a willing seller in a bona fide, arm's-length transaction. Fair market value generally is determined on the date on which a contract to purchase or sell the nonpurpose investment becomes binding (*i.e.*, the trade date rather than the settlement date). Except as otherwise provided in this paragraph (d)(6), an investment that is not of a type traded on an established securities market, within the meaning of section 1273, is rebuttably presumed to be acquired or disposed of for a price that is not equal to its fair market value. On the purchase date, the fair market value of a United States Treasury obligation that is purchased directly from the United States Treasury, including a State and Local Government Series Security, is its purchase price. The fair market value of a State and Local Government Series Security on any date other than the purchase date is the redemption price for redemption on that date.

(ii) *Safe harbor for establishing fair market value for certificates of deposit.* This paragraph (d)(6)(ii) applies to a certificate of deposit that has a fixed interest rate, a fixed payment schedule, and a substantial penalty for early withdrawal. The purchase price of such a certificate of deposit is treated as its fair market value on the purchase date if the yield on the certificate of deposit is not less than—

(A) The yield on reasonably comparable direct obligations of the United States; and

(B) The highest yield that is published or posted by the provider to be currently available from the provider on reasonably comparable certificates of deposit offered to the public.

(iii) *Safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.* The purchase price of a guaranteed investment contract and the purchase price of an investment purchased for a yield restricted defeasance escrow will be treated as the fair market value of the investment on the purchase date if all of the following requirements are satisfied:

(A) The issuer makes a bona fide solicitation for the purchase of the investment. A bona fide solicitation is a solicitation that satisfies all of the following requirements:

(*1*) The bid specifications are in writing and are timely disseminated to potential providers. For purposes of this paragraph (d)(6)(iii)(A)(*1*), a writing may be in electronic form and may be disseminated by fax, email, an internet-based Web site, or other electronic medium that is similar to an internet-based Web site and regularly used to post bid specifications.

(*2*) The bid specifications include all material terms of the bid. A term is material if it may directly or indirectly affect the yield or the cost of the investment.

(*3*) The bid specifications include a statement notifying potential providers that submission of a bid is a representation that the potential provider did not consult with any other potential provider about its bid, that the bid was determined without regard to any other formal or informal agreement that the potential provider has with the issuer or any other person (whether or not in connection with the bond issue), and that the bid is not being submitted solely as a courtesy to the issuer or any other person for purposes of satisfying the requirements of paragraph (d)(6)(iii)(B)(*1*) or (*2*) of this section.

(*4*) The terms of the bid specifications are commercially reasonable. A term is commercially reasonable if there is a legitimate business purpose for the term other than to increase the purchase price or reduce the yield of the investment. For example, for solicitations of investments for a yield restricted defeasance escrow, the hold firm period must be no longer than the issuer reasonably requires.

(*5*) For purchases of guaranteed investment contracts only, the terms of the solicitation take into account the issuer's reasonably expected deposit and drawdown schedule for the amounts to be invested.

(*6*) All potential providers have an equal opportunity to bid. If the bidding process affords any opportunity for a potential provider to review other bids before providing a bid, then providers have an equal opportunity to bid only if all potential providers have an equal opportunity to review other bids. Thus, no potential provider may be given an opportunity to review other bids that is not equally given to all potential providers (that is, no exclusive ''last look'').

(*7*) At least three reasonably competitive providers are solicited for bids. A reasonably competitive provider is a provider that has an established industry reputation as a competitive provider of the type of investments being purchased.

(B) The bids received by the issuer meet all of the following requirements:

(*1*) The issuer receives at least three bids from providers that the issuer solicited under a bona fide solicitation meeting the requirements of paragraph (d)(6)(iii)(A) of this section and that do not have a material financial interest in the issue. A lead underwriter in a negotiated underwriting transaction is deemed to have a material financial interest in the issue until 15 days after the issue date of the issue. In addition, any entity acting as a financial advisor with respect to the purchase of the investment at the time the bid specifications are forwarded to potential providers has a material financial interest in the issue. A provider that is a related party to a provider that has a material financial interest in the issue is deemed to have a material financial interest in the issue.

(*2*) At least one of the three bids described in paragraph (d)(6)(iii)(B)(*1*) of this section is from a reasonably competitive provider, within the meaning of paragraph (d)(6)(iii)(A)(*7*) of this section.

(*3*) If the issuer uses an agent to conduct the bidding process, the agent did not bid to provide the investment.

(C) The winning bid meets the following requirements:

(*1*) *Guaranteed investment contracts.* If the investment is a guaranteed investment contract, the winning bid is the highest yielding bona fide bid (determined net of any broker's fees).

(*2*) *Other investments.* If the investment is not a guaranteed investment contract, the following requirements are met:

(*i*) The winning bid is the lowest cost bona fide bid (including any broker's fees). The lowest cost bid is either the lowest cost bid for the portfolio or, if the issuer compares the bids on an investment-by-investment basis, the aggregate cost of a portfolio comprised of the lowest cost bid for each investment. Any payment received by the issuer from a provider at the time a guaranteed investment contract is purchased (e.g., an escrow float contract) for a yield restricted defeasance escrow under a bidding procedure meeting the requirements of this paragraph (d)(6)(iii) is taken into account in determining the lowest cost bid.

(*ii*) The lowest cost bona fide bid (including any broker's fees) is not greater than the cost of the most efficient portfolio comprised exclusively of

State and Local Government Series Securities from the United States Department of the Treasury, Bureau of Public Debt. The cost of the most efficient portfolio of State and Local Government Series Securities is to be determined at the time that bids are required to be submitted pursuant to the terms of the bid specifications.

(*iii*) If State and Local Government Series Securities from the United States Department of the Treasury, Bureau of Public Debt are not available for purchase on the day that bids are required to be submitted pursuant to terms of the bid specifications because sales of those securities have been suspended, the cost comparison of paragraph (d)(6)(iii) (C)(*2*)(*ii*) of this section is not required.

(D) The provider of the investments or the obligor on the guaranteed investment contract certifies the administrative costs that it pays (or expects to pay, if any) to third parties in connection with supplying the investment.

(E) The issuer retains the following records with the bond documents until three years after the last outstanding bond is redeemed:

(*1*) For purchases of guaranteed investment contracts, a copy of the contract, and for purchases of investments other than guaranteed investment contracts, the purchase agreement or confirmation.

(*2*) The receipt or other record of the amount actually paid by the issuer for the investments, including a record of any administrative costs paid by the issuer, and the certification under paragraph (d)(6)(iii)(D) of this section.

(*3*) For each bid that is submitted, the name of the person and entity submitting the bid, the time and date of the bid, and the bid results.

(*4*) The bid solicitation form and, if the terms of the purchase agreement or the guaranteed investment contract deviated from the bid solicitation form or a submitted bid is modified, a brief statement explaining the deviation and stating the purpose for the deviation. For example, if the issuer purchases a portfolio of investments for a yield restricted defeasance escrow and, in order to satisfy the yield restriction requirements of section 148, an investment in the winning bid is replaced with an investment with a lower yield, the issuer must retain a record of the substitution and how the price of the substitute investment was determined. If the issuer replaces an investment in the winning bid portfolio with another investment, the purchase price of the new investment is not covered by the safe harbor unless the investment is bid under a bidding procedure meeting the requirements of this paragraph (d)(6)(iii).

(*5*) For purchases of investments other than guaranteed investment contracts, the cost of the most efficient portfolio of State and Local Government Series Securities, determined at the time that the bids were required to be submitted pursuant to the terms of the bid specifications.

(e) *Administrative costs of investments*—(1) *In general*. Except as otherwise provided in this paragraph (e), an allocation of gross proceeds of an issue to a payment or a receipt on an investment is not adjusted to take into account any costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment (administrative costs). Thus, these administrative costs generally do not increase the payments for, or reduce the receipts from, investments.

(2) *Qualified administrative costs on nonpurpose investments*—(i) *In general*. In determining payments and receipts on nonpurpose investments, qualified administrative costs are taken into account. Thus, qualified administrative costs increase the payments for, or decrease the receipts from, the investments. Qualified administrative costs are reasonable, direct administrative costs, other than carrying costs, such as separately stated brokerage or selling commissions, but not legal and accounting fees, recordkeeping, custody, and similar costs. General overhead costs and similar indirect costs of the issuer such as employee salaries and office expenses and costs associated with computing the rebate amount under section 148(f) are not qualified administrative costs. In general, administrative costs are not reasonable unless they are comparable to administrative costs that would be charged for the same investment or a reasonably comparable investment if acquired with a

source of funds other than gross proceeds of tax-exempt bonds.

(ii) *Special rule for administrative costs of nonpurpose investments in certain regulated investment companies and commingled funds.* Qualified administrative costs include all reasonable administrative costs, without regard to the limitation on indirect costs under paragraph (e)(2)(i) of this section, incurred by:

(A) *Regulated investment companies.* A publicly offered regulated investment company (as defined in section 67(c)(2)(B)); and

(B) *External commingled funds.* A widely held commingled fund in which no investor in the fund owns more than 10 percent of the beneficial interest in the fund. For purposes of this paragraph (e)(2)(ii)(B), a fund is treated as widely held only if, during the immediately preceding fixed, semiannual period chosen by the fund (for example, semiannual periods ending June 30 and December 31), the fund had a daily average of more than 15 investors that were not related parties, and at least 16 of the unrelated investors each maintained a daily average amount invested in the fund that was not less than the lesser of $500,000 and one percent (1%) of the daily average of the total amount invested in the fund (with it being understood that additional smaller investors will not disqualify the fund). For purposes of this paragraph (e)(2)(ii)(B), an investor will be treated as owning not more than 10 percent of the beneficial interest in the fund if, on the date of each deposit by the investor into the fund, the total amount the investor and any related parties have on deposit in the fund is not more than 10 percent of the total amount that all investors have on deposit in the fund. For purposes of the preceding sentence, the total amount that all investors have on deposit in the fund is equal to the sum of all deposits made by the investor and any related parties on the date of those deposits and the closing balance in the fund on the day before those deposits. If any investor in the fund owns more than 10 percent of the beneficial interest in the fund, the fund does not qualify under this paragraph (e)(2)(ii)(B) until that investor makes sufficient withdrawals from the fund to reduce its beneficial interest in the fund to 10 percent or less.

(iii) *Special rule for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow*—(A) *In general.* An amount paid for a broker's commission or similar fee with respect to a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow is a qualified administrative cost if the fee is reasonable within the meaning of paragraph (e)(2)(i) of this section.

(B) *Safe harbor*—(*1*) *In general.* A broker's commission or similar fee with respect to the acquisition of a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow is reasonable within the meaning of paragraph (e)(2)(i) of this section to the extent that—

(*i*) The amount of the fee that the issuer treats as a qualified administrative cost does not exceed the lesser of:

(*A*) $30,000 and

(*B*) 0.2% of the computational base or, if more, $3,000; and

(*ii*) For any issue, the issuer does not treat as qualified administrative costs more than $85,000 in brokers' commissions or similar fees with respect to all guaranteed investment contracts and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue.

(*2*) *Computational base.* For purposes of paragraph (e)(2)(iii)(B)(*1*) of this section, computational base shall mean—

(*i*) For a guaranteed investment contract, the amount of gross proceeds the issuer reasonably expects, as of the date the contract is acquired, to be deposited in the guaranteed investment contract over the term of the contract, and

(*ii*) For investments (other than guaranteed investment contracts) to be deposited in a yield restricted defeasance escrow, the amount of gross proceeds initially invested in those investments.

(*3*) *Cost-of-living adjustment.* In the case of a calendar year after 2004, each of the dollar amounts in paragraph (e)(2)(iii)(B)(*1*) of this section shall be increased by an amount equal to—

(*i*) Such dollar amount; multiplied by

(*ii*) The cost-of-living adjustment determined under section 1(f)(3) for such calendar year by using the language ''calendar year 2003'' instead of ''calendar year 1992'' in section 1(f)(3)(B).

(*4*) *Rounding.* If any increase determined under paragraph (e)(2)(iii)(B)(*3*) of this section is not a multiple of $1,000, such increase shall be rounded to the nearest multiple thereof.

(*5*) *Applicable year for cost-of-living adjustment.* The cost-of-living adjustments under paragraph (e)(2)(iii)(B)(*3*) of this section shall apply to the safe harbor amounts under paragraph (e)(2)(iii)(B)(*1*) of this section based on the year the guaranteed investment contract or the investments for the yield restricted defeasance escrow, as applicable, are acquired.

(*6*) *Cost-of-living adjustment to determine remaining amount of per-issue safe harbor*—(i) *In general.* This paragraph (e)(2)(iii)(B)(*6*) applies to determine the portion of the safe harbor amount under paragraph (e)(2)(iii)(B)(1)(*ii*) of this section, as modified by paragraph (e)(2)(iii)(B)(*3*) of this section (the per-issue safe harbor), that is available (the remaining amount) for any year (the determination year) if the per-issue safe harbor was partially used in one or more prior years.

(*ii*) *Remaining amount of per-issue safe harbor.* The remaining amount of the per-issue safe harbor for any determination year is equal to the per-issue safe harbor for that year, reduced by the portion of the per-issue safe harbor used in one or more prior years.

(*iii*) *Portion of per-issue safe harbor used in prior years.* The portion of the per-issue safe harbor used in any prior year (the prior year) is equal to the total amount of broker's commissions or similar fees paid in connection with guaranteed investment contracts or investments for a yield restricted defeasance escrow acquired in the prior year that the issuer treated as qualified administrative costs for the issue, multiplied by a fraction the numerator of which is the per-issue safe harbor for the determination year and the denominator of which is the per-issue safe harbor for the prior year. See paragraph (e)(2)(iii)(C) *Example 2* of this section.

(C) *Examples.* The following examples illustrate the application of the safe harbor in paragraph (e)(2)(iii)(B) of this section:

Example 1. Multipurpose issue. In 2003, the issuer of a multipurpose issue uses brokers to acquire the following investments with gross proceeds of the issue: a guaranteed investment contract for amounts to be deposited in a construction fund (construction GIC), Treasury securities to be deposited in a yield restricted defeasance escrow (Treasury investments) and a guaranteed investment contract that will be used to earn a return on what otherwise would be idle cash balances from maturing investments in the yield restricted defeasance escrow (the float GIC). The issuer deposits $22,000,000 into the construction GIC and reasonably expects that no further deposits will be made over its term. The issuer uses $8,040,000 of the proceeds to purchase the Treasury investments. The issuer reasonably expects that it will make aggregate deposits of $600,000 to the float GIC over its term. The brokers' fees are $30,000 for the construction GIC, $16,080 for the Treasury investments and $3,000 for the float GIC. The issuer has not previously treated any brokers' commissions or similar fees as qualified administrative costs. The issuer may claim all $49,080 in brokers' fees for these investments as qualified administrative costs because the fees do not exceed the safe harbors in paragraph (e)(2)(iii)(B) of this section. Specifically, each of the brokers' fees equals the lesser of $30,000 and 0.2% of the computational base (or, if more, $3,000) (*i.e.*, lesser of $30,000 and 0.2% × $22,000,000 for the construction GIC; lesser of $30,000 and 0.2% × $8,040,000 for the Treasury investments; and lesser of $30,000 and $3,000 for the float GIC). In addition, the total amount of brokers' fees claimed by the issuer as qualified administrative costs ($49,080) does not exceed the per-issue safe harbor of $85,000.

Example 2. Cost-of-living adjustment. In 2003, an issuer issues bonds and uses gross proceeds of the issue to acquire two guaranteed investment contracts. The issuer pays a total of $50,000 in brokers' fees for the two guaranteed investment contracts and treats these fees as qualified administrative costs. In a year subsequent to 2003 (Year Y), the issuer uses gross proceeds of the issue to acquire two additional guaranteed investment contracts, paying a total of $20,000 in broker's fees for the two guaranteed investment contracts, and treats those fees as qualified administrative costs. For Year Y, applying the cost-of-living adjustment under paragraph (e)(2)(iii)(B)(*3*) of this section, the safe harbor dollar limits under paragraph (e)(2)(iii)(B)(*1*) of this section are $3,000, $32,000 and $90,000. The remaining amount of the per-issue safe harbor for Year Y is $37,059

($90,000–[$50,000 × $90,000/$85,000]). The broker's fees in Year Y do not exceed the per-issue safe harbor under paragraph (e)(2)(iii)(B)(*1*)(*ii*) (as modified by paragraph (e)(2)(iii)(B)(*3*)) of this section because the broker's fees do not exceed the remaining amount of the per-issue safe harbor determined under paragraph (e)(2)(iii)(B)(*6*) of this section for Year Y. In a year subsequent to Year Y (Year Z), the issuer uses gross proceeds of the issue to acquire an additional guaranteed investment contract, pays a broker's fee of $15,000 for the guaranteed investment contract, and treats the broker's fee as a qualified administrative cost. For Year Z, applying the cost-of-living adjustment under paragraph (e)(2)(iii)(B)(*3*) of this section, the safe harbor dollar limits under paragraph (e)(2)(iii)(B)(*1*) of this section are $3,000, $33,000 and $93,000. The remaining amount of the per-issue safe harbor for Year Z is $17,627 ($93,000—[($50,000 × $93,000/$85,000) + ($20,000 × $93,000/$90,000)]). The broker's fee incurred in Year Z does not exceed the per-issue safe harbor under paragraph (e)(2)(iii)(B)(*1*)(*ii*) (as modified by paragraph (e)(2)(iii)(B)(*3*)) of this section because the broker's fee does not exceed the remaining amount of the per-issue safe harbor determined under paragraph (e)(2)(iii)(B)(*6*) of this section for Year Z. See paragraph (e)(2)(iii)(B)(*6*) of this section.

(3) *Qualified administrative costs on purpose investments*—(i) *In general*. In determining payments and receipts on purpose investments, qualified administrative costs described in this paragraph (e)(3) paid by the conduit borrower are taken into account. Thus, these costs increase the payments for, or decrease the receipts from, the purpose investments. This rule applies even if those payments merely reimburse the issuer. Although the actual payments by the conduit borrower may be made at any time, for this purpose, a pro rata portion of each payment made by a conduit borrower is treated as a reimbursement of reasonable administrative costs, if the present value of those payments does not exceed the present value of the reasonable administrative costs paid by the issuer, using the yield on the issue as the discount rate.

(ii) *Definition of qualified administrative costs of purpose investments*—(A) *In general*. Except as otherwise provided in this paragraph (e)(3)(ii), qualified administrative costs of a purpose investment means—

(*1*) Costs or expenses paid, directly or indirectly, to purchase, carry, sell, or retire the investment; and

(*2*) Costs of issuing, carrying, or repaying the issue, and any underwriters' discount.

(B) *Limitation on program investments*. For a program investment, qualified administrative costs include only those costs described in paragraph (e)(3)(ii)(A)(*2*) of this section.

[T.D. 8476, 58 FR 33529, June 18, 1993; 58 FR 44452, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24044, May 10, 1994; T.D. 8718, 62 FR 25511, May 9, 1997; T.D. 8801, 63 FR 71751, Dec. 30, 1998; T.D. 9097, 68 FR 69022, Dec. 11, 2003; T.D. 9777, 81 FR 46595, July 17, 2016]

§ 1.148–6 General allocation and accounting rules.

(a) *In general*—(1) *Reasonable accounting methods required*. An issuer may use any reasonable, consistently applied accounting method to account for gross proceeds, investments, and expenditures of an issue.

(2) *Bona fide deviations from accounting method*. An accounting method does not fail to be reasonable and consistently applied solely because a different accounting method is used for a bona fide governmental purpose to consistently account for a particular item. Bona fide governmental purposes may include special State law restrictions imposed on specific funds or actions to avoid grant forfeitures.

(3) *Absence of allocation and accounting methods*. If an issuer fails to maintain books and records sufficient to establish the accounting method for an issue and the allocation of the proceeds of that issue, the rules of this section are applied using the specific tracing method. This paragraph (a)(3) applies to bonds issued on or after May 16, 1997.

(b) *Allocation of gross proceeds to an issue*—(1) *One-issue rule and general ordering rules*. Except as otherwise provided, amounts are allocable to only one issue at a time as gross proceeds, and if amounts simultaneously are proceeds of one issue and replacement proceeds of another issue, those amounts are allocable to the issue of which they are proceeds. Amounts cease to be allocated to an issue as proceeds only when those amounts are allocated to an expenditure for a governmental purpose, are allocated to transferred proceeds of another issue, or cease to be allocated to that issue at retirement of the issue or under the universal cap of paragraph (b)(2) of this section. Amounts cease to be allocated to an issue as replacement proceeds only when those amounts are allocated to an expenditure for a governmental purpose, are no longer used in a manner that causes those amounts to be replacement proceeds of that issue, or cease to be allocated to that issue because of the retirement of the issue or the application of the universal cap under paragraph (b)(2) of this section. Amounts that cease to be allocated to an issue as gross proceeds are eligible for allocation to another issue. Under §1.148–10(a), however, the rules in this paragraph (b)(1) do not apply in certain cases involving abusive arbitrage devices.

(2) *Universal cap on value of nonpurpose investments allocated to an issue*—(i) *Application.* The rules in this paragraph (b)(2) provide an overall limitation on the amount of gross proceeds allocable to an issue. Although the universal cap generally may be applied at any time in the manner described in this paragraph (b)(2), it need not be applied on any otherwise required date of application if its application on that date would not result in a reduction or reallocation of gross proceeds of an issue. For this purpose, if an issuer reasonably expects as of the issue date that the universal cap will not reduce the amount of gross proceeds allocable to the issue during the term of the issue, the universal cap need not be applied on any date on which an issue actually has all of the following characteristics—

(A) No replacement proceeds are allocable to the issue, other than replacement proceeds in a bona fide debt service fund or a reasonably required reserve or replacement fund;

(B) The net sale proceeds of the issue—

(*1*) Qualified for one of the temporary periods available for capital projects, restricted working capital expenditures, or pooled financings under §1.148–2 (e)(2), (e)(3), or (e)(4), and those net sales proceeds were in fact allocated to expenditures prior to the expiration of the longest applicable temporary period; or

(*2*) were deposited in a refunding escrow and expended as originally expected;

(C) The issue does not refund a prior issue that, on any transfer date, has unspent proceeds allocable to it;

(D) None of the bonds are retired prior to the date on which those bonds are treated as retired in computing the yield on the issue; and

(E) No proceeds of the issue are invested in qualified student loans or qualified mortgage loans.

(ii) *General rule.* Except as otherwise provided below, amounts that would otherwise be gross proceeds allocable to an issue are allocated (and remain allocated) to the issue only to the extent that the value of the nonpurpose investments allocable to those gross proceeds does not exceed the value of all outstanding bonds of the issue. For this purpose, gross proceeds allocable to cash, tax-exempt bonds that would be nonpurpose investments (absent section 148(b)(3)(A)), qualified student loans, and qualified mortgage loans are treated as nonpurpose investments. The values of bonds and investments are determined under §1.148–4(e) and §1.148–5(d), respectively. The value of all outstanding bonds of the issue is referred to as the *universal cap.* Thus, for example, the universal cap for an issue of plain par bonds is equal to the outstanding stated principal amount of those bonds plus accrued interest.

(iii) *Determination and application of the universal cap.* Except as otherwise provided, beginning with the first bond year that commences after the second anniversary of the issue date, the amount of the universal cap and the value of the nonpurpose investments must be determined as of the first day of each bond year. For refunding and refunded issues, the cap and values must be determined as of each date that, but for this paragraph (b)(2), proceeds of the refunded issue would become transferred proceeds of the refunding issue, and need not otherwise be determined in the bond year in which that date occurs. All values are determined as of the close of business on each determination date, after giving effect to all payments on bonds and payments for and receipts on investments on that date.

(iv) *General ordering rule for allocations of amounts in excess of the universal cap*—(A) *In general.* If the value of all nonpurpose investments allocated to the gross proceeds of an issue exceeds the universal cap for that issue on a date as of which the cap is determined under paragraph (b)(2)(iii) of this section, nonpurpose investments allocable to gross proceeds necessary to eliminate that excess cease to be allocated to the issue, in the following order of priority—

(*1*) First, nonpurpose investments allocable to replacement proceeds;

(*2*) Second, nonpurpose investments allocable to transferred proceeds; and

(*3*) Third, nonpurpose investments allocable to sale proceeds and investment proceeds.

(B) *Re-allocation of certain amounts.* Except as provided in §1.148–9(b)(3), amounts that cease to be allocated to an issue as a result of the application of the universal cap may only be allocated to another issue as replacement proceeds.

(C) *Allocations of portions of investments.* Portions of investments to which this paragraph (b)(2)(iv) applies are allocated under either the ratable method or the representative method in the same manner as allocations of portions of investments to transferred proceeds under §1.148–9(c).

(v) *Nonpurpose investments in a bona fide debt service fund not counted.* For purposes of this paragraph (b)(2), nonpurpose investments allocated to gross proceeds in a bona fide debt service fund for an issue are not taken into account in determining the value of the nonpurpose investments, and those nonpurpose investments remain allocated to the issue.

(c) *Fair market value limit on allocations to nonpurpose investments.* Upon a purchase or sale of a nonpurpose investment, gross proceeds of an issue are not allocated to a payment for that nonpurpose investment in an amount greater than, or to a receipt from that nonpurpose investment in an amount less than, the fair market value of the nonpurpose investment as of the purchase or sale date. For purposes of this paragraph (c) only, the fair market value of a nonpurpose investment is adjusted to take into account qualified administrative costs allocable to the investment.

(d) *Allocation of gross proceeds to expenditures*—(1) *Expenditures in general*—(i) *General rule.* Reasonable accounting methods for allocating funds from different sources to expenditures for the same governmental purpose include any of the following methods if consistently applied: a specific tracing method; a gross proceeds spent first method; a first-in, first-out method; or a ratable allocation method.

(ii) *General limitation.* An allocation of gross proceeds of an issue to an expenditure must involve a current outlay of cash for a governmental purpose of the issue. A *current outlay of cash* means an outlay reasonably expected to occur not later than 5 banking days after the date as of which the allocation of gross proceeds to the expenditure is made.

(iii) *Timing.* An issuer must account for the allocation of proceeds to expenditures not later than 18 months after the later of the date the expenditure is paid or the date the project, if any, that is financed by the issue is placed in service. This allocation must be made in any event by the date 60 days after the fifth anniversary of the issue date or the date 60 days after the retirement of the issue, if earlier. This paragraph (d)(1)(iii) applies to bonds issued on or after May 16, 1997.

(2) *Treatment of gross proceeds invested in purpose investments*—(i) *In general.* Gross proceeds of an issue invested in a purpose investment are allocated to an expenditure on the date on which the conduit borrower under the purpose investment allocates the gross proceeds to an expenditure in accordance with this paragraph (d).

(ii) *Exception for qualified mortgage loans and qualified student loans.* If gross proceeds of an issue are allocated to a purpose investment that is a qualified mortgage loan or a qualified student loan, those gross proceeds are allocated to an expenditure for the governmental purpose of the issue on the date on which the issuer allocates gross proceeds to that purpose investment.

(iii) *Continuing allocation of gross proceeds to purpose investments.* Regardless of whether gross proceeds of a conduit financing issue invested in a purpose investment have been allocated to an expenditure under paragraph (d)(2) (i) or (ii) of this section, with respect to the actual issuer those gross proceeds continue to be allocated to the purpose investment until the sale, discharge, or other disposition of the purpose investment.

(3) *Expenditures for working capital purposes*—(i) *In general.* Except as otherwise provided in this paragraph (d)(3) or paragraph (d)(4) of this section, proceeds of an issue may only be allocated to working capital expenditures as of any date to the extent that those working capital expenditures exceed available amounts (as defined in paragraph (d)(3)(iii) of this section) as of that date (*i.e.*, a ''proceeds-spent-last'' method). For this purpose, proceeds include replacement proceeds described in §1.148–1(c)(4).

(ii) *Exceptions*—(A) *General de minimis exception.* Paragraph (d)(3)(i) of this section does not apply to expenditures to pay—

(*1*) Any issuance costs of the issue or any qualified administrative costs within the meaning of §§1.148–5(e)(2) (i) or (ii), or §1.148–5(e)(3)(ii)(A);

(*2*) Fees for qualified guarantees of the issue or payments for a qualified hedge for the issue;

(*3*) Interest on the issue for a period commencing on the issue date and ending on the date that is the later of three years from the issue date or one year after the date on which the project is placed in service;

(*4*) Amounts paid to the United States under §§1.148–3, 1.148–5(c), or 1.148–7 for the issue;

(*5*) Costs, other than those described in paragraphs (d)(3)(ii)(A) (*1*) through (*4*) of this section, that do not exceed 5 percent of the sale proceeds of an issue and that are directly related to capital expenditures financed by the issue (e.g., initial operating expenses for a new capital project);

(*6*) Principal or interest on an issue paid from unexpected excess sale or investment proceeds; and

(*7*) Principal or interest on an issue paid from investment earnings on a reserve or replacement fund that are deposited in a bona fide debt service fund.

(B) *Exception for extraordinary items.* Paragraph (d)(3)(i) of this section does not apply to expenditures for extraordinary, nonrecurring items that are not customarily payable from current revenues, such as casualty losses or extraordinary legal judgments in amounts in excess of reasonable insurance coverage. If, however, an issuer or a related party maintains a reserve for such items (e.g., a self-insurance fund) or has set aside other available amounts for such expenses, gross proceeds within that reserve must be allocated to expenditures only after all other available amounts in that reserve are expended.

(C) *Exception for payment of principal and interest on prior issues.* Paragraph (d)(3)(i) of this section does not apply to expenditures for payment of principal, interest, or redemption prices on a prior issue and, for a crossover refunding issue, interest on that issue.

(D) *No exceptions if replacement proceeds created.* The exceptions provided in this paragraph (d)(3)(ii) do not apply if the allocation merely substitutes gross proceeds for other amounts that would have been used to make those expenditures in a manner that gives rise to replacement proceeds. For example, if a purported reimbursement allocation of proceeds of a reimbursement bond does not result in an expenditure under §1.150–2, those proceeds may not be allocated to pay interest on an issue that, absent this allocation, would have been paid from the issuer's current revenues.

(iii) *Definition of available amount*—(A) *In general.* For purposes of this paragraph (d)(3), *available amount* means any amount that is available to an issuer for working capital expenditure purposes of the type financed by an issue. Except as otherwise provided, available amount excludes proceeds of any issue but includes cash, investments, and other amounts held in accounts or otherwise by the issuer or a related party if those amounts may be used by the issuer for working capital expenditures of the type being financed by an issue without legislative or judicial action and without a legislative, judicial, or contractual requirement that those amounts be reimbursed.

(B) *Reasonable working capital reserve treated as unavailable.* A reasonable working capital reserve is treated as unavailable. Any working capital reserve is reasonable if it does not exceed 5 percent of the actual working capital expenditures of the issuer in the fiscal year before the year in which the determination of available amounts is made. For this purpose only, in determining the working capital expenditures of an issuer for a prior fiscal year, any expenditures (whether capital or working capital expenditures) that are paid out of current revenues may be treated as working capital expenditures.

(C) *Qualified endowment funds treated as unavailable.* For a 501(c)(3) organization, a qualified endowment fund is treated as unavailable. A fund is a qualified endowment fund if—

(*1*) The fund is derived from gifts or bequests, or the income thereon, that were neither made nor reasonably expected to be used to pay working capital expenditures;

(*2*) Pursuant to reasonable, established practices of the organization, the governing body of the 501(c)(3) organization designates and consistently operates the fund as a permanent endowment fund or quasi-endowment fund restricted as to use; and

(*3*) There is an independent verification that the fund is reasonably necessary as part of the organization's permanent capital.

(D) *Application to statutory safe harbor for tax and revenue anticipation bonds.* For purposes of section 148(f)(4)(B)(iii)(II), *available amount* has the same meaning as in paragraph (d)(3)(iii) of this section, except that the otherwise-permitted reasonable working capital reserve is treated as part of the available amount.

(4) *Expenditures for grants*—(i) *In general.* Gross proceeds of an issue that are used to make a grant are allocated to an expenditure on the date on which the grant is made.

(ii) *Characterization of repayments of grants.* If any amount of a grant financed by gross proceeds of an issue is repaid to the grantor, the repaid amount is treated as unspent proceeds of the issue as of the repayment date unless expended within 60 days of repayment.

(5) *Expenditures for reimbursement purposes.* In allocating gross proceeds of issues of reimbursement bonds (as defined in §1.150–2)) to certain expenditures, §1.150–2 applies. In allocating gross proceeds to an expenditure to reimburse a previously paid working capital expenditure, paragraph (d)(3) of this section applies. Thus, if the expenditure is described in paragraph (d)(3)(ii) of this section or there are no available amounts on the date a working capital expenditure is made and there are no other available amounts on the date of the reimbursement of that expenditure, gross proceeds are allocated to the working capital expenditure as of the date of the reimbursement.

(6) *Expenditures of certain commingled investment proceeds of governmental issues.* This paragraph (d)(6) applies to any issue of governmental bonds, any issue of private activity bonds issued to finance a facility that is required by section 142 to be owned by a governmental unit, and any portion of an issue that is not treated as consisting of private activity bonds under section 141(b)(9). Investment proceeds of the issue (other than investment proceeds held in a refunding escrow) are treated as allocated to expenditures for a governmental purpose when the amounts are deposited in a commingled fund with substantial tax or other revenues from governmental operations of the issuer and the amounts are reasonably expected to be spent for governmental purposes within 6 months from the date of the commingling. In establishing these reasonable expectations, an issuer may use any reasonable accounting assumption and is not bound by the *proceeds-spent-last* assumption generally required for working capital expenditures under paragraph (d)(3) of this section.

(7) *Payments to related parties.* Any payment of gross proceeds of the issue to a related party of the payor is not an expenditure of those gross proceeds.

(e) *Special rules for commingled funds*—(1) *In general.* An accounting method for gross proceeds of an issue in a commingled fund, other than a bona fide debt service fund, is reasonable only if it satisfies the requirements of paragraphs (e)(2) through (6) of this section in addition to the other requirements of this section.

(2) *Investments held by a commingled fund*—(i) *Required ratable allocations.* Not less frequently than as of the close of each fiscal period, all payments and receipts (including deemed payments and receipts) on investments held by a commingled fund must be allocated (but not necessarily distributed) among the different investors in the fund. This allocation must be based on a consistently applied, reasonable ratable allocation method.

(ii) *Safe harbors for ratable allocation methods.* Reasonable ratable allocation methods include, without limitation, methods that allocate these items in proportion to either—

(A) The average daily balances of the amounts in the commingled fund from different investors during a fiscal period (as described in paragraph (e)(4) of this section); or

(B) The average of the beginning and ending balances of the amounts in the commingled fund from different investors for a fiscal period that does not exceed one month.

(iii) *Definition of investor.* For purposes of this paragraph (e), the term *investor* means each different source of funds invested in a commingled fund. For example, if a city invests gross proceeds of an issue and tax revenues in a commingled fund, it is treated as two different investors.

(3) *Certain expenditures involving a commingled fund.* If a ratable allocation method is used under paragraph (d) of this section to allocate expenditures from the commingled fund, the same ratable allocation method must be used to allocate payments and receipts on investments in the commingled fund under paragraph (e)(2) of this section.

(4) *Fiscal periods.* The fiscal year of a commingled fund is the calendar year unless the fund adopts another fiscal year. A commingled fund may use any consistent fiscal period that does not exceed three months (e.g., a daily, weekly, monthly, or quarterly fiscal period).

(5) *Unrealized gains and losses on investments of a commingled fund*—(i) *Mark-to-market requirement for internal commingled funds with longer-term investment portfolios.* Except as otherwise provided in this paragraph (e), in the case of a commingled fund in which the issuer and any related party own more than 25 percent of the beneficial interests in the fund (an *internal commingled fund*), the fund must treat all its investments as if sold at fair market value either on the last day of the fiscal year or the last day of each fiscal period. The net gains or losses from these deemed sales of investments must be allocated to all investors of the commingled fund during the period since the last allocation.

(ii) *Exception for internal commingled funds with shorter-term investment portfolios.* If the remaining weighted average maturity of all investments held by a commingled fund during a particular fiscal year does not exceed 18 months, and the investments held by the commingled fund during that fiscal year consist exclusively of obligations, the mark-to-market requirement of paragraph (e)(5)(i) of this section does not apply.

(iii) *Exception for commingled reserve funds and sinking funds.* The mark-to-market requirement of paragraph (e)(5)(i) of this section does not apply to a commingled fund that operates exclusively as a reserve fund, sinking fund, or replacement fund for two or more issues of the same issuer.

(6) *Allocations of commingled funds serving as common reserve funds or sinking funds*—(i) *Permitted ratable allocation methods.* If a commingled fund serves as a common reserve fund, replacement fund, or sinking fund for two or more issues (a *commingled reserve*), after making reasonable adjustments to account for proceeds allocated under paragraph (b)(1) or (b)(2) of this section, investments held by that commingled fund must be allocated ratably among the issues served by the commingled fund in accordance with one of the following methods—

(A) The relative values of the bonds of those issues under §1.148–4(e);

(B) The relative amounts of the remaining maximum annual debt service requirements on the outstanding principal amounts of those issues; or

(C) The relative original stated principal amounts of the outstanding issues.

(ii) *Frequency of allocations.* An issuer must make any allocations required by this paragraph (e)(6) as of a date at least every 3 years and as of each date that an issue first becomes secured by the commingled reserve. If relative original principal amounts are used to allocate, allocations must also be made on the retirement of any issue secured by the commingled reserve.

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§ 1.148–7 Spending exceptions to the rebate requirement.

(a) *Scope of section*—(1) *In general.* This section provides guidance on the spending exceptions to the arbitrage rebate requirement of section 148(f)(2). These exceptions are the 6-month exception in section 148(f)(4)(B) (the *6-month exception*), the 18-month exception under paragraph (d) of this section (the *18-month exception*), and the 2-year construction exception under section 148(f)(4)(C) (the *2-year exception*) (collectively, the *spending exceptions*).

(2) *Relationship of spending exceptions.* Each of the spending exceptions is an independent exception to arbitrage rebate. For example, a construction issue may qualify for the 6-month exception or the 18-month exception even though the issuer makes one or more elections under the 2-year exception with respect to the issue.

(3) *Spending exceptions not mandatory.* Use of the spending exceptions is not mandatory. An issuer may apply the arbitrage rebate requirement to an issue that otherwise satisfies a spending exception. If an issuer elects to pay penalty in lieu of rebate under the 2-year exception, however, the issuer must apply those penalty provisions.

(b) *Rules applicable for all spending exceptions.* The provisions of this paragraph (b) apply for purposes of applying each of the spending exceptions.

(1) *Special transferred proceeds rules*—(i) *Application to prior issues.* For purposes of applying the spending exceptions to a prior issue only, proceeds of the prior issue that become transferred proceeds of the refunding issue continue to be treated as unspent proceeds of the prior issue. If the prior issue satisfies one of the spending exceptions, the proceeds of the prior issue that are excepted from rebate under that spending exception are not subject to rebate either as proceeds of the prior issue or as transferred proceeds of the refunding issue.

(ii) *Application to refunding issues*—(A) *In general.* The only spending exception applicable to refunding issues is the 6-month exception. For purposes of applying the 6-month exception to a refunding issue only, proceeds of the prior issue that become transferred proceeds of the refunding issue generally are not treated as proceeds of the refunding issue and need not be spent for the refunding issue to satisfy that spending exception. Even if the refunding issue qualifies for that spending exception, those transferred proceeds are subject to rebate as proceeds of the refunding issue unless an exception to rebate applied to those proceeds as proceeds of the prior issue.

(B) *Exception.* For purposes of applying the 6-month exception to refunding issues, those transferred proceeds of the refunding issue excluded from the gross proceeds of the prior issue under the special definition of gross proceeds in paragraph (c)(3) of this section, and those that transferred from a prior taxable issue, are generally treated as gross proceeds of the refunding issue. Thus, for the refunding issue to qualify for the 6-month exception, those proceeds must be spent within 6 months of the issue date of the refunding issue, unless those amounts continue to be used in a manner that does not cause those amounts to be gross proceeds under paragraph (c)(3) of this section.

(2) *Application of multipurpose issue rules.* Except as otherwise provided, if any portion of an issue is treated as a separate issue allocable to refunding purposes under §1.148–9(h) (relating to multipurpose issues), for purposes of this section, that portion is treated as a separate issue.

(3) *Expenditures for governmental purposes of the issue.* For purposes of this

section, expenditures for the governmental purpose of an issue include payments for interest, but not principal, on the issue, and for principal or interest on another issue of obligations. The preceding sentence does not apply for purposes of the 18-month and 2-year exceptions if those payments cause the issue to be a refunding issue.

(4) *De minimis rule.* Any failure to satisfy the final spending requirement of the 18-month exception or the 2-year exception is disregarded if the issuer exercises due diligence to complete the project financed and the amount of the failure does not exceed the lesser of 3 percent of the issue price of the issue or $250,000.

(5) *Special definition of reasonably required reserve or replacement fund.* For purposes of this section only, a reasonably required reserve or replacement fund also includes any fund to the extent described in §1.148–5(c)(3)(i)(E) or (G).

(6) *Pooled financing issue*—(i) *In general.* Except as otherwise provided in this paragraph (b)(6), the spending exceptions apply to a pooled financing issue as a whole, rather than to each loan separately.

(ii) *Election to apply spending exceptions separately to each loan*—(A) *In general.* At the election (made on or before the issue date) of the issuer of a pooled financing issue, the spending exceptions are applied separately to each conduit loan, and the applicable spending requirements for a loan begin on the earlier of the date the loan is made, or the first day following the 1-year period beginning on the issue date of the pooled financing issue. If this election is made, the rebate requirement applies to, and none of the spending exceptions are available for, gross proceeds of the pooled financing bonds before the date on which the spending requirements for those proceeds begin.

(B) *Application of spending exceptions.* If the issuer makes the election under this paragraph (b)(6)(ii), the rebate requirement is satisfied for proceeds used to finance a particular conduit loan to the extent that the loan satisfies a spending exception or the small issuer exception under §1.148–8, regardless of whether any other conduit loans allocable to the issue satisfy such an exception. A pooled financing issue is an issue of arbitrage bonds, however, unless the entire issue satisfies the requirements of section 148. An issuer may pay rebate for some conduit loans and 1½ percent penalty for other conduit loans from the same pooled financing issue. The 1½ percent penalty is computed separately for each conduit loan.

(C) *Elections under 2-year exception.* If the issuer makes the election under this paragraph (b)(6)(ii), the issuer may make all elections under the 2-year exception separately for each loan. Elections regarding a loan that otherwise must be made by the issuer on or before the issue date instead may be made on or before the date the loan is made (but not later than 1 year after the issue date).

(D) *Example.* The operation of this paragraph (b)(6) is illustrated by the following example:

Example. Pooled financing issue. On January 1, 1994, Authority *J* issues bonds. As of the issue date, *J* reasonably expects to use the proceeds of the issue to make loans to City *K*, County *L*, and City *M*. *J* does not reasonably expect to use more than 75 percent of the available construction proceeds of the issue for construction expenditures. On or before the issue date, *J* elects to apply the spending exceptions separately for each loan, with spending requirements beginning on the earlier of the date the loan is made or the first day following the 1-year period beginning on the issue date. On February 1, 1994, *J* loans a portion of the proceeds to *K*, and *K* reasonably expects that 45 percent of those amounts will be used for construction expenditures. On the date this loan is made, *J* elects under paragraph (j) of this section to treat 60 percent of the amount loaned to *K* as a separate construction issue, and also elects the 1½ percent penalty under paragraph (k) of this section for the separate construction issue. On March 1, 1994, *J* loans a portion of the proceeds to *L*, and *L* reasonably expects that more than 75 percent of those amounts will be used for construction expenditures. On March 1, 1995, *J* loans the remainder of the proceeds to *M*, and none of those amounts will be used for construction expenditures. *J* must satisfy the rebate requirement for all gross proceeds before those amounts are loaned. For the loan to *K*, the spending periods begin on February 1, 1994, and the 1½ percent penalty must be paid for any failure to meet a spending requirement for the portion of the loan to *K* that is treated as a separate construction issue. Rebate must be paid on the remaining portion of the loan to *K*, unless that portion qualifies for the 6-month exception. For the loan to *L*, the spending periods begin on March 1, 1994, and the rebate requirement must be satisfied unless the 6-month, 18-month, or the 2-year exception is satisfied with respect to those amounts. For the loan to *M*, the spending periods begin on January 2, 1995, and the rebate requirement must be satisfied for those amounts unless the 6-month or 18-month exception is satisfied.

(c) *6-month exception*—(1)*General rule*. An issue is treated as meeting the rebate requirement if—

(i) The gross proceeds (as modified by paragraph (c)(3) of this section) of the issue are allocated to expenditures for the governmental purposes of the issue within the 6-month period beginning on the issue date (the *6-month spending period*); and

(ii) The rebate requirement is met for amounts not required to be spent within the 6-month spending period (excluding earnings on a bona fide debt service fund).

(2) *Additional period for certain bonds*. The 6-month spending period is extended for an additional 6 months in certain circumstances specified under section 148(f)(4)(B)(ii).

(3) *Amounts not included in gross proceeds*. For purposes of paragraph (c)(1)(i) of this section only, gross proceeds has the meaning used in §1.148–1, except it does not include amounts—

(i) In a bona fide debt service fund;

(ii) In a reasonably required reserve or replacement fund (see §1.148–7(b)(5));

(iii) That, as of the issue date, are not reasonably expected to be gross proceeds but that become gross proceeds after the end of the 6-month spending period;

(iv) Representing sale or investment proceeds derived from payments under any purpose investment of the issue; and

(v) Representing repayments of grants (as defined in §1.150–1(f)) financed by the issue.

(4) *Series of refundings*. If a principal purpose of a series of refunding issues is to exploit the difference between taxable and tax-exempt interest rates by investing proceeds during the temporary periods provided in §1.148–9(d), the 6-month spending period for all issues in the series begins on the issue date of the first issue in the series.

(d) *18-month exception*—(1) *General rule*. An issue is treated as meeting the rebate requirement if all of the following requirements are satisfied—

(i) *18-month expenditure schedule met*. The gross proceeds (as defined in paragraph (d)(3) of this section) are allocated to expenditures for a governmental purpose of the issue in accordance with the following schedule (the *18-month expenditure schedule*) measured from the issue date—

(A) At least 15 percent within 6 months (the *first spending period*);

(B) At least 60 percent within 12 months (the *second spending period*); and

(C) 100 percent within 18 months (the *third spending period*).

(ii) *Rebate requirement met for amounts not required to be spent*. The rebate requirement is met for all amounts not required to be spent in accordance with the 18-month expenditure schedule (other than earnings on a bona fide debt service fund).

(iii) *Issue qualifies for initial temporary period*. All of the gross proceeds (as defined in paragraph (d)(3)(i) of this section) of the issue qualify for the initial temporary period under §1.148–2(e)(2).

(2) *Extension for reasonable retainage*. An issue does not fail to satisfy the spending requirement for the third spending period as a result of a reasonable retainage if the reasonable retainage is allocated to expenditures within 30 months of the issue date. Reasonable retainage has the meaning under paragraph (h) of this section, as modified to refer to net sale proceeds on the date 18 months after the issue date.

(3) *Gross proceeds*—(i) *Definition of gross proceeds*. For purposes of paragraph (d)(1) of this section only, *gross proceeds* means gross proceeds as defined in paragraph (c)(3) of this section, as modified to refer to ''18 months'' in paragraph (c)(3)(iii) of this section in lieu of ''6 months.''

(ii) *Estimated earnings*. For purposes of determining compliance with the first two spending periods under paragraph (d)(1)(i) of this section, the amount of investment proceeds included in gross proceeds of the issue is determined based on the issuer's reasonable expectations on the issue date.

(4) *Application to multipurpose issues.* This paragraph (d) does not apply to an issue any portion of which is treated as meeting the rebate requirement under paragraph (e) of this section (relating to the 2-year exception).

(e) *2-year exception*—(1) *General rule.* A construction issue is treated as meeting the rebate requirement for available construction proceeds if those proceeds are allocated to expenditures for governmental purposes of the issue in accordance with the following schedule (the *2-year expenditure schedule*), measured from the issue date—

(i) At least 10 percent within 6 months (the *first spending period*);

(ii) At least 45 percent within 1 year (the *second spending period*);

(iii) At least 75 percent within 18 months (the *third spending period*); and

(iv) 100 percent within 2 years (the *fourth spending period*).

(2) *Extension for reasonable retainage.* An issue does not fail to satisfy the spending requirement for the fourth spending period as a result of unspent amounts for reasonable retainage (as defined in paragraph (h) of this section) if those amounts are allocated to expenditures within 3 years of the issue date.

(3) *Definitions.* For purposes of the 2-year exception, the following definitions apply:

(i) *Real property* means land and improvements to land, such as buildings or other inherently permanent structures, including interests in real property. For example, real property includes wiring in a building, plumbing systems, central heating or air-conditioning systems, pipes or ducts, elevators, escalators installed in a building, paved parking areas, roads, wharves and docks, bridges, and sewage lines.

(ii) *Tangible personal property* means any tangible property other than real property, including interests in tangible personal property. For example, tangible personal property includes machinery that is not a structural component of a building, subway cars, fire trucks, automobiles, office equipment, testing equipment, and furnishings.

(iii) *Substantially completed.* Construction may be treated as substantially completed when the issuer abandons construction or when at least 90 percent of the total costs of the construction reasonably expected, as of that date, to be financed with the available construction proceeds have been allocated to expenditures.

(f) *Construction issue*—(1) *Definition. Construction issue* means any issue that is not a refunding issue if—

(i) The issuer reasonably expects, as of the issue date, that at least 75 percent of the available construction proceeds of the issue will be allocated to construction expenditures (as defined in paragraph (g) of this section) for property owned by a governmental unit or a 501(c)(3) organization; and

(ii) Any private activity bonds that are part of the issue are qualified 501(c)(3) bonds or private activity bonds issued to finance property to be owned by a governmental unit or a 501(c)(3) organization.

(2) *Use of actual facts.* For the provisions of paragraphs (e) through (m) of this section that apply based on the issuer's reasonable expectations, an issuer may elect on or before the issue date to apply all of those provisions based on actual facts, except that this election does not apply for purposes of determining whether an issue is a construction issue under paragraph (f)(1) of this section if the 1½ percent penalty election is made under paragraph (k) of this section.

(3) *Ownership requirement*—(i) *In general.* A governmental unit or 501(c)(3) organization is treated as the owner of property if it would be treated as the owner for Federal income tax purposes. For obligations issued on behalf of a State or local governmental unit, the entity that actually issues the bonds is treated as a governmental unit.

(ii) *Safe harbor for leases and management contracts.* Property leased by a governmental unit or a 501(c)(3) organization is treated as owned by the governmental unit or 501(c)(3) organization if the lessee complies with the requirements of section 142(b)(1)(B). For a bond described in section 142(a)(6), the requirements of section 142(b)(1)(B) apply as modified by section 146(h)(2).

(g) *Construction expenditures*—(1) *Definition.* Except as otherwise provided, *construction expenditures* means capital expenditures (as defined in §1.150–1) that are allocable to the cost of real property or constructed personal property (as defined in paragraph (g)(3) of this section). Except as provided in paragraph (g)(2) of this section, construction expenditures do not include expenditures for acquisitions of interests in land or other existing real property.

(2) *Certain acquisitions under turnkey contracts treated as construction expenditures.* Expenditures are not for the acquisition of an interest in existing real property other than land if the contract between the seller and the issuer requires the seller to build or install the property (e.g., a *turnkey contract*), but only to the extent that the property has not been built or installed at the time the parties enter into the contract.

(3) *Constructed personal property. Constructed personal property* means tangible personal property (or, if acquired pursuant to a single acquisition contract, properties) or specially developed computer software if—

(i) A substantial portion of the property or properties is completed more than 6 months after the earlier of the date construction or rehabilitation commenced and the date the issuer entered into an acquisition contract;

(ii) Based on the reasonable expectations of the issuer, if any, or representations of the person constructing the property, with the exercise of due diligence, completion of construction or rehabilitation (and delivery to the issuer) could not have occurred within that 6-month period; and

(iii) If the issuer itself builds or rehabilitates the property, not more than 75 percent of the capitalizable cost is attributable to property acquired by the issuer (e.g., components, raw materials, and other supplies).

(4) *Specially developed computer software. Specially developed computer software* means any programs or routines used to cause a computer to perform a desired task or set of tasks, and the documentation required to describe and maintain those programs, provided that the software is specially developed and is functionally related and subordinate to real property or other constructed personal property.

(5) *Examples.* The operation of this paragraph (g) is illustrated by the following examples:

Example 1. Purchase of construction materials. City A issues bonds to finance a new office building. *A* uses proceeds of the bonds to purchase materials to be used in constructing the building, such as bricks, pipes, wires, lighting, carpeting, heating equipment, and similar materials. Expenditures by *A* for the construction materials are construction expenditures because those expenditures will be capitalizable to the cost of the building upon completion, even though they are not initially capitalizable to the cost of existing real property. This result would be the same if *A* hires a third-party to perform the construction, unless the office building is partially constructed at the time that *A* contracts to purchase the building.

Example 2. Turnkey contract. City *B* issues bonds to finance a new office building. *B* enters into a turnkey contract with developer *D* under which *D* agrees to provide *B* with a completed building on a specified completion date on land currently owned by *D*. Under the agreement, *D* holds title to the land and building and assumes any risk of loss until the completion date, at which time title to the land and the building will be transferred to *B*. No construction has been performed by the date that *B* and *D* enter into the agreement. All payments by *B* to *D* for construction of the building are construction expenditures because all the payments are properly capitalized to the cost of the building, but payments by *B* to *D* allocable to the acquisition of the land are not construction expenditures.

Example 3. Right-of-way. P, a public agency, issues bonds to finance the acquisition of a right-of-way and the construction of sewage lines through numerous parcels of land. The right-of-way is acquired primarily through *P*' s exercise of its powers of eminent domain. As of the issue date, *P* reasonably expects that it will take approximately 2 years to acquire the entire right-of-way because of the time normally required for condemnation proceedings. No expenditures for the acquisition of the right-of-way are construction expenditures because they are costs incurred to acquire an interest in existing real property.

Example 4. Subway cars. City *C* issues bonds to finance new subway cars. *C* reasonably expects that it will take more than 6 months for the subway cars to be constructed to *C*'s specifications. The subway cars are constructed personal property. Alternatively, if the builder of the subway cars informs *C* that it will only take 3 months to build the subway cars to *C*'s specifications, no payments for the subway cars are construction expenditures.

Example 5. Fractional interest in property. U, a public agency, issues bonds to finance an undivided fractional interest in a newly constructed power-generating facility. *U* contributes its ratable share of the cost of building the new facility to the project manager for the facility. *U*'s contributions are construction expenditures in the same proportion that the total expenditures for the facility qualify as construction expenditures.

Example 6. Park land. City *D* issues bonds to finance the purchase of unimproved land and the cost of subsequent improvements to the land, such as grading and landscaping, necessary to transform it into a park. The costs of the improvements are properly capitalizable to the cost of the land, and therefore, are construction expenditures, but expenditures for the acquisition of the land are not.

(h) *Reasonable retainage definition. Reasonable retainage* means an amount, not to exceed 5 percent of available construction proceeds as of the end of the fourth spending period, that is retained for reasonable business purposes relating to the property financed with the proceeds of the issue. For example, a reasonable retainage may include a retention to ensure or promote compliance with a construction contract in circumstances in which the retained amount is not yet payable, or in which the issuer reasonably determines that a dispute exists regarding completion or payment.

(i) *Available construction proceeds*—(1) *Definition in general. Available construction proceeds* has the meaning used in section 148(f)(4)(C)(vi). For purposes of this definition, earnings include earnings on any tax-exempt bond. Pre-issuance accrued interest and earnings thereon may be disregarded. Amounts that are not gross proceeds as a result of the application of the universal cap under §1.148–6(b)(2) are not available construction proceeds.

(2) *Earnings on a reasonably required reserve or replacement fund.* Earnings on any reasonably required reserve or replacement fund are available construction proceeds only to the extent that those earnings accrue before the earlier of the date construction is substantially completed or the date that is 2 years after the issue date. An issuer may elect on or before the issue date to exclude from available construction proceeds the earnings on such a fund. If the election is made, the rebate requirement applies to the excluded amounts from the issue date.

(3) *Reasonable expectations test for future earnings.* For purposes of determining compliance with the spending requirements as of the end of each of the first three spending periods, available construction proceeds include the amount of future earnings that the issuer reasonably expected as of the issue date.

(4) *Issuance costs.* Available construction proceeds do not include gross proceeds used to pay issuance costs financed by an issue, but do include earnings on such proceeds. Thus, an expenditure of gross proceeds of an issue for issuance costs does not count toward meeting the spending requirements. The expenditure of earnings on gross proceeds used to pay issuance costs does count toward meeting those requirements. If the spending requirements are met and the proceeds used to pay issuance costs are expended by the end of the fourth spending period, those proceeds and the earnings thereon are treated as having satisfied the rebate requirement.

(5) *One and one-half percent penalty in lieu of arbitrage rebate.* For purposes of the spending requirements of paragraph (e) of this section, available construction proceeds as of the end of any spending period are reduced by the amount of penalty in lieu of arbitrage rebate (under paragraph (k) of this section) that the issuer has paid from available construction proceeds before the last day of the spending period.

(6) *Payments on purpose investments and repayments of grants.* Available construction proceeds do not include—

(i) Sale or investment proceeds derived from payments under any purpose investment of the issue; or

(ii) Repayments of grants (as defined in §1.150–1(f)) financed by the issue.

(7) *Examples.* The operation of this paragraph (i) is illustrated by the following examples:

Example 1. Treatment of investment earnings. City *F* issues bonds having an issue price of $10,000,000. *F* deposits all of the proceeds of the issue into a construction fund to be used for expenditures other than costs of issuance. *F* estimates on the issue date that, based on reasonably expected expenditures and rates of investment, earnings on the construction fund will be $800,000. As of the issue date and the end of each of the first three spending periods, the amount of available construction proceeds is $10,800,000. To qualify as a construction issue, *F* must reasonably expect on the issue date that at least $8,100,000 (75 percent of $10,800,000) will be used for construction expenditures. In order to meet the 10 percent spending requirement at the end of the first spending period, *F* must spend at least $1,080,000. As of the end of the fourth spending period, *F* has received $1,100,000 in earnings. In order to meet the spending requirement at the end of the fourth spending period, however, *F* must spend all of the $11,100,000 of actual available construction proceeds (except for reasonable retainage not exceeding $555,000).

Example 2. Treatment of investment earnings without a reserve fund. City *G* issues bonds having an issue price of $11,200,000. *G* does not elect to exclude earnings on the reserve fund from available construction proceeds. *G* uses $200,000 of proceeds to pay issuance costs and deposits $1,000,000 of proceeds into a reasonably required reserve fund. *G* deposits the remaining $10,000,000 of proceeds into a construction fund to be used for construction expenditures. On the issue date, *G* reasonably expects that, based on the reasonably expected date of substantial completion and rates of investment, total earnings on the construction fund will be $800,000, and total earnings on the reserve fund to the date of substantial completion will be $150,000. *G* reasonably expects that substantial completion will occur during the fourth spending period. As of the issue date, the amount of available construction proceeds is $10,950,000 ($10,000,000 originally deposited into the construction fund plus $800,000 expected earnings on the construction fund and $150,000 expected earnings on the reserve fund). To qualify as a construction issue, *G* must reasonably expect on the issue date that at least $8,212,500 will be used for construction expenditures.

Example 3. Election to exclude earnings on a reserve fund. The facts are the same as *Example 2*, except that *G* elects on the issue date to exclude earnings on the reserve fund from available construction proceeds. The amount of available construction proceeds as of the issue date is $10,800,000.

(j) *Election to treat portion of issue used for construction as separate issue*—(1) *In general.* For purposes of paragraph (e) of this section, if any proceeds of an issue are to be used for construction expenditures, the issuer may elect on or before the issue date to treat the portion of the issue that is not a refunding issue as two, and only two, separate issues, if—

(i) One of the separate issues is a construction issue as defined in paragraph (f) of this section;

(ii) The issuer reasonably expects, as of the issue date, that this construction issue will finance all of the construction expenditures to be financed by the issue; and

(iii) The issuer makes an election to apportion the issue under this paragraph (j)(1) in which it identifies the amount of the issue price of the issue allocable to the construction issue.

(2) *Example.* The operation of this paragraph (j) is illustrated by the following example.

Example. City *D* issues bonds having an issue price of $19,000,000. On the issue date, *D* reasonably expects to use $10,800,000 of bond proceeds (including investment earnings) for construction expenditures for the project being financed. *D* deposits $10,000,000 in a construction fund to be used for construction expenditures and $9,000,000 in an acquisition fund to be used for acquisition of equipment not qualifying as construction expenditures. *D* estimates on the issue date, based on reasonably expected expenditures and rates of investment, that total earnings on the construction fund will be $800,000 and total earnings on the acquisition fund will be $200,000. Because the total construction expenditures to be financed by the issue are expected to be $10,800,000, the maximum available construction proceeds for a construction issue is $14,400,000 ($10,800,000 divided by 0.75). To determine the maximum amount of the issue price allocable to a construction issue, the estimated investment earnings allocable to the construction issue are subtracted. The entire $800,000 of earnings on the construction fund are allocable to the construction issue. Only a portion of the $200,000 of earnings on the acquisition fund, however, are allocable to the construction issue. The total amount of the available construction proceeds that is expected to be used for acquisition is $3,600,000 ($14,400,000 − $10,800,000). The portion of earnings on the acquisition fund that is allocable to the construction issue is $78,261 ($200,000 × $3,600,000/$9,200,000). Accordingly, *D* may elect on or before the issue date to treat up to $13,521,739 of the issue price as a construction issue ($14,400,000 − $800,000 − $78,261). *D*'s election must specify the amount of the issue price treated as a construction issue. The balance of the issue price is treated as a separate nonconstruction issue that is subject to the rebate requirement unless it meets another exception to arbitrage rebate. Because the financing of a construction issue is a separate governmental purpose under §1.148–9(h), the election causes the issue to be a multipurpose issue under that section.

(k) *One and one-half percent penalty in lieu of arbitrage rebate*—(1) *In general.* Under section 148(f)(4)(C)(vii), an issuer of a construction issue may elect on or before the issue date to pay a penalty (the *1½ percent penalty*) to the United States in lieu of the obligation to pay the rebate amount on available construction proceeds upon failure to satisfy the spending requirements of paragraph (e) of this section. The 1½ percent penalty is calculated separately for each spending period, including each semiannual period after the end of the fourth spending period, and is equal to 1.5 percent times the underexpended proceeds as of the end of the spending period. For each spending period, underexpended proceeds equal the amount of available construction proceeds required to be spent by the end of the spending period, less the amount actually allocated to expenditures for the governmental purposes of the issue by that date. The 1½ percent penalty must be paid to the United States no later than 90 days after the end of the spending period to which it relates. The 1½ percent penalty continues to apply at the end of each spending period and each semiannual period thereafter until the earliest of the following—

(i) The termination of the penalty under paragraph (l) of this section;

(ii) The expenditure of all of the available construction proceeds; or

(iii) The last stated final maturity date of bonds that are part of the issue and any bonds that refund those bonds.

(2) *Application to reasonable retainage.* If an issue meets the exception for reasonable retainage except that all retainage is not spent within 3 years of the issue date, the issuer must pay the 1½ percent penalty to the United States for any reasonable retainage that was not so spent as of the close of the 3-year period and each later spending period.

(3) *Coordination with rebate requirement.* The rebate requirement is treated as met with respect to available construction proceeds for a period if the 1½ percent penalty is paid in accordance with this section.

(l) *Termination of 1½ percent penalty*—(1)*Termination after initial temporary period.* The issuer may terminate the 1½ percent penalty after the initial temporary period (a *section 148(f)(4)(C)(viii) penalty termination*) if—

(i) Not later than 90 days after the earlier of the end of the initial temporary period or the date construction is substantially completed, the issuer elects to terminate the 1½ percent penalty; provided that solely for this purpose, the initial temporary period may be extended by the issuer to a date ending 5 years after the issue date;

(ii) Within 90 days after the end of the initial temporary period, the issuer pays a penalty equal to 3 percent of the unexpended available construction proceeds determined as of the end of the initial temporary period, multiplied by the number of years (including fractions of years computed to 2 decimal places) in the initial temporary period;

(iii) For the period beginning as of the close of the initial temporary period, the unexpended available construction proceeds are not invested in higher yielding investments; and

(iv) On the earliest date on which the bonds may be called or otherwise redeemed, with or without a call premium, the unexpended available construction proceeds as of that date (not including any amount earned after the date on which notice of the redemption was required to be given) must be used to redeem the bonds. Amounts used to pay any call premium are treated as used to redeem bonds. This redemption requirement may be met by purchases of bonds by the issuer on the open market at prices not exceeding fair market value. A portion of the annual principal payment due on serial bonds of a construction issue may be paid from the unexpended amount, but only in an amount no greater than the amount that bears the same ratio to the annual principal due that the total unexpended amount bears to the issue price of the construction issue.

(2) *Termination before end of initial temporary period.* If the construction to be financed by the construction issue is substantially completed before the end of the initial temporary period, the issuer may elect to terminate the 1½ percent penalty before the end of the

initial temporary period (a *section 148(f)(4)(C)(ix) penalty termination*) if—

(i) Before the close of the initial temporary period and not later than 90 days after the date the construction is substantially completed, the issuer elects to terminate the 1½ percent penalty;

(ii) The election identifies the amount of available construction proceeds that will not be spent for the governmental purposes of the issue; and

(iii) The issuer has met all of the conditions for a section 148(f)(4)(C)(viii) penalty termination, applied as if the initial temporary period ended as of the date the required election for a section 148(f)(4)(C)(ix) penalty termination is made. That penalty termination election satisfies the required election for a section 148(f)(4)(C)(viii) termination.

(3) *Application to reasonable retainage*. Solely for purposes of determining whether the conditions for terminating the 1½ percent penalty are met, reasonable retainage may be treated as spent for a governmental purpose of the construction issue. Reasonable retainage that is so treated continues to be subject to the 1½ percent penalty.

(4) *Example*. The operation of this paragraph (l) is illustrated by the following example.

Example. City *I* issues a construction issue having a 20-year maturity and qualifying for a 3-year initial temporary period. The bonds are first subject to optional redemption 10 years after the issue date at a premium of 3 percent. *I* elects, on or before the issue date, to pay the 1½ percent penalty in lieu of arbitrage rebate. At the end of the 3-year temporary period, the project is not substantially completed, and $1,500,000 of available construction proceeds of the issue are unspent. At that time, *I* reasonably expects to need $500,000 to complete the project. *I* may terminate the 1½ percent penalty in lieu of arbitrage rebate with respect to the excess $1,500,000 by electing to terminate within 90 days of the end of the initial temporary period; paying a penalty to the United States of $135,000 (3 percent of $1,500,000 multiplied by 3 years); restricting the yield on the investment of unspent available construction proceeds for 7 years until the first call date, although any portion of these proceeds may still be spent on the project prior to that call date; and using the available construction proceeds that, as of the first call date, have not been allocated to expenditures for the governmental purposes of the issue to redeem bonds on that call date. If *I* fails to make the termination election, *I* is required to pay the 1½ percent penalty on unspent available construction proceeds every 6 months until the latest maturity date of bonds of the issue (or any bonds of another issue that refund such bonds).

(m) *Payment of penalties*. Each penalty payment under this section must be paid in the manner provided in §1.148–3(g). See §1.148–3(h) for rules on failures to pay penalties under this section.

[T.D. 8476, 58 FR 33535, June 18, 1993; 58 FR 44452, Aug. 23, 1993; T.D. 9777, 81 FR 46597, July 18, 2016]

§ 1.148–8 Small issuer exception to rebate requirement.

(a) *Scope*. Under section 148(f)(4)(D), bonds issued to finance governmental activities of certain small issuers are treated as meeting the arbitrage rebate requirement of section 148(f)(2) (the "small issuer exception"). This section provides guidance on the small issuer exception.

(b) *General taxing powers*. The small issuer exception generally applies only to bonds issued by governmental units with general taxing powers. A governmental unit has general taxing powers if it has the power to impose taxes (or to cause another entity to impose taxes) of general applicability which, when collected, may be used for the general purposes of the issuer. The taxing power may be limited to a specific type of tax, provided that the applicability of the tax is not limited to a small number of persons. The governmental unit's exercise of its taxing power may be subject to procedural limitations, such as voter approval requirements, but may not be contingent on approval by another governmental unit. See, also, section 148(f)(4)(D)(iv).

(c) *Size limitation*—(1) *In general*. An issue (other than a refunding issue) qualifies for the small issuer exception only if the issuer reasonably expects, as of the issue date, that the aggregate face amount of all tax-exempt bonds (other than private activity bonds) issued by it during that calendar year will not exceed $5,000,000; or the aggregate face amount of all tax-exempt bonds of the issuer (other than private activity bonds) actually issued during that calendar year does not exceed $5,000,000. For this purpose, if an issue has more than a de minimis amount of original issue discount or premium, *aggregate face amount* means the aggregate issue price of that issue (determined without regard to pre-issuance accrued interest).

(2) *Aggregation rules.* The following aggregation rules apply for purposes of applying the $5,000,000 size limitation under paragraph (c)(1) of this section.

(i) *On-behalf-of issuers.* An issuer and all entities (other than political subdivisions) that issue bonds on behalf of that issuer are treated as one issuer.

(ii) *Subordinate entities*—(A) *In general.* Except as otherwise provided in paragraph (d) of this section and section 148(f)(4)(D)(iv), all bonds issued by a subordinate entity are also treated as issued by each entity to which it is subordinate. An issuer is subordinate to another governmental entity if it is directly or indirectly controlled by the other entity within the meaning of §1.150–1(e).

(B) *Exception for allocations of size limitation.* If an entity properly makes an allocation of a portion of its $5,000,000 size limitation to a subordinate entity (including an on behalf of issuer) under section 148(f)(4)(D)(iv), the portion of bonds issued by the subordinate entity under the allocation is treated as issued only by the allocating entity and not by any other entity to which the issuing entity is subordinate. These allocations are irrevocable and must bear a reasonable relationship to the benefits received by the allocating unit from issues issued by the subordinate entity. The benefits to be considered include the manner in which—

(*1*) Proceeds are to be distributed;

(*2*) The debt service is to be paid;

(*3*) The facility financed is to be owned;

(*4*) The use or output of the facility is to be shared; and

(*5*) Costs of operation and maintenance are to be shared.

(iii) *Avoidance of size limitation.* An entity formed or availed of to avoid the purposes of the $5,000,000 size limitation and all entities that would benefit from the avoidance are treated as one issuer. Situations in which an entity is formed or availed of to avoid the purposes of the $5,000,000 size limitation include those in which the issuer—

(A) Issues bonds which, but for the $5,000,000 size limitation, would have been issued by another entity; and

(B) Does not receive a substantial benefit from the project financed by the bonds.

(3) *Certain refunding bonds not taken into account.* In applying the $5,000,000 size limitation, there is not taken into account the portion of an issue that is a current refunding issue to the extent that the stated principal amount of the refunding bond does not exceed the portion of the outstanding stated principal amount of the refunded bond paid with proceeds of the refunding bond. For this purpose, *principal amount* means, in reference to a plain par bond, its stated principal amount plus accrued unpaid interest, and in reference to any other bond, its present value.

(d) *Pooled financings—treatment of conduit borrowers.* A loan to a conduit borrower in a pooled financing qualifies for the small issuer exception, regardless of the size of either the pooled financing or of any loan to other conduit borrowers, only if—

(1) The bonds of the pooled financing are not private activity bonds;

(2) None of the loans to conduit borrowers are private activity bonds; and

(3) The loan to the conduit borrower meets all the requirements of the small issuer exception.

(e) *Refunding issues*—(1) *In general.* Sections 148(f)(4)(D) (v) and (vi) provide restrictions on application of the small issuer exception to refunding issues.

(2) *Multipurpose issues.* The multipurpose issue allocation rules of §1.148–9(h) apply for purposes of determining whether refunding bonds meet the requirements of section 148(f)(4)(D)(v).

[T.D. 8476, 58 FR 33540, June 18, 1993, as amended by T.D. 9777, 81 FR 46597, July 18, 2016]

§ 1.148–9 Arbitrage rules for refunding issues.

(a) *Scope of application.* This section contains special arbitrage rules for refunding issues. These rules apply for all purposes of section 148 and govern allocations of proceeds, bonds, and investments to determine transferred proceeds, temporary periods, reasonably required reserve or replacement funds, minor portions, and separate issue treatment of certain multipurpose issues.

(b) *Transferred proceeds allocation rule*—(1) *In general.* When proceeds of the refunding issue discharge any of the outstanding principal amount of the prior issue, proceeds of the prior issue become transferred proceeds of the refunding issue and cease to be proceeds of the prior issue. The amount of proceeds of the prior issue that becomes transferred proceeds of the refunding issue is an amount equal to the proceeds of the prior issue on the date of that discharge multiplied by a fraction—

(i) The numerator of which is the principal amount of the prior issue discharged with proceeds of the refunding issue on the date of that discharge; and

(ii) The denominator of which is the total outstanding principal amount of the prior issue on the date immediately before the date of that discharge.

(2) *Special definition of principal amount.* For purposes of this section, *principal amount* means, in reference to a plain par bond, its stated principal amount, and in reference to any other bond, its present value.

(3) *Relation of transferred proceeds rule to universal cap rule*—(i) *In general.* Paragraphs (b)(1) and (c) of this section apply to allocate transferred proceeds and corresponding investments to a refunding issue on any date required by those paragraphs before the application of the universal cap rule of §1.148–6(b)(2) to reallocate any of those amounts. To the extent nonpurpose investments allocable to proceeds of a refunding issue exceed the universal cap for the issue on the date that amounts become transferred proceeds of the refunding issue, those transferred proceeds and corresponding investments are reallocated back to the issue from which they transferred on that same date to the extent of the unused universal cap on that prior issue.

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

Example. On January 1, 1995, $100,000 of nonpurpose investments allocable to proceeds of issue *A* become transferred proceeds of issue *B* under §1.148–9, but the unused portion of issue *B*' s universal cap is $75,000 as of that date. On January 1, 1995, issue *A* has unused universal cap in excess of $25,000. Thus, $25,000 of nonpurpose investments representing the transferred proceeds are immediately reallocated back to issue *A* on January 1, 1995, and are proceeds of issue *A*. On the next transfer date under §1.148–9, the $25,000 receives no priority in determining transferred proceeds as of that date but is treated the same as all other proceeds of issue *A* subject to transfer.

(4) *Limitation on multi-generational transfers.* This paragraph (b)(4) contains limitations on the manner in which proceeds of a first generation issue that is refunded by a refunding issue (a *second generation issue*) become transferred proceeds of a refunding issue (a *third generation issue*) that refunds the second generation issue. Proceeds of the first generation issue that become transferred proceeds of the third generation issue are treated as having a yield equal to the yield on the refunding escrow allocated to the second generation issue (*i.e.*, as determined under §1.148–5(b)(2)(iv)). The determination of the transferred proceeds of the third generation issue does not affect compliance with the requirements of section 148, including the determination of the amount of arbitrage rebate with respect to or the yield on the refunding escrow, of the second generation issue.

(c) *Special allocation rules for refunding issues*—(1) *Allocations of investments*—(i) *In general.* Except as otherwise provided in this paragraph (c), investments purchased with sale proceeds or investment proceeds of a refunding issue must be allocated to those proceeds, and investments not purchased with those proceeds may not be allocated to those proceeds (*i.e.*, a *specific tracing method*).

(ii) *Allocations to transferred proceeds.* When proceeds of a prior issue become transferred proceeds of a refunding issue, investments (and the related payments and receipts) of proceeds of the prior issue that are held in a refunding escrow for another issue are allocated to the transferred proceeds under the ratable allocation method described in paragraph (c)(1)(iii) of this section. Investments of proceeds of the prior issue that are not held in a refunding escrow for another issue are allocated to the transferred proceeds by application of the allocation methods described in paragraph (c)(1) (iii) or (iv) of this section, consistently applied to all investments on a transfer date.

(iii) *Ratable allocation method.* Under the ratable allocation method, a ratable portion of each nonpurpose and purpose investment of proceeds of the prior issue is allocated to transferred proceeds of the refunding issue.

(iv) *Representative allocation method*—(A) *In general.* Under the representative allocation method, representative portions of the portfolio of nonpurpose investments and the portfolio of purpose investments of proceeds of the prior issue are allocated to transferred proceeds of the refunding issue. Unlike the ratable allocation method, this representative allocation method permits an allocation of particular whole investments. Whether a portion is representative is based on all the facts and circumstances, including, without limitation, whether the current yields, maturities, and current unrealized gains or losses on the particular allocated investments are reasonably comparable to those of the unallocated investments in the aggregate. In addition, if a portion of nonpurpose investments is otherwise representative, it is within the issuer's discretion to allocate the portion from whichever source of funds it deems appropriate, such as a reserve fund or a construction fund for a prior issue.

(B) *Mark-to-market safe harbor for representative allocation method.* In addition to other representative allocations, a specific allocation of a particular nonpurpose investment to transferred proceeds (e.g., of lower yielding investments) is treated as satisfying the representative allocation method if that investment is valued at fair market value on the transfer date in determining the payments and receipts on that date, but only if the portion of the nonpurpose investments that transfers is based on the relative fair market value of all nonpurpose investments.

(2) *Allocations of mixed escrows to expenditures for principal, interest, and redemption prices on a prior issue*—(i) *In general.* Except for amounts required or permitted to be accounted for under paragraph (c)(2)(ii) of this section, proceeds of a refunding issue and other amounts that are not proceeds of a refunding issue that are deposited in a refunding escrow (a *mixed escrow*) must be accounted for under this paragraph (c)(2)(i). Those proceeds and other amounts must be allocated to expenditures for principal, interest, or stated redemption prices on the prior issue so that the expenditures of those proceeds do not occur faster than ratably with expenditures of the other amounts in the mixed escrow. During the period that the prior issue has unspent proceeds, however, these allocations must be ratable (with reasonable adjustments for rounding) both between sources for expenditures (*i.e.*, proceeds and other amounts) and between uses (*i.e.*, principal, interest, and stated redemption prices on the prior issue).

(ii) *Exceptions*—(A) *Mandatory allocation of certain non-proceeds to earliest expenditures.* If amounts other than proceeds of the refunding issue are deposited in a mixed escrow, but before the issue date of the refunding issue those amounts had been held in a bona fide debt service fund or a fund to carry out the governmental purpose of the prior issue (e.g., a construction fund), those amounts must be allocated to the earliest maturing investments in the mixed escrow.

(B) *Permissive allocation of non-proceeds to earliest expenditures.* Excluding amounts covered by paragraph (c)(2)(ii)(A) of this section and subject to any required earlier expenditure of those amounts, any amounts in a mixed escrow that are not proceeds of a refunding issue may be allocated to the earliest maturing investments in the mixed escrow, provided that those investments mature and the proceeds thereof are expended before the date of any expenditure from the mixed escrow to pay any principal of the prior issue.

(d) *Temporary periods in refundings*—(1) *In general.* Proceeds of a refunding issue may be invested in higher yielding investments under section 148(c) only during the temporary periods described in paragraph (d)(2) of this section.

(2) *Types of temporary periods in refundings.* The available temporary periods for proceeds of a refunding issue are as follows:

(i) *General temporary period for refunding issues.* Except as otherwise provided in this paragraph (d)(2), the temporary period for proceeds (other than transferred proceeds) of a refunding issue is the period ending 30 days after the issue date of the refunding issue.

(ii) *Temporary periods for current refunding issues*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(ii)(B) of this section, the temporary period for proceeds (other than transferred proceeds) of a current refunding issue is 90 days.

(B) *Temporary period for short-term current refunding issues.* The temporary period for proceeds (other than transferred proceeds) of a current refunding issue that has an original term to maturity of 270 days or less may not exceed 30 days. The aggregate temporary periods for proceeds (other than transferred proceeds) of all current refunding issues described in the preceding sentence that are part of the same series of refundings is 90 days. An issue is part of a series of refundings if it finances or refinances the same expenditures for a particular governmental purpose as another issue.

(iii) *Temporary periods for transferred proceeds*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(iii)(B) of this section, each available temporary period for transferred proceeds of a refunding issue begins on the date those amounts become transferred proceeds of the refunding issue and ends on the date that, without regard to the discharge of the prior issue, the available temporary period for those proceeds would have ended had those proceeds remained proceeds of the prior issue.

(B) *Termination of initial temporary period for prior issue in an advance refunding.* The initial temporary period under §1.148–2(e) (2) and (3) for the proceeds of a prior issue that is refunded by an advance refunding issue (including transferred proceeds) terminates on the issue date of the advance refunding issue.

(iv) *Certain short-term gross proceeds.* Except for proceeds of a refunding issue held in a refunding escrow, proceeds otherwise reasonably expected to be used to pay principal or interest on the prior issue, replacement proceeds not held in a bona fide debt service fund, and transferred proceeds, the temporary period for gross proceeds of a refunding issue is the 13-month period beginning on the date of receipt.

(e) *Reasonably required reserve or replacement funds in refundings.* In addition to the requirements of §1.148–2(f), beginning on the issue date of a refunding issue, a reserve or replacement fund for a refunding issue or a prior issue is a reasonably required reserve or replacement fund under section 148(d) that may be invested in higher yielding investments only if the aggregate amount invested in higher yielding investments under this paragraph (e) for both the refunding issue and the prior issue does not exceed the size limitations under §1.148–2 (f)(2) and (f)(3), measured by reference to the refunding issue only (regardless of whether proceeds of the prior issue have become transferred proceeds of the refunding issue).

(f) *Minor portions in refundings.* Beginning on the issue date of the refunding issue, gross proceeds not in excess of a minor portion of the refunding issue qualify for investment in higher yielding investments under section 148(e), and gross proceeds not in excess of a minor portion of the prior issue qualify for investment in higher yielding investments under either section 148(e) or section 149(d)(3)(A)(v), whichever is applicable. *Minor portion* is defined in §1.148–2(g).

(g) *Certain waivers permitted.* On or before the issue date, an issuer may waive the right to invest in higher yielding investments during any temporary period or as part of a reasonably required reserve or replacement fund. At any time, an issuer may waive the right to invest in higher yielding investments as part of a minor portion.

(h) *Multipurpose issue allocations*—(1) *Application of multipurpose issue allocation rules.* The portion of the bonds of a multipurpose issue reasonably allocated to any separate purpose under this paragraph (h) is treated as a separate issue for all purposes of section 148 except the following—

(i) *Arbitrage yield*. Except to the extent that the proceeds of an issue are allocable to two or more conduit loans that are tax-exempt bonds, determining the yield on a multipurpose issue and the yield on investments for purposes of the arbitrage yield restrictions of section 148 and the arbitrage rebate requirement of section 148(f);

(ii) *Rebate amount*. Except as provided in paragraph (h)(1)(i) of this section, determining the rebate amount for a multipurpose issue, including subsidiary matters with respect to that determination, such as the computation date credit under § 1.148–3(d)(1), the due date for payments, and the $100,000 bona fide debt service fund exception under section 148(f)(4)(A)(ii);

(iii) *Minor portion*. Determining the *minor portion* of an issue under section 148(e);

(iv) *Reasonably required reserve or replacement fund*. Determining the portion of an issue eligible for investment in higher yielding investments as part of a reasonably required reserve or replacement fund under section 148(d); and

(v) *Effective date*. Applying the provisions of § 1.148–11(b) (relating to elective retroactive application of §§ 1.148–1 through 1.148–10 to certain issues).

(2) *Rules on allocations of multipurpose issues*—(i) *In general*. This paragraph (h) applies to allocations of multipurpose issues, including allocations involving the refunding purposes of the issue. Except as otherwise provided in this paragraph (h), proceeds, investments, and bonds of a multipurpose issue may be allocated among the various separate purposes of the issue using any reasonable, consistently applied allocation method. An allocation is not reasonable if it achieves more favorable results under section 148 or 149(d) than could be achieved with actual separate issues. An allocation under this paragraph (h) may be made at any time, but once made may not be changed.

(ii) *Allocations involving certain common costs*. A ratable allocation of common costs (as described in paragraph (h)(3)(ii) of this section) among the separate purposes of the multipurpose issue is generally reasonable. If another allocation method more accurately reflects the extent to which any separate purpose of a multipurpose issue enjoys the economic benefit or bears the economic burden of certain common costs, that allocation method may be used.

(3) *Separate purposes of a multipurpose issue*—(i) *In general*. Separate purposes of a multipurpose issue include refunding a separate prior issue, financing a separate purpose investment, financing a construction issue (as defined in § 1.148–7(f)), and any clearly discrete governmental purpose reasonably expected to be financed by that issue. In general, all integrated or functionally related capital projects that qualify for the same initial temporary period under § 1.148–2(e)(2) are treated as having a single governmental purpose. The separate purposes of a refunding issue include the separate purposes of the prior issue, if any. Separate purposes may be treated as a single purpose if the proceeds used to finance those purposes are eligible for the same initial temporary period under section 148(c). For example, the use of proceeds of a multipurpose issue to finance separate qualified mortgage loans may be treated as a single purpose.

(ii) *Financing common costs*. Common costs of a multipurpose issue are not separate purposes. Common costs include issuance costs, accrued interest, capitalized interest on the issue, a reserve or replacement fund, qualified guarantee fees, and similar costs properly allocable to the separate purposes of the issue.

(iii) *Example*. The following example illustrates the application of this paragraph (h)(3).

Example. On January 1, 1994, Housing Authority of State *A* issues a $10 million issue (the *1994 issue*) at an interest rate of 10 percent to finance qualified mortgage loans for owner-occupied residences under section 143. During 1994, *A* originates $5 million in qualified mortgage loans at an interest rate of 10 percent. In 1995, the market interest rates for housing loans falls to 8 percent and *A* is unable to originate further loans from the 1994 issue. On January 1, 1996, *A* issues a $5 million issue (the *1996 issue*) at an interest rate of 8 percent to refund partially the 1994 issue. Under paragraph (h) of this section, *A* treats the portion of the 1994 issue used to originate $5 million in loans as a separate issue comprised of that group of purpose investments. *A* allocates those purpose investments representing those loans to that separate unrefunded portion of the issue. In addition, *A* treats the unoriginated portion of the 1994 issue as a separate issue and allocates the nonpurpose investments representing the unoriginated proceeds of the 1994 issue to the refunded portion of the issue. Thus, when proceeds of the 1996 issue are used to pay principal on the refunded portion of the 1994 issue that is treated as a separate issue under paragraph (h) of this section, only the portion of the 1994 issue representing unoriginated loan funds invested in nonpurpose investments transfer to become transferred proceeds of the 1996 issue.

(4) *Allocations of bonds of a multipurpose issue*—(i) *Reasonable allocation of bonds to portions of issue.* After reasonable adjustment of the issue price of a multipurpose issue to account for common costs, the portion of the bonds of a multipurpose issue allocated to a separate purpose must have an issue price that bears the same ratio to the aggregate issue price of the multipurpose issue as the portion of the sale proceeds of the multipurpose issue used for that separate purpose bears to the aggregate sale proceeds of the multipurpose issue. For a refunding issue used to refund two or more prior issues, the portion of the sales proceeds allocated to the refunding of a separate prior issue is based on the present value of the refunded debt service on that prior issue, using the yield on investments in the refunding escrow allocable to the entire refunding issue as the discount rate.

(ii) *Safe harbor for pro rata allocation method for bonds.* The use of the relative amount of sales proceeds used for each separate purpose to ratably allocate each bond or a ratable number of substantially identical whole bonds is a reasonable method for allocating bonds of a multipurpose issue.

(iii) *Safe harbor for allocations of bonds used to finance separate purpose investments.* An allocation of a portion of the bonds of a multipurpose issue to a particular purpose investment is generally reasonable if that purpose investment has principal and interest payments that reasonably coincide in time and amount to principal and interest payments on the bonds allocated to that purpose investment.

(iv) *Rounding of bond allocations to next whole bond denomination permitted.* An allocation that rounds each resulting fractional bond up or down to the next integral multiple of a permitted denomination of bonds of that issue not in excess of $100,000 does not prevent the allocation from satisfying this paragraph (h)(4).

(v) *Restrictions on allocations of bonds to refunding purposes.* For each portion of a multipurpose issue that is used to refund a separate prior issue, a method of allocating bonds of that issue is reasonable under this paragraph (h) only if, in addition to the requirements of paragraphs (h)(1) and (h)(2) of this section, the portion of the bonds allocated to the refunding of that prior issue—

(A) Results from a pro rata allocation under paragraph (h)(4)(ii) of this section;

(B) Reflects aggregate principal and interest payable in each bond year that is less than, equal to, or proportionate to, the aggregate principal and interest payable on the prior issue in each bond year;

(C) Results from an allocation of all the bonds of the entire multipurpose issue in proportion to the remaining weighted average economic life of the capital projects financed or refinanced by the issue, determined in the same manner as under section 147(b); or

(D) Results from another reasonable allocation method, but only to the extent that the application of the allocation methods provided in this paragraph (h)(4)(v) is not permitted under state law restrictions applicable to the bonds, reasonable terms of bonds issued before, or subject to a master indenture that became effective prior to, July 1, 1993, or other similar restrictions or circumstances. This paragraph (h)(4)(v)(D) shall be strictly construed and is available only if it does not result in a greater burden on the market for tax-exempt bonds than would occur using one of the other allocation methods provided in this paragraph (h)(4)(v). (See also § 1.148–11(c)(2).)

(vi) *Exception for refundings of interim notes.* Paragraph (h)(4)(v) of this section need not be applied to refunding bonds issued to provide permanent financing for one or more projects if the prior issue had a term of less than 3 years and was sold in anticipation of permanent financing, but only if the aggregate term of all prior issues sold in anticipation of permanent financing was less than 3 years.

(5) *Limitation on multi-generation allocations.* This paragraph (h) does not apply to allocations of a multipurpose refunded issue unless that refunded issue is refunded directly by an issue to which this paragraph (h) applies. For example, if a 1994 issue refunds a 1984 multipurpose issue, which in turn refunded a 1980 multipurpose issue, this paragraph (h) applies to allocations of the 1984 issue for purposes of allocating the refunding purposes of the 1994 issue, but does not permit allocations of the 1980 issue.

(i) *Operating rules for separation of prior issue into refunded and unrefunded portions*—(1) *In general.* For purposes of paragraph (h)(3)(i) of this section, the separate purposes of a prior issue include the refunded and unrefunded portions of the prior issue. Thus, the refunded and unrefunded portions are treated as separate issues under paragraph (h)(1) of this section. Those separate issues must satisfy the requirements of paragraphs (h) and (i) of this section. The refunded portion of the bonds of a prior issue is based on a fraction the numerator of which is the principal amount of the prior issue to be paid with proceeds of the refunding issue and the denominator of which is the outstanding principal amount of the bonds of the prior issue, each determined as of the issue date of the refunding issue. (See also paragraph (b)(2) of this section.)

(2) *Allocations of proceeds and investments in a partial refunding.* As of the issue date of a partial refunding issue under this paragraph (i), unspent proceeds of the prior issue are allocated ratably between the refunded and unrefunded portions of the prior issue and the investments allocable to those unspent proceeds are allocated in the manner required for the allocation of investments to transferred proceeds under paragraph (c)(1)(ii) of this section.

(3) *References to prior issue.* If the refunded and unrefunded portions of a prior issue are treated as separate issues under this paragraph (i), then, except to the extent that the context clearly requires otherwise (e.g., references to the aggregate prior issue in the mixed escrow rule in paragraph (c)(2) of this section), all references in this section to a prior issue refer only to the refunded portion of that prior issue.

[T.D. 8476, 58 FR 33541, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24045, May 10, 1994; T.D. 8718, 62 FR 25512, May 9, 1997]

§ 1.148–10 Anti-abuse rules and authority of Commissioner.

(a) *Abusive arbitrage device*—(1) *In general.* Bonds of an issue are arbitrage bonds under section 148 if an abusive arbitrage device under paragraph (a)(2) of this section is used in connection with the issue. This paragraph (a) is to be applied and interpreted broadly to carry out the purposes of section 148, as further described in § 1.148–0. Except as otherwise provided in paragraph (c) of this section, any action that is expressly permitted by section 148 or §§ 1.148–1 through 1.148–11 is not an abusive arbitrage device (e.g., investment in higher yielding investments during a permitted temporary period under section 148(c)).

(2) *Abusive arbitrage device defined.* Any action is an abusive arbitrage device if the action has the effect of—

(i) Enabling the issuer to exploit the difference between tax-exempt and taxable interest rates to obtain a material financial advantage; and

(ii) Overburdening the tax-exempt bond market.

(3) *Exploitation of tax-exempt interest rates.* An action may exploit tax-exempt interest rates under paragraph (a)(2) of this section as a result of an investment of any portion of the gross proceeds of an issue over any period of time, notwithstanding that, in the aggregate, the gross proceeds of the issue are not invested in higher yielding investments over the term of the issue.

(4) *Overburdening the tax-exempt market.* An action overburdens the tax-exempt bond market under paragraph (a)(2)(ii) of this section if it results in issuing more bonds, issuing bonds earlier, or allowing bonds to remain outstanding longer than is otherwise reasonably necessary to accomplish the

governmental purposes of the bonds, based on all the facts and circumstances. Whether an action is reasonably necessary to accomplish the governmental purposes of the bonds depends on whether the primary purpose of the transaction is a bona fide governmental purpose (e.g., an issue of refunding bonds to achieve a debt service restructuring that would be issued independent of any arbitrage benefit). An important factor bearing on this determination is whether the action would reasonably be taken to accomplish the governmental purpose of the issue if the interest on the issue were not excludable from gross income under section 103(a) (assuming that the hypothetical taxable interest rate would be the same as the actual tax-exempt interest rate). Factors evidencing an overissuance include the issuance of an issue the proceeds of which are reasonably expected to exceed by more than a minor portion the amount necessary to accomplish the governmental purposes of the issue, or an issue the proceeds of which are, in fact, substantially in excess of the amount of sale proceeds allocated to expenditures for the governmental purposes of the issue. One factor evidencing an early issuance is the issuance of bonds that do not qualify for a temporary period under §1.148–2(e)(2), (e)(3), or (e)(4). One factor evidencing that bonds may remain outstanding longer than necessary is a term that exceeds the safe harbors against the creation of replacement proceeds under §1.148–1(c)(4)(i)(B). These factors may be outweighed by other factors, such as bona fide cost underruns, an issuer's bona fide need to finance extraordinary working capital items, or an issuer's long-term financial distress.

(b) *Consequences of overburdening the tax-exempt bond market*—(1) *In general.* An issue that overburdens the tax-exempt bond market (within the meaning of paragraph (a)(4) of this section) is subject to the following special limitations—

(i) *Special yield restriction.* Investments are subject to the definition of *materially higher* yield under §1.148–2(d) that is equal to one-thousandth of 1 percent. In addition, each investment is treated as a separate class of investments under §1.148–5(b)(2)(ii), the yield on which may not be blended with that of other investments.

(ii) *Certain regulatory provisions inapplicable.* The provisions of §1.148–5(c) (relating to yield reduction payments) and §1.148–5(e) (2) and (3) (relating to recovery of qualified administrative costs) do not apply.

(iii) *Restrictive expenditure rule.* Proceeds are not allocated to expenditures unless the proceeds-spent-last rule under §1.148–6(d)(3)(i) is satisfied, applied by treating those proceeds as proceeds to be used for restricted working capital expenditures. For this purpose, available amount includes a reasonable working capital reserve as defined in §1.148–6(d)(3)(iii)(B).

(2) *Application.* The provisions of this paragraph (b) only apply to the portion of an issue that, as a result of actions taken (or actions not taken) after the issue date, overburdens the market for tax-exempt bonds, except that for an issue that is reasonably expected as of the issue date to overburden the market, those provisions apply to all of the gross proceeds of the issue.

(c) *Anti-abuse rules on excess gross proceeds of advance refunding issues*—(1) *In general.* Except as otherwise provided in this paragraph (c), an abusive arbitrage device is used and bonds of an advance refunding issue are arbitrage bonds if the issue has excess gross proceeds.

(2) *Definition of excess gross proceeds.* Excess gross proceeds means all gross proceeds of an advance refunding issue that exceed an amount equal to 1 percent of sale proceeds of the issue, other than gross proceeds allocable to—

(i) Payment of principal, interest, or call premium on the prior issue;

(ii) Payment of pre-issuance accrued interest on the refunding issue, and interest on the refunding issue that accrues for a period up to the completion date of any capital project for which the prior issue was issued, plus one year;

(iii) A reasonably required reserve or replacement fund for the refunding issue or investment proceeds of such a fund;

(iv) Payment of costs of issuance of the refunding issue;

(v) Payment of administrative costs allocable to repaying the prior issue, carrying and repaying the refunding issue, or investments of the refunding issue;

(vi) Transferred proceeds that will be used or maintained for the governmental purpose of the prior issue;

(vii) Interest on purpose investments;

(viii) Replacement proceeds in a sinking fund for the refunding issue;

(ix) Qualified guarantee fees for the refunding issue or the prior issue; and

(x) Fees for a qualified hedge for the refunding issue.

(3) *Special treatment of transferred proceeds.* For purposes of this paragraph (c), all unspent proceeds of the prior issue as of the issue date of the refunding issue are treated as transferred proceeds of the advance refunding issue.

(4) *Special rule for crossover refundings.* An advance refunding issue is not an issue of arbitrage bonds under this paragraph (c) if all excess gross proceeds of the refunding issue are used to pay interest that accrues on the refunding issue before the prior issue is discharged, and no gross proceeds of any refunding issue are used to pay interest on the prior issue or to replace funds used directly or indirectly to pay such interest (other than transferred proceeds used to pay interest on the prior issue that accrues for a period up to the completion date of the project for which the prior issue was issued, plus one year, or proceeds used to pay principal that is attributable to accrued original issue discount).

(5) *Special rule for gross refundings.* This paragraph (c)(5) applies if an advance refunding issue (the *series B issue*) is used together with one or more other advance refunding issues (the *series A issues*) in a gross refunding of a prior issue, but only if the use of a gross refunding method is required under bond documents that were effective prior to November 6, 1992. These advance refunding issues are not arbitrage bonds under this paragraph (c) if—

(i) All excess gross proceeds of the series B issue and each series A issue are investment proceeds used to pay principal and interest on the series B issue;

(ii) At least 99 percent of all principal and interest on the series B issue is paid with proceeds of the series B and series A issues or with the earnings on other amounts in the refunding escrow for the prior issue;

(iii) The series B issue is discharged not later than the prior issue; and

(iv) As of any date, the amount of gross proceeds of the series B issue allocated to expenditures does not exceed the aggregate amount of expenditures before that date for principal and interest on the series B issue, and administrative costs of carrying and repaying the series B issue, or of investments of the series B issue.

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

Example 1. Mortgage sale. In 1982, City issued its revenue issue (the *1982 issue*) and lent the proceeds to Developer to finance a low-income housing project under former section 103(b)(4)(A) of the 1954 Code. In 1994, Developer encounters financial difficulties and negotiates with City to refund the 1982 issue. City issues $10 million in principal amount of its 8 percent bonds (the *1994 issue*). City lends the proceeds of the 1994 issue to Developer. To evidence Developer's obligation to repay that loan, Developer, as obligor, issues a note to City (the *City note*). Bank agrees to provide Developer with a direct-pay letter of credit pursuant to which Bank will make all payments to the trustee for the 1994 issue necessary to meet Developer's obligations under the City note. Developer pays Bank a fee for the issuance of the letter of credit and issues a note to Bank (the *Bank note*). The Bank note is secured by a mortgage on the housing project and is guaranteed by FHA. The Bank note and the 1994 issue have different prepayment terms. The City does not reasonably expect to treat prepayments of the Bank note as gross proceeds of the 1994 issue. At the same time or pursuant to a series of related transactions, Bank sells the Bank note to Investor for $9.5 million. Bank invests these monies together with its other funds. In substance, the transaction is a loan by City to Bank, under which Bank enters into a series of transactions that, in effect, result in Bank retaining $9.5 million in amounts treated as proceeds of the 1994 issue. Those amounts are invested in materially higher yielding investments that provide funds sufficient to equal or exceed the Bank's liability under the letter of credit. Alternatively, the letter of credit is investment property in a sinking fund for the 1994 issue provided by Developer, a substantial beneficiary of the financing. Because, in substance, Developer acquires the $10 million principal amount letter of credit for a fair market value purchase price of $9.5 million, the letter of credit is a materially higher yielding investment. Neither result would change if Developer's obligation under the Bank note is contingent on Bank performing its obligation under the letter of credit. Each characterization causes the bonds to be arbitrage bonds.

Example 2. Bonds outstanding longer than necessary for yield-blending device. (i) *Longer bond maturity to create sinking fund.* In 1994, Authority issues an advance refunding issue (the *refunding issue*) to refund a 1982 prior issue (the *prior issue*). Under current market conditions, Authority will have to invest the refunding escrow at a yield significantly below the yield on the refunding issue. Authority issues its refunding issue with a longer weighted average maturity than otherwise necessary primarily for the purpose of creating a sinking fund for the refunding issue that will be invested in a guaranteed investment contract. The weighted average maturity of the refunding issue is less than 120 percent of the remaining average economic life of the facilities financed with the proceeds of the prior issue. The guaranteed investment contract has a yield that is higher than the yield on the refunding issue. The yield on the refunding escrow blended with the yield on the guaranteed investment contract does not exceed the yield on the issue. The refunding issue uses an abusive arbitrage device and the bonds of the issue are arbitrage bonds under section 148(a).

(ii) *Refunding of noncallable bonds.* The facts are the same as in paragraph (i) of this *Example 2* except that instead of structuring the refunding issue to enable it to take advantage of sinking fund investments, Authority will also refund other long-term, non-callable bonds in the same refunding issue. There are no savings attributable to the refunding of the non-callable bonds (e.g., a *low-to-high* refunding). The Authority invests the portion of the proceeds of the refunding issue allocable to the refunding of the non-callable bonds in the refunding escrow at a yield that is higher than the yield on the refunding issue, based on the relatively long escrow period for this portion of the refunding. The Authority invests the other portion of the proceeds of the refunding issue in the refunding escrow at a yield lower than the yield on the refunding issue. The blended yield on all the investments in the refunding escrow for the prior issues does not exceed the yield on the refunding issue. The portion of the refunding issue used to refund the noncallable bonds, however, was not otherwise necessary and was issued primarily to exploit the difference between taxable and tax-exempt rates for that long portion of the refunding escrow to minimize the effect of lower yielding investments in the other portion of the escrow. The refunding issue uses an abusive arbitrage device and the bonds of the issue are arbitrage bonds.

(iii) *Governmental purpose.* In paragraphs (i) and (ii) of this *Example 2*, the existence of a governmental purpose for the described financing structures would not change the conclusions unless Authority clearly established that the primary purpose for the use of the particular structure was a bona fide governmental purpose. The fact that each financing structure had the effect of eliminating significant amounts of negative arbitrage is strong evidence of a primary purpose that is not a bona fide governmental purpose. Moreover, in paragraph (i) of this *Example 2*, the structure of the refunding issue coupled with the acquisition of the guaranteed investment contract to lock in the investment yield associated with the structure is strong evidence of a primary purpose that is not a bona fide governmental purpose.

Example 3. Window refunding. (i) Authority issues its 1994 refunding issue to refund a portion of the principal and interest on its outstanding 1985 issue. The 1994 refunding issue is structured using zero-coupon bonds that pay no interest or principal for the 5-year period following the issue date. The proceeds of the 1994 refunding issue are deposited in a refunding escrow to be used to pay only the interest requirements of the refunded portion of the 1985 issue. Authority enters into a guaranteed investment contract with a financial institution, *G*, under which *G* agrees to provide a guaranteed yield on revenues invested by Authority during the 5-year period following the issue date. The guaranteed investment contract has a yield that is no higher than the yield on the refunding issue. The revenues to be invested under this guaranteed investment contract consist of the amounts that Authority otherwise would have used to pay principal and interest on the 1994 refunding issue. The guaranteed investment contract is structured to generate receipts at times and in amounts sufficient to pay the principal and redemption requirements of the refunded portion of the 1985 issue. A principal purpose of these transactions is to avoid transferred proceeds. Authority will continue to invest the unspent proceeds of the 1985 issue that are on deposit in a refunding escrow for its 1982 issue at a yield equal to the yield on the 1985 issue and will not otherwise treat those unspent proceeds as transferred proceeds of the 1994 refunding issue. The 1994 refunding issue is an issue of arbitrage bonds since those bonds involve a transaction or series of transactions that overburdens the market by leaving bonds outstanding longer than is necessary to obtain a material financial advantage based on arbitrage. Specifically, Authority has structured the 1994 refunding issue to make available for the refunding of the 1985 issue replacement proceeds rather than proceeds so that the unspent proceeds of the 1985 issue will not become transferred proceeds of the 1994 refunding issue.

(ii) The result would be the same in each of the following circumstances:

(A) The facts are the same as in paragraph (i) of this *Example 3* except that Authority does not enter into the guaranteed investment contract but instead, as of the issue date of the 1994 refunding issue, reasonably expects that the released revenues will be available for investment until used to pay principal and interest on the 1985 issue.

(B) The facts are the same as in paragraph (i) of this *Example 3* except that there are no unspent proceeds of the 1985 issue and Authority invests the released revenues at a yield materially higher than the yield on the 1994 issue.

(C) The facts are the same as in paragraph (i) of this *Example 3* except that Authority uses the proceeds of the 1994 issue for capital projects instead of to refund a portion of the 1985 issue.

Example 4. Sale of conduit loan. On January 1, 1994, Authority issues a conduit financing issue (the *1994 conduit financing issue*) and uses the proceeds to purchase from City, an unrelated party, a tax-exempt bond of City (the *City note*). The proceeds of the 1994 conduit financing issue are to be used to advance refund a prior conduit financing issue that was issued in 1988 and used to make a loan to City. The 1994 conduit financing issue and the City note each have a yield of 8 percent on January 1, 1994. On June 30, 1996, interest rates have decreased and Authority sells the City note to D, a person unrelated to either City or Authority. Based on the sale price of the City note and treating June 30, 1996 as the issue date of the City note, the City note has a 6 percent yield. Authority deposits the proceeds of the sale of the City note into an escrow to redeem the bonds of the 1994 conduit financing issue on January 1, 2001. The escrow is invested in nonpurpose investments having a yield of 8 percent. For purposes of section 149(d), City and Authority are related parties and, therefore, the issue date of the City note is treated as being June 30, 1996. Thus, the City note is an advance refunding of Authority's 1994 conduit financing issue. Interest on the City note is not exempt from Federal income tax from the date it is sold to D under section 149(d), because, by investing the escrow investments at a yield of 8 percent instead of a yield not materially higher than 6 percent, the sale of the City note employs a device to obtain a material financial advantage, based on arbitrage, apart from the savings attributable to lower interest rates. In addition, the City note is not a tax-exempt bond because the note is the second advance refunding of the original bond under section 149(d)(3). The City note also employs an abusive arbitrage device and is an arbitrage bond under section 148.

Example 5. Re-refunding. (i) On January 1, 1984, City issues a tax-exempt issue (the *1984 issue*) to finance the cost of constructing a prison. The 1984 issue has a 7 percent yield and a 30-year maturity. The 1984 issue is callable at any time on or after January 1, 1994. On January 1, 1990, City issues a refunding issue (the *1990 issue*) to advance refund the 1984 issue. The 1990 issue has an 8 percent yield and a 30-year maturity. The 1990 issue is callable at any time on or after January 1, 2000. The proceeds of the 1990 issue are invested at an 8 percent yield in a refunding escrow for the 1984 issue (the *original 1984 escrow*) in a manner sufficient to pay debt service on the 1984 issue until maturity (*i.e.*, an escrow to maturity). On January 1, 1994, City issues a refunding issue (the *1994 issue*). The 1994 issue has a 6 percent yield and a 30-year maturity. City does not invest the proceeds of the 1994 issue in a refunding escrow for the 1990 issue in a manner sufficient to pay a portion of the debt service until, and redeem a portion of that issue on, January 1, 2000. Instead, City invests those proceeds at a 6 percent yield in a new refunding escrow for a portion of the 1984 issue (the *new 1984 escrow*) in a manner sufficient to pay debt service on a portion of the 1984 issue until maturity. City also liquidates the investments allocable to the proceeds of the 1990 issue held in the original 1984 escrow and reinvests those proceeds in an escrow to pay a portion of the debt service on the 1990 issue itself until, and redeem a portion of that issue on, January 1, 2000 (the *1990 escrow*). The 1994 bonds are arbitrage bonds and employ an abusive device under section 149(d)(4). Although, in form, the proceeds of the 1994 issue are used to pay principal on the 1984 issue, this accounting for the use of the proceeds of the 1994 issue is an unreasonable, inconsistent accounting method under §1.148–6(a). Moreover, since the proceeds of the 1990 issue were set aside in an escrow to be used to retire the 1984 issue, the use of proceeds of the 1994 issue for that same purpose involves a replacement of funds invested in higher yielding investments under section 148(a)(2). Thus, using a reasonable, consistent accounting method and giving effect to the substance of the transaction, the proceeds of the 1994 issue are treated as used to refund the 1990 issue and are allocable to the 1990 escrow. The proceeds of the 1990 issue are treated as used to refund the 1984 issue and are allocable to the investments in the new 1984 escrow. The proceeds of the 1990 issue allocable to the nonpurpose investments in the new 1984 escrow become transferred proceeds of the 1994 issue as principal is paid on the 1990 issue from amounts on deposit in the 1990 escrow. As a result, the yield on nonpurpose investments allocable to the 1994 issue is materially higher than the yield on the 1994 issue, causing the bonds of the 1994 issue to be arbitrage bonds. In addition, the transaction employs a device under section 149(d)(4) to obtain a material financial advantage based on arbitrage, other than savings attributable to lower interest rates.

(ii) The following changes in the facts do not affect the conclusion that the 1994 issue consists of arbitrage bonds—

(1) The 1990 issue is a taxable issue;

(2) The original 1984 escrow is used to pay the 1994 issue (rather than the 1990 issue); or

(3) The 1994 issue is used to retire the 1984 issue within 90 days of January 1, 1994.

(e) *Authority of the Commissioner to prevent transactions that are inconsistent with the purpose of the arbitrage investment restrictions.* If an issuer enters into a transaction for a principal purpose of obtaining a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148, the Commissioner may exercise the Commissioner's discretion to depart from the rules of §1.148–1 through §1.148–11 as necessary to reflect the economics of the transaction to prevent such financial advantage. For this purpose, the Commissioner may recompute yield on an issue or on investments, reallocate payments and receipts on investments, recompute the rebate amount on an issue, treat a hedge as either a qualified hedge or not a qualified hedge, or otherwise adjust any item whatsoever bearing upon the investments and expenditures of gross proceeds of an issue. For example, if the amount paid for a hedge is specifically based on the amount of arbitrage earned or expected to be earned on the hedged bonds, a principal purpose of entering into the contract is to obtain a material financial advantage based on the difference between tax-exempt and taxable interest rates in a manner that is inconsistent with the purposes of section 148.

(f) *Authority of the Commissioner to require an earlier date for payment of rebate.* If the Commissioner determines that an issue is likely to fail to meet the requirements of §1.148–3 and that a failure to serve a notice of demand for payment on the issuer will jeopardize the assessment or collection of tax on interest paid or to be paid on the issue, the date that the Commissioner serves notice on the issuer is treated as a required computation date for payment of rebate for that issue.

(g) *Authority of the Commissioner to waive regulatory limitations.* Notwithstanding any specific provision in §§1.148–1 through 1.148–11, the Commissioner may prescribe extensions of temporary periods, larger reasonably required reserve or replacement funds, or consequences of failures or remedial action under section 148 in lieu of or in addition to other consequences of those failures, or take other action, if the Commissioner finds that good faith or other similar circumstances so warrant, consistent with the purposes of section 148.

[T.D. 8476, 58 FR 33544, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8476, 59 FR 24351, May 11, 1994; T.D. 8718, 62 FR 25512, May 9, 1997; T.D. 9777, 81 FR 46597, July 18, 2016]

§ 1.148–11 Effective/applicability dates.

(a) *In general.* Except as otherwise provided in this section, §§1.148–1 through 1.148–11 apply to bonds sold on or after July 8, 1997.

(b) *Elective retroactive application in whole*—(1) *In general.* Except as otherwise provided in this section, and subject to the applicable effective dates for the corresponding statutory provisions, an issuer may apply the provisions of §§1.148–1 through 1.148–11 in whole, but not in part, to any issue that is outstanding on July 8, 1997, and is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954, in lieu of otherwise applicable regulations under those sections.

(2) *No elective retroactive application for 18-month spending exception.* The provisions of §1.148–7(d) (relating to the 18-month spending exception) may not be applied to any issue issued on or before June 30, 1993.

(3) *No elective retroactive application for hedges of fixed rate issues.* The provisions of §1.148–4(h)(2)(i)(B) (relating to hedges of fixed rate issues) may not be applied to any bond sold on or before July 8, 1997.

(4) *No elective retroactive application for safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.* The

provisions of §§ 1.148–5(d)(6)(iii) (relating to the safe harbor for establishing fair market value of guaranteed investment contracts and yield restricted defeasance escrow investments) and 1.148–5(e)(2)(iv) (relating to a special rule for yield restricted defeasance escrow investments) may not be applied to any bond sold before December 30, 1998.

(c) *Elective retroactive application of certain provisions and special rules*—(1) *Retroactive application of overpayment recovery provisions*. An issuer may apply the provisions of § 1.148–3(i) to any issue that is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954.

(2) *Certain allocations of multipurpose issues*. An allocation of bonds to a refunding purpose under § 1.148–9(h) may be adjusted as necessary to reflect allocations made between May 18, 1992, and August 15, 1993, if the allocations satisfied the corresponding prior provision of § 1.148–11(j)(4) under applicable prior regulations.

(3) *Special limitation*. The provisions of § 1.148–9 apply to issues issued before August 15, 1993, only if the issuer in good faith estimates the present value savings, if any, associated with the effect of the application of that section on refunding escrows, using any reasonable accounting method, and applies those savings, if any, to redeem outstanding tax-exempt bonds of the applicable issue at the earliest possible date on which those bonds may be redeemed or otherwise retired. These savings are not reduced to take into account any administrative costs associated with applying these provisions retroactively.

(d) *Transition rule excepting certain state guarantee funds from the definition of replacement proceeds*—(1) *Certain perpetual trust funds*. (i) A guarantee by a fund created and controlled by a State and established pursuant to its constitution does not cause the amounts in the fund to be pledged funds treated as replacement proceeds if—

(A) Substantially all of the corpus of the fund consists of nonfinancial assets, revenues derived from these assets, gifts, and bequests;

(B) The corpus of the guarantee fund may be invaded only to support specifically designated essential governmental functions (designated functions) carried on by political subdivisions with general taxing powers or public elementary and public secondary schools;

(C) Substantially all of the available income of the fund is required to be applied annually to support designated functions;

(D) The issue guaranteed consists of obligations that are not private activity bonds (other than qualified 501(c)(3) bonds) substantially all of the proceeds of which are to be used for designated functions;

(E) The fund satisfied each of the requirements of paragraphs (d)(1)(i) through (d)(1)(iii) of this section on August 16, 1986; and

(F) As of the sale date of the bonds to be guaranteed, the amount of the bonds to be guaranteed by the fund plus the then-outstanding amount of bonds previously guaranteed by the fund does not exceed a total amount equal to 500 percent of the total costs of the assets held by the fund as of December 16, 2009.

(ii) The Commissioner may, by published guidance, set forth additional circumstances under which guarantees by certain perpetual trust funds will not cause amounts in the fund to be treated as replacement proceeds.

(2) *Permanent University Fund*. Replacement proceeds do not include amounts allocable to investments of the fund described in section 648 of Public Law 98–369.

(e) *Transition rule regarding special allowance payments*. Section 1.148–5(b)(5) applies to any bond issued after January 5, 1990, except a bond issued exclusively to refund a bond issued before January 6, 1990, if the amount of the refunding bond does not exceed 101 percent of the amount of the refunded bond, and the maturity date of the refunding bond is not later than the date that is 17 years after the date on which the refunded bond was issued (or, in the case of a series of refundings, the date on which the original bond was issued), but only if § 1.148–2(d)(2)(iv) is applied by substituting *1 and one-half percentage points* for *2 percentage points*.

(f) *Transition rule regarding applicability of yield reduction rule*. Section

1.148–5(c) applies to nonpurpose investments allocable to replacement proceeds of an issue that are held in a reserve or replacement fund to the extent that—

(1) Amounts must be paid into the fund under a constitutional provision, statute, or ordinance adopted before May 3, 1978;

(2) Under that provision, amounts paid into the fund (and investment earnings thereon) can be used only to pay debt service on the issues; and

(3) The size of the payments made into the fund is independent of the size of the outstanding issues or the debt service thereon.

(g) *Provisions applicable to certain bonds sold before effective date.* Except for bonds to which paragraph (b)(1) of this section applies—

(1) Section 1.148–11A provides rules applicable to bonds sold after June 6, 1994, and before July 8, 1997; and

(2) Sections 1.148–1 through 1.148–11 as in effect on July 1, 1993 (see 26 CFR part 1 as revised April 1, 1994), and §1.148–11A(i) (relating to elective retroactive application of certain provisions) provide rules applicable to certain issues issued before June 7, 1994.

(h) *Safe harbor for establishing fair market value for guaranteed investment contracts and investments purchased for a yield restricted defeasance escrow.* The provisions of §1.148–5(d)(6)(iii) are applicable to bonds sold on or after March 1, 1999. Issuers may apply these provisions to bonds sold on or after December 30, 1998, and before March 1, 1999.

(i) *Special rule for certain broker's commissions and similar fees.* Section 1.148–5(e)(2)(iii) applies to bonds sold on or after February 9, 2004. In the case of bonds sold before February 9, 2004, that are subject to §1.148–5 (pre-effective date bonds), issuers may apply §1.148–5(e)(2)(iii), in whole but not in part, with respect to transactions entered into on or after December 11, 2003. If an issuer applies §1.148–5(e)(2)(iii) to pre-effective date bonds, the per-issue safe harbor in §1.148–5(e)(2)(iii)(B)(*1*)(*ii*) is applied by taking into account all brokers' commissions or similar fees with respect to guaranteed investment contracts and investments for yield restricted defeasance escrows that the issuer treats as qualified administrative costs for the issue, including all such commissions or fees paid before February 9, 2004. For purposes of §§1.148–5(e)(2)(iii)(B)(*3*) and 1.148–5(e)(2)(iii)(B)(*6*) (relating to cost-of-living adjustments), transactions entered into before 2003 are treated as entered into in 2003.

(j) *Certain prepayments.* Section 1.148–1(e)(1) and (2) apply to bonds sold on or after October 3, 2003. Issuers may apply §1.148–1(e)(1) and (2), in whole but not in part, to bonds sold before October 3, 2003, that are subject to §1.148–1.

(k) *Certain arbitrage guidance updates*—(1) *In general.* Sections 1.148–1(c)(4)(i)(B)(1); 1.148–1(c)(4)(i)(B)(4); 1.148–1(c)(4)(ii); 1.148–2(e)(3)(i); 1.148–3(d)(1)(iv); 1.148–3(d)(4); 1.148–4(a); 1.148–4(b)(3)(i); 1.148–4(h)(2)(ii)(A); 1.148–4(h)(2)(v); 1.148–4(h)(2)(vi); 1.148(h)(4)(i)(C); 1.148–5(c)(3); 1.148–5(d)(2); 1.148–5(d)(3); 1.148–5(d)(6)(i); 1.148–5(d)(6)(iii)(A); 1.148–5(e)(2)(ii)(B); 1.148–6(d)(3)(iii)(A); 1.148–6(d)(4); 1.148–7(c)(3)(v); 1.148–7(i)(6)(ii); 1.148–10(a)(4); 1.148–10(e); 1.148–11(d)(1)(i)(B); 1.148–11(d)(1)(i)(D); 1.148–11(d)(1)(i)(F); and 1.148–11(d)(1)(ii) apply to bonds sold on or after October 17, 2016.

(2) *Valuation of investments in refunding transactions.* Section 1.148–5(d)(3) also applies to bonds refunded by bonds sold on or after October 17, 2016.

(3) *Rebate overpayment recovery.* (i) Section 1.148–3(i)(3)(i) applies to claims arising from an issue of bonds to which §1.148–3(i) applies and for which the final computation date is after June 24, 2008. For purposes of this paragraph (k)(3)(i), issues for which the actual final computation date is on or before June 24, 2008, are deemed to have a final computation date of July 1, 2008, for purposes of applying §1.148–3(i)(3)(i).

(ii) Section 1.148–3(i)(3)(ii) and (iii) apply to claims arising from an issue of bonds to which §1.148–3(i) applies and for which the final computation date is after September 16, 2013.

(iii) Section 1.148–3(j) applies to bonds subject to §1.148–3(i).

(4) *Hedge identification.* Section 1.148–4(h)(2)(viii) applies to hedges that are entered into on or after October 17, 2016.

(5) *Hedge modifications and termination.* Section 1.148–4(h)(3)(iv)(A) through (H) and (h)(4)(iv) apply to—

(i) Hedges that are entered into on or after *October 17, 2016;*

(ii) Qualified hedges that are modified on or after October 17, 2016 with respect to modifications on or after such date; and

(iii) Qualified hedges on bonds that are refunded on or after October 17, 2016 with respect to the refunding on or after such date.

(6) *Small issuer exception to rebate requirement for conduit borrowers of pooled financings.* Section 1.148–8(d) applies to bonds issued after May 17, 2006.

(l) *Permissive application of certain arbitrage updates*—(1) *In general.* Except as otherwise provided in this paragraph (l), issuers may apply the provisions described in paragraph (k)(1), (2), and (5) in whole, but not in part, to bonds sold before October 17, 2016.

(2) *Computation credit.* Issuers may apply §1.148–3(d)(1)(iv) and (d)(4) for bond years ending on or after July 18, 2016.

(3) *Yield reduction payments.* Issuers may apply §1.148–5(c)(3) for investments purchased on or after July 18, 2016.

(4) *External commingled funds.* Issuers may apply §1.148–5(e)(2)(ii)(B) with respect to costs incurred on or after July 18, 2016.

(m) *Definition of issue price.* The definition of issue price in §1.148–1(b) and (f) applies to bonds that are sold on or after June 7, 2017.

(n) *Investment-type property.* Section 1.148–1(e)(1) and (4) apply to bonds sold on or after July 8, 2019. An issuer may apply the provisions of §1.148–1(e)(1) and (4) to bonds sold before July 8, 2019.

[T.D. 8476, 58 FR 33547, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8718, 62 FR 25512, May 9, 1997; T.D. 8476, 64 FR 37037, July 9, 1999; T.D. 9085, 68 FR 45777, Aug. 4, 2003; T.D. 9097, 68 FR 69023, Dec. 11, 2003; T.D. 9701, 79 FR 67351, Nov. 13, 2014; T.D. 9777, 81 FR 46597, July 18, 2016; 81 FR 57459, Aug. 23, 2016; T.D. 9801, 81 FR 89004, Dec. 9, 2016; 82 FR 37817, Aug. 14, 2017; T.D. 9854, 84 FR 14007, Apr. 9, 2019]

§ 1.149(b)–1 Federally guaranteed bonds.

(a) *General rule.* Under section 149(b) and this section, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue that is federally guaranteed.

(b) *Exceptions.* Pursuant to section 149(b)(3)(B), section 149(b)(1) and paragraph (a) of this section do not apply to—

(1) Investments in obligations issued pursuant to §21B(d)(3) of the Federal Home Loan Bank Act, as amended by §511 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, or any successor provision; or

(2) Any investments that are held in a refunding escrow (as defined in §1.148–1).

(c) *Effective date.* This section applies to investments made after June 30, 1993.

[T.D. 8476, 58 FR 33548, June 18, 1993]

§ 1.149(d)–1 Limitations on advance refundings.

(a) *General rule.* Under section 149(d) and this section, nothing in section 103(a) or in any other provision of law shall be construed to provide an exemption from Federal income tax for interest on any bond issued as part of an issue described in paragraphs (2), (3), or (4) of section 149(d).

(b) *Advance refunding issues that employ abusive devices*—(1) *In general.* An advance refunding issue employs an abusive device and is described in section 149(d)(4) if the issue violates any of the anti-abuse rules under §1.148–10.

(2) *Failure to pay required rebate.* An advance refunding issue is described in section 149(d)(4) if the issue fails to meet the requirements of §1.148–3. This paragraph (b)(2) applies to any advance refunding issue issued after August 31, 1986.

(3) *Mixed escrows invested in tax-exempt bonds.* An advance refunding issue is described in section 149(d)(4) if—

(i) Any of the proceeds of the issue are invested in a refunding escrow in which a portion of the proceeds are invested in tax-exempt bonds and a portion of the proceeds are invested in nonpurpose investments;

(ii) The yield on the tax-exempt bonds in the refunding escrow exceeds the yield on the issue;

(iii) The yield on all the investments (including investment property and tax-exempt bonds) in the refunding escrow exceeds the yield on the issue; and

(iv) The weighted average maturity of the tax-exempt bonds in the refunding escrow is more than 25 percent greater or less than the weighted average maturity of the nonpurpose investments in the refunding escrow, and the weighted average maturity of nonpurpose investments in the refunding escrow is greater than 60 days.

(4) *Tax-exempt conduit loans.* For purposes of applying section 149(d) to a conduit financing issue that finances any conduit loan that is a tax-exempt bond, the actual issuer of a conduit financing issue and the conduit borrower of that conduit financing issue are treated as related parties. Thus, the issue date of the conduit loan does not occur prior to the date on which the actual issuer of the conduit financing issue sells, exchanges, or otherwise disposes of that conduit loan, and the use of the proceeds of the disposition to pay debt service on the conduit financing issue causes the conduit loan to be a refunding issue. See §1.148–10(d), *Example 4.*

(c) *Unrefunded debt service remains eligible for future advance refunding.* For purposes of section 149(d)(3)(A)(i), any principal or interest on a prior issue that has not been paid or provided for by any advance refunding issue is treated as not having been advance refunded.

(d) *Application of arbitrage regulations*—(1) *Application of multipurpose issue rules.* For purposes of sections 149(d)(2) and (3)(A)(i), (ii), and (iii), the provisions of the multipurpose issue rule in §1.148–9(h) apply, except that the limitation in §1.148–9(h)(5) is disregarded.

(2) *General mixed escrow rules.* For purposes of section 149(d), the provisions of §1.148–9(c) (relating to mixed escrows) apply, except that those provisions do not apply for purposes of section 149(d)(2) and (d)(3)(A) (i) and (ii) to amounts that were not gross proceeds of the prior issue before the issue date of the refunding issue.

(3) *Temporary periods and minor portions.* Section 1.148–9(d) and (f) contains rules applicable to temporary periods and minor portions for advance refunding issues.

(4) *Definitions.* Section 1.148–1 applies for purposes of section 149(d).

(e) *Taxable refundings*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, for purposes of section 149(d)(3)(A)(i), an advance refunding issue the interest on which is not excludable from gross income under section 103(a) (*i.e.*, a taxable advance refunding issue) is not taken into account. In addition, for this purpose, an advance refunding of a taxable issue is not taken into account unless the taxable issue is a conduit loan of a tax-exempt conduit financing issue.

(2) *Use to avoid section 149(d)(3)(A)(i).* A taxable issue is taken into account under section 149(d)(3)(A)(i) if it is issued to avoid the limitations of that section. For example, in the case of a refunding of a tax-exempt issue with a taxable advance refunding issue that is, in turn, currently refunded with a tax-exempt issue, the taxable advance refunding issue is taken into account under section 149(d)(3)(A)(i) if the two tax-exempt issues are outstanding concurrently for more than 90 days.

(f) *Redemption at first call date*—(1) *General rule.* Under sections 149(d)(3)(A) (ii) and (iii) (the *first call requirement*), bonds refunded by an advance refunding must be redeemed on their first call date if the savings test under section 149(d)(3)(B)(i) (the *savings test*) is satisfied. The savings test is satisfied if the issuer may realize present value debt service savings (determined without regard to administrative expenses) in connection with the issue of which the refunding bond is a part.

(2) *First call date. First call date* means the earliest date on which a bond may be redeemed (or, if issued before 1986, on the earliest date on which that bond may be redeemed at a redemption price not in excess of 103 percent of par). If, however, the savings test is not met with respect to the date described in

the preceding sentence (*i.e.*, there are no present value savings if the refunded bonds are retired on that date), the first call date is the first date thereafter on which the bonds can be redeemed and on which the savings test is met.

(3) *Application of savings test to multipurpose issues.* Except as otherwise provided in this paragraph (f)(3), the multipurpose issue rules in §1.148–9(h) apply for purposes of the savings test. If any separate issue in a multipurpose issue increases the aggregate present value debt service savings on the entire multipurpose issue or reduces the present value debt service losses on that entire multipurpose issue, that separate issue satisfies the savings test.

(g) *Limitation on advance refundings of private activity bonds.* Under section 149(d)(2) and this section, interest on a bond is not excluded from gross income if any portion of the issue of which the bond is a part is issued to advance refund a private activity bond (other than a qualified 501(c)(3) bond). For this purpose, the term private activity bond—

(1) Includes a qualified bond described in section 141(e) (other than a qualified 501(c)(3) bond), regardless of whether the refunding issue consists of private activity bonds under §1.141–13; and

(2) Does not include a taxable bond.

(h) *Effective dates*—(1) *In general.* Except as provided in this paragraph (h), this section applies to bonds issued after June 30, 1993, to which §§1.148–1 through 1.148–11 apply, including conduit loans that are treated as issued after June 30, 1993, under paragraph (b)(4) of this section. In addition, this section applies to any issue to which the election described in §1.148–11(b)(1) is made.

(2) *Special effective date for paragraph (b)(3).* Paragraph (b)(3) of this section applies to any advance refunding issue issued after May 28, 1991.

(3) *Special effective date for paragraph (f)(3).* Paragraph (f)(3) of this section applies to bonds sold on or after July 8, 1997 and to any issue to which the election described in §1.148–11(b)(1) is made. See §1.148–11A(i) for rules relating to certain bonds sold before July 8, 1997.

(4) *Special effective date for paragraph (g).* See §1.141–15 for the applicability date of paragraph (g) of this section.

[T.D. 8476, 58 FR 33548, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8718, 62 FR 25513, May 9, 1997; T.D. 9234, 70 FR 75035, Dec. 19, 2005]

§ 1.149(e)–1 Information reporting requirements for tax-exempt bonds.

(a) *General rule.* Interest on a bond is included in gross income unless certain information with respect to the issue of which the bond is a part is reported to the Internal Revenue Service in accordance with the requirements of this section. This section applies to any bond if the issue of which the bond is a part is issued after December 31, 1986 (including any bond issued to refund a bond issued on or before December 31, 1986).

(b) *Requirements for private activity bonds*—(1) *In general.* If the issue of which the bond is a part is an issue of private activity bonds, the issuer must comply with the following requirements—

(i) Not later than the 15th day of the second calendar month after the close of the calendar quarter in which the issue is issued, the issuer must file with the Internal Revenue Service a completed information reporting form prescribed for this purpose;

(ii) If any bond that is part of the issue is taken into account under section 146 (relating to volume cap on private activity bonds), the state certification requirement of paragraph (b)(2) of this section must be satisfied; and

(iii) If any bond that is part of the issue is a qualified mortgage bond or qualified veterans' mortgage bond (within the meaning of section 143 (a) or (b) or section 103A(c) (1) or (3) as in effect on the day before enactment of the Tax Reform Act of 1986), the issuer must submit the annual report containing information on the borrowers of the original proceeds of the issue as required under §1.103A–2 (k)(2)(ii) and (k)(3) through (k)(6).

(2) *State certification with respect to volume cap*—(i) *In general.* If an issue is subject to the volume cap under section 146, a state official designated by state law (if there is no such official,

then the governor or the governor's delegate) must certify that the issue meets the requirements of section 146, and a copy of this certification must be attached to the information reporting form filed with respect to the issue. In the case of any constitutional home rule city (as defined in section 146(d)(3)(C)), the preceding sentence is applied by substituting ''city'' for ''state'' and ''chief executive officer'' for ''governor.''

(ii) *Certification.* The certifying official need not perform an independent investigation in order to certify that the issue meets the requirements of section 146. For example, if the certifying official receives an affidavit that was executed by an officer of the issuer who is responsible for issuing the bonds and that sets forth, in brief and summary terms, the facts necessary to determine that the issue meets the requirements of section 146 and if the certifying official has compared the information in that affidavit to other readily available information with respect to that issuer (e.g., previous affidavits and certifications for other private activity bonds issued by that issuer), the certifying official may rely on the affidavit.

(c) *Requirements for governmental bonds*—(1) *Issue price of $100,000 or more.* If the issue of which the bond is a part has an issue price of $100,000 or more and is not an issue of private activity bonds, then, not later than the 15th day of the second calendar month after the close of the calendar quarter in which the issue is issued, the issuer must file with the Internal Revenue Service a completed information reporting form prescribed for this purpose.

(2) *Issue price of less than $100,000*—(i) *In general.* If the issue of which the bond is a part has an issue price of less than $100,000 and is not an issue of private activity bonds, the issuer must file with the Internal Revenue Service one of the following information reporting forms within the prescribed period—

(A) *Separate return.* Not later than the 15th day of the second calendar month after the close of the calendar quarter in which the issue is issued, a completed information reporting form prescribed for this purpose with respect to that issue; or

(B) *Consolidated return.* Not later than February 15 of the calendar year following the calendar year in which the issue is issued, a completed information form prescribed for this purpose with respect to all issues to which this paragraph (c)(2) applies that were issued by the issuer during the calendar year and for which information was not reported on a separate information return pursuant to paragraph (c)(2)(i)(A) of this section.

(ii) *Bond issues issued before January 1, 1992.* Paragraph (c)(2)(i)(A) of this section does not apply if the issue of which the bond is a part is issued before January 1, 1992.

(iii) *Extended filing date for first and second calendar quarters of 1992.* If the issue of which the bond is a part is issued during the first or second calendar quarter of 1992, the prescribed period for filing an information reporting form with respect to that issue pursuant to paragraph (c)(2)(i)(A) of this section is extended until November 16, 1992.

(d) *Filing of forms and special rules*—(1) *Completed form.* For purposes of this section—

(i) *Good faith effort.* An information reporting form is treated as completed if the issuer (or a person acting on behalf of the issuer) has made a good faith effort to complete the form (taking into account the instructions to the form).

(ii) *Information.* In general, information reporting forms filed pursuant to this section must be completed on the basis of available information and reasonable expectations as of the date the issue is issued. Forms that are filed on a consolidated basis pursuant to paragraph (c)(2)(i)(B) of this section, however, may be completed on the basis of information readily available to the issuer at the close of the calendar year to which the form relates, supplemented by estimates made in good faith.

(iii) *Certain information not required.* An issuer need not report to the Internal Revenue Service any information specified in the first sentence of section 149(e)(2) that is not required to be reported to the Internal Revenue Service pursuant to the information reporting forms prescribed under that section and the instructions to those forms.

(2) *Manner of filing*—(i) *Place for filing*. The information reporting form must be filed with the Internal Revenue Service at the address specified on the form or in the instructions to the form.

(ii) *Extension of time*. The Commissioner may grant an extension of time to file any form or attachment required under this section if the Commissioner determines that the failure to file in a timely manner was not due to willful neglect. The Commissioner may make this determination with respect to an issue or to a class of issues.

(e) *Definitions*. For purposes of this section only—(1) *Private activity bond*. The term ''private activity bond'' has the meaning given that term in section 141(a) of the Internal Revenue Code, except that the term does not include any bond described in section 1312(c) of the Tax Reform Act of 1986 to which section 1312 or 1313 of the Tax Reform Act of 1986 applies.

(2) *Issue*—(i) *In general*. Except as otherwise provided in this paragraph (e)(2), bonds are treated as part of the same issue only if the bonds are issued—

(A) By the same issuer;

(B) On the same date; and

(C) Pursuant to a single transaction or to a series of related transactions.

(ii) *Draw-down loans, commercial paper, etc*. (A) Bonds issued during the same calendar year may be treated as part of the same tissue if the bonds are issued—

(*1*) Pursuant to a loan agreement under which amounts are to be advanced periodically (''draw-down loan''); or

(*2*) With a term not exceeding 270 days.

(B) In addition, the bonds must be equally and ratably secured under a single indenture or loan agreement and issued pursuant to a common financing arrangement (e.g., pursuant to the same official statement that is periodically updated to reflect changing factual circumstances). In the case of bonds issued pursuant to a draw-down loan that meets the requirements of the preceding sentence, bonds issued during different calendar years may be treated as part of the same issue if all the amounts to be advanced pursuant to the draw-down loan are reasonably expected to be advanced within three years of the date of issue of the first bond.

(iii) *Leases and installment sales*. Bonds other than private activity bonds may be treated as part of the same issue if—

(A) The bonds are issued pursuant to a single agreement that is in the form of a lease or installment sales agreement; and

(B) All of the property covered by that agreement is reasonably expected to be delivered within three years of the date of issue of the first bond.

(iv) *Qualified 501(c)(3) bonds*. If an issuer elects under section 141(b)(9) to treat a portion of an issue as a qualified 501(c)(3) bond, that portion is treated as a separate issue.

(3) *Date of issue*—(i) *Bond*. The date of issue of a bond is determined under §1.150–1.

(ii) *Issue*. The date of issue of an issue of bonds is the date of issue of the first bond that is part of the issue. See paragraphs (e)(2) (ii) and (iii) of this section for rules relating to draw-down loans, commercial paper, etc., and leases and installment sales.

(iii) *Bonds to which prior law applied*. Notwithstanding the provisions of this paragraph (e)(3), an issue for which an information report was required to be filed under section 103(l) or section 103A(j)(3) is treated as issued prior to January 1, 1987.

(4) *Issue price*. The term ''issue price'' has the same meaning given the term under §1.148–1(b).

[T.D. 8425, 57 FR 36002, Aug. 12, 1992, as amended at 59 FR 24351, May 11, 1994]

§ 1.149(g)–1 Hedge bonds.

(a) *Certain definitions*. Except as otherwise provided, the definitions set forth in §1.148–1 apply for purposes of section 149(g) and this section. In addition, the following terms have the following meanings:

Reasonable expectations means reasonable expectations (as defined in §1.148–1), as modified to take into account the provisions of section 149(f)(2)(B).

Spendable proceeds means net sale proceeds (as defined in §1.148–1).

(b) *Applicability of arbitrage allocation and accounting rules.* Section 1.148–6 applies for purposes of section 149(g), except that an expenditure that results in the creation of replacement proceeds (other than amounts in a bona fide debt service fund or a reasonably required reserve or replacement fund) is not an expenditure for purposes of section 149(g).

(c) *Refundings*—(1) *Investment in tax-exempt bonds.* A bond issued to refund a bond that is a tax-exempt bond by virtue of the rule in section 149(g)(3)(B) is not a tax-exempt bond unless the gross proceeds of that refunding bond (other than proceeds in a refunding escrow for the refunded bond) satisfy the requirements of section 149(g)(3)(B).

(2) *Anti-abuse rule.* A refunding bond is treated as a hedge bond unless there is a significant governmental purpose for the issuance of that bond (e.g., an advance refunding bond issued to realize debt service savings or to relieve the issuer of significantly burdensome document provisions, but not to otherwise hedge against future increases in interest rates).

(d) *Effective date.* This section applies to bonds issued after June 30, 1993 to which §§1.148–1 through 1.148–11 apply. In addition, this section applies to any issue to which the election described in §1.148–11(b)(1) is made.

[T.D. 8476, 58 FR 33549, June 18, 1993]

§ 1.150–1 Definitions.

(a) *Scope and effective date*—(1) *In general.* Except as otherwise provided, the definitions in this section apply for all purposes of sections 103 and 141 through 150.

(2) *Effective/applicability date*—(i) *In general.* Except as otherwise provided in this paragraph (a)(2), this section applies to issues issued after June 30, 1993 to which §§1.148–1 through 1.148–11 apply. In addition, this section (other than paragraph (c)(3) of this section) applies to any issue to which the election described in §1.148–11(b)(1) is made.

(ii) *Special effective date for paragraphs (c)(1), (c)(4)(iii), and (c)(6).* Paragraphs (c)(1), (c)(4)(iii), and (c)(6) of this section apply to bonds sold on or after July 8, 1997 and to any issue to which the election described in §1.148–11(b)(1) is made. See §1.148–11A(i) for rules relating to certain bonds sold before July 8, 1997.

(iii) *Special effective date for definitions of tax-advantaged bond, issue, and grant.* The definition of tax-advantaged bond in paragraph (b) of this section, the revisions to the definition of issue in paragraph (c)(2) of this section, and the definition and rules regarding the treatment of grants in paragraph (f) of this section apply to bonds that are sold on or after October 17, 2016.

(3) *Exceptions to general effective date.* See §1.141–15 for the applicability date of the definition of bond documents contained in paragraph (b) of this section and the effective date of paragraph (c)(3)(ii) of this section.

(4) *Additional exception to the general applicability date.* Section 1.150–1(b), *Issuance costs*, applies on and after July 6, 2011.

(b) *Certain general definitions.* The following definitions apply:

Bond means any obligation of a State or political subdivision thereof under section 103(c)(1).

Bond documents means the bond indenture or resolution, transcript of proceedings, and any related documents.

Capital expenditure means any cost of a type that is properly chargeable to capital account (or would be so chargeable with a proper election or with the application of the definition of placed in service under §1.150–2(c)) under general Federal income tax principles. For example, costs incurred to acquire, construct, or improve land, buildings, and equipment generally are capital expenditures. Whether an expenditure is a capital expenditure is determined at the time the expenditure is paid with respect to the property. Future changes in law do not affect whether an expenditure is a capital expenditure.

Conduit borrower means the obligor on a purpose investment (as defined in §1.148–1). For example, if an issuer invests proceeds in a purpose investment in the form of a loan, lease, installment sale obligation, or similar obligation to another entity and the obligor uses the proceeds to carry out the governmental purpose of the issue, the obligor is a conduit borrower.

Conduit financing issue means an issue the proceeds of which are used or are reasonably expected to be used to finance at least one purpose investment representing at least one conduit loan to one conduit borrower.

Conduit loan means a purpose investment (as defined in §1.148–1).

Governmental bond means any bond of an issue of tax-exempt bonds in which none of the bonds are private activity bonds.

Issuance costs means costs to the extent incurred in connection with, and allocable to, the issuance of an issue within the meaning of section 147(g). For example, issuance costs include the following costs but only to the extent incurred in connection with, and allocable to, the borrowing: underwriters' spread; counsel fees; financial advisory fees; fees paid to an organization to evaluate the credit quality of an issue; trustee fees; paying agent fees; bond registrar, certification, and authentication fees; accounting fees; printing costs for bonds and offering documents; public approval process costs; engineering and feasibility study costs; guarantee fees, other than for qualified guarantees (as defined in §1.148–4(f)); and similar costs.

Issue date means, in reference to an issue, the first date on which the issuer receives the purchase price in exchange for delivery of the evidence of indebtedness representing any bond included in the issue. Issue date means, in reference to a bond, the date on which the issuer receives the purchase price in exchange for that bond. In no event is the issue date earlier than the first day on which interest begins to accrue on the bond or bonds for Federal income tax purposes.

Obligation means any valid evidence of indebtedness under general Federal income tax principles.

Pooled financing issue means an issue the proceeds of which are to be used to finance purpose investments representing conduit loans to two or more conduit borrowers, unless those conduit loans are to be used to finance a single capital project.

Private activity bond means a private activity bond (as defined in section 141).

Qualified mortgage loan means a mortgage loan with respect to an owner-occupied residence acquired with the proceeds of an obligation described in section 143(a)(1) or 143(b) (or applicable prior law).

Qualified student loan means a student loan acquired with the proceeds of an obligation described in section 144(b)(1).

Related party means, in reference to a governmental unit or a 501(c)(3) organization, any member of the same controlled group, and, in reference to any person that is not a governmental unit or 501(c)(3) organization, a related person (as defined in section 144(a)(3)).

Taxable bond means any obligation the interest on which is not excludable from gross income under section 103.

Tax-advantaged bond means a tax-exempt bond, a taxable bond that provides a federal tax credit to the investor with respect to the issuer's borrowing costs, a taxable bond that provides a refundable federal tax credit payable directly to the issuer of the bond for its borrowing costs under section 6431, or any future similar bond that provides a federal tax benefit that reduces an issuer's borrowing costs. Examples of tax-advantaged bonds include qualified tax credit bonds under section 54A(d)(1) and build America bonds under section 54AA.

Tax-exempt bond means any bond the interest on which is excludable from gross income under section 103(a). For purposes of section 148, tax-exempt bond includes:

(1) An interest in a regulated investment company to the extent that at least 95 percent of the income to the holder of the interest is interest that is excludable from gross income under section 103; and

(2) A certificate of indebtedness issued by the United States Treasury pursuant to the Demand Deposit State and Local Government Series program described in 31 CFR part 344.

Working capital expenditure means any cost that is not a capital expenditure. Generally, current operating expenses are working capital expenditures.

(c) *Definition of issue*—(1) *In general*. Except as otherwise provided in this paragraph (c), the term *issue* means two or more bonds that meet all of the following requirements:

(i) *Sold at substantially the same time.* The bonds are sold at substantially the same time. Bonds are treated as sold at substantially the same time if they are sold less than 15 days apart.

(ii) *Sold pursuant to the same plan of financing.* The bonds are sold pursuant to the same plan of financing. Factors material to the plan of financing include the purposes for the bonds and the structure of the financing. For example, generally—

(A) Bonds to finance a single facility or related facilities are part of the same plan of financing;

(B) Short-term bonds to finance working capital expenditures and long-term bonds to finance capital projects are not part of the same plan of financing; and

(C) Certificates of participation in a lease and general obligation bonds secured by tax revenues are not part of the same plan of financing.

(iii) *Payable from same source of funds.* The bonds are reasonably expected to be paid from substantially the same source of funds, determined without regard to guarantees from parties unrelated to the obligor.

(2) *Exceptions for different types of tax-advantaged bonds and taxable bonds.* Each type of tax-advantaged bond that has a different structure for delivery of the tax benefit that reduces the issuer's borrowing costs or different program eligibility requirements is treated as part of a different issue under this paragraph (c). Further, tax-advantaged bonds and bonds that are not tax-advantaged bonds are treated as part of different issues under this paragraph (c). The issuance of tax-advantaged bonds in a transaction with other bonds that are not tax-advantaged bonds must be tested under the arbitrage anti-abuse rules under §1.148–10(a) and other applicable anti-abuse rules (for example, limitations against window maturity structures or unreasonable allocations of bonds).

(3) *Exception for certain bonds financing separate purposes*—(i) *In general.* Bonds may be treated as part of separate issues if the requirements of this paragraph (c)(3) are satisfied. Each of these separate issues must finance a separate purpose (e.g., refunding a separate prior issue, financing a separate purpose investment, financing integrated or functionally related capital projects, and financing any clearly discrete governmental purpose). Each of these separate issues independently must be a tax-exempt bond (e.g., a governmental bond or a qualified mortgage bond). The aggregate proceeds, investments, and bonds in such a transaction must be allocated between each of the separate issues using a reasonable, consistently applied allocation method. If any separate issue consists of refunding bonds, the allocation rules in §1.148–9(h) must be satisfied. An allocation is not reasonable if it achieves more favorable results under sections 103 and 141 to 150 than could be achieved with actual separate issues. All allocations under this paragraph (c)(3) must be made in writing on or before the issue date.

(ii) *Exceptions.* This paragraph (c)(3) does not apply for purposes of sections 141, 144(a), 148, 149(d) and 149(g).

(4) *Special rules for certain financings*—(i) *Draw-down loans.* Bonds issued pursuant to a draw-down loan are treated as part of a single issue. The issue date of that issue is the first date on which the aggregate draws under the loan exceed the lesser of $50,000 or 5 percent of the issue price.

(ii) *Commercial paper*—(A) *In general.* Short-term bonds having a maturity of 270 days or less (*commercial paper*) issued pursuant to the same commercial paper program may be treated as part of a single issue, the issue date of which is the first date the aggregate amount of commercial paper issued under the program exceeds the lesser of $50,000 or 5 percent of the aggregate issue price of the commercial paper in the program. A commercial paper program is a program to issue commercial paper to finance or refinance the same governmental purpose pursuant to a single master legal document. Commercial paper is not part of the same commercial paper program unless issued during an 18-month period, beginning on the deemed issue date. In addition, commercial paper issued after the end of this 18-month period may be treated as part of the program to the extent issued to refund commercial paper that is part of the program, but only to the extent that—

(*1*) There is no increase in the principal amount outstanding; and

(*2*) The program does not have a term in excess of—

(*i*) 30 years; or

(*ii*) The period reasonably necessary for the governmental purposes of the program.

(B) *Safe harbor.* The requirement of paragraph (c)(4)(ii)(A)(*2*) of this section is treated as satisfied if the weighted average maturity of the issue does not exceed 120 percent of the weighted average expected economic life of the property financed by the issue.

(iii) *Certain general obligation bonds.* Except as otherwise provided in paragraph (c)(2) of this section, bonds that are secured by a pledge of the issuer's full faith and credit (or a substantially similar pledge) and sold and issued on the same dates pursuant to a single offering document may be treated as part of the same issue if the issuer so elects on or before the issue date.

(5) *Anti-abuse rule.* In order to prevent the avoidance of sections 103 and 141 through 150 and the general purposes thereof, the Commissioner may treat bonds as part of the same issue or as part of separate issues to clearly reflect the economic substance of a transaction.

(6) *Sale date.* The sale date of a bond is the first day on which there is a binding contract in writing for the sale or exchange of the bond.

(d) *Definition of refunding issue and related definitions*—(1) *General definition of refunding issue. Refunding issue* means an issue of obligations the proceeds of which are used to pay principal, interest, or redemption price on another issue (a *prior issue,* as more particularly defined in paragraph (d)(5) of this section), including the issuance costs, accrued interest, capitalized interest on the refunding issue, a reserve or replacement fund, or similar costs, if any, properly allocable to that refunding issue.

(2) *Exceptions and special rules.* For purposes of paragraph (d)(1) of this section, the following exceptions and special rules apply—

(i) *Payment of certain interest.* An issue is not a refunding issue if the only principal and interest that is paid with proceeds of the issue (determined without regard to the multipurpose issue rules of §1.148–9(h)) is interest on another issue that—

(A) Accrues on the other issue during a one-year period including the issue date of the issue that finances the interest;

(B) Is a capital expenditure; or

(C) Is a working capital expenditure to which the de minimis rule of §1.148–6(d)(3)(ii)(A) applies.

(ii) *Certain issues with different obligors*—(A) *In general.* An issue is not a refunding issue to the extent that the obligor (as defined in paragraph (d)(2)(ii)(B) of this section) of one issue is neither the obligor of the other issue nor a related party with respect to the obligor of the other issue.

(B) *Definition of obligor.* The *obligor* of an issue means the actual issuer of the issue, except that the obligor of the portion of an issue properly allocable to an investment in a purpose investment means the conduit borrower under that purpose investment. The obligor of an issue used to finance qualified mortgage loans, qualified student loans, or similar program investments (as defined in §1.148–1) does not include the ultimate recipient of the loan (e.g., the homeowner, the student).

(iii) *Certain special rules for purpose investments.* For purposes of this paragraph (d), the following special rules apply:

(A) *Refunding of a conduit financing issue by a conduit loan refunding issue.* Except as provided in paragraph (d)(2)(iii)(B) of this section, the use of the proceeds of an issue that is used to refund an obligation that is a purpose investment (a *conduit refunding issue*) by the actual issuer of the conduit financing issue determines whether the conduit refunding issue is a refunding of the conduit financing issue (in addition to a refunding of the obligation that is the purpose investment).

(B) *Recycling of certain payments under purpose investments.* A conduit refunding issue is not a refunding of a conduit financing issue to the extent that the actual issuer of the conduit financing issue reasonably expects as of the date of receipt of the proceeds of the conduit refunding issue to use those amounts within 6 months (or, if greater, during the applicable temporary period for those amounts under section 148(c) or under applicable prior law) to acquire a new purpose investment. Any new purpose investment is treated as made from the proceeds of the conduit financing issue.

(C) *Application to tax-exempt loans.* For purposes of this paragraph (d), obligations that would be purpose investments (absent section 148(b)(3)(A)) are treated as purpose investments.

(iv) *Substance of transaction controls.* In the absence of other applicable controlling rules under this paragraph (d), the determination of whether an issue is a refunding issue is based on the substance of the transaction in light of all the facts and circumstances.

(v) *Certain integrated transactions in connection with asset acquisition not treated as refunding issues.* If, within six months before or after a person assumes (including taking subject to) obligations of an unrelated party in connection with an asset acquisition (other than a transaction to which section 381(a) applies if the person assuming the obligation is the acquiring corporation within the meaning of section 381(a)), the assumed issue is refinanced, the refinancing issue is not treated as a refunding issue.

(3) *Current refunding issue. Current refunding issue* means:

(i) Except as provided in paragraph (d)(3)(ii) of this section, a refunding issue that is issued not more than 90 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; and

(ii) In the case of a refunding issue issued before 1986—

(A) A refunding issue that is issued not more than 180 days before the last expenditure of any proceeds of the refunding issue for the payment of principal or interest on the prior issue; or

(B) A refunding issue if the prior issue had a term of less than 3 years and was sold in anticipation of permanent financing, but only if the aggregate term of all prior issues sold in anticipation of permanent financing was less than 3 years.

(4) *Advance refunding issue. Advance refunding issue* means a refunding issue that is not a current refunding issue.

(5) *Prior issue. Prior issue* means an issue of obligations all or a portion of the principal, interest, or call premium on which is paid or provided for with proceeds of a refunding issue. A prior issue may be issued before, at the same time as, or after a refunding issue. If the refunded and unrefunded portions of a prior issue are treated as separate issues under §1.148–9(i), for the purposes for which that section applies, except to the extent that the context clearly requires otherwise, references to a prior issue refer only to the refunded portion of that prior issue.

(e) *Controlled group* means a group of entities controlled directly or indirectly by the same entity or group of entities within the meaning of this paragraph (e).

(1) *Direct control.* The determination of direct control is made on the basis of all the relevant facts and circumstances. One entity or group of entities (the *controlling entity*) generally controls another entity or group of entities (the *controlled entity*) for purposes of this paragraph if the controlling entity possesses either of the following rights or powers and the rights or powers are discretionary and non-ministerial—

(i) The right or power both to approve and to remove without cause a controlling portion of the governing body of the controlled entity; or

(ii) The right or power to require the use of funds or assets of the controlled entity for any purpose of the controlling entity.

(2) *Indirect control.* If a controlling entity controls a controlled entity under the test in paragraph (e)(1) of this section, then the controlling entity also controls all entities controlled, directly or indirectly, by the controlled entity or entities.

(3) *Exception for general purpose governmental entities.* An entity is not a controlled entity under this paragraph (e) if the entity possesses substantial taxing, eminent domain, and police powers. For example, a city possessing substantial amounts of each of these sovereign powers is not a controlled entity of the state.

(f) *Definition and treatment of grants*—(1) *Definition.* Grant means a transfer for a governmental purpose of money or property to a transferee that is not a related party to or an agent of the transferor. The transfer must not impose any obligation or condition to directly or indirectly repay any amount to the transferor or a related party. Obligations or conditions intended solely to assure expenditure of the transferred moneys in accordance with the governmental purpose of the transfer do not prevent a transfer from being a grant.

(2) *Treatment*. Except as otherwise provided (for example, §1.148–6(d)(4), which treats proceeds used for grants as spent for arbitrage purposes when the grant is made), the character and nature of a grantee's use of proceeds are taken into account in determining which rules are applicable to the bond issue and whether the applicable requirements for the bond issue are met. For example, a grantee's use of proceeds generally determines whether the proceeds are used for capital projects or working capital expenditures under section 148 and whether the qualified purposes for the specific type of bond issue are met.

[T.D. 8476, 58 FR 33549, June 18, 1993; 58 FR 44453, Aug. 23, 1993, as amended by T.D. 8538, 59 FR 24046, May 10, 1994; T.D. 8712, 62 FR 2304, Jan. 16, 1997; T.D. 8718, 62 FR 25513, May 9, 1997; T.D. 9234, 70 FR 75036, Dec. 19, 2005; T.D. 9533, 76 FR 39280, July 6, 2011; T.D. 9637, 78 FR 54759, Sept. 6, 2013; T.D. 9777, 81 FR 46598, July 18, 2016]

§ 1.150–2 Proceeds of bonds used for reimbursement.

(a) *Table of contents*. This table of contents contains a listing of the headings contained in §1.150–2.

(b) *Scope*. This section applies to reimbursement bonds (as defined in paragraph (c) of this section) for all purposes of sections 103 and 141 to 150.

(c) *Definitions*. The following definitions apply:

Issuer means—

(1) For any private activity bond (excluding a qualified 501(c)(3) bond, qualified student loan bond, qualified mortgage bond, or qualified veterans' mortgage bond), the entity that actually issues the reimbursement bond; and

(2) For any bond not described in paragraph (1) of this definition, either the entity that actually issues the reimbursement bond or, to the extent that the reimbursement bond proceeds are to be loaned to a conduit borrower, that conduit borrower.

Official intent means an issuer's declaration of intent to reimburse an original expenditure with proceeds of an obligation.

Original expenditure means an expenditure for a governmental purpose that is originally paid from a source other than a reimbursement bond.

Placed in service means, with respect to a facility, the date on which, based on all the facts and circumstances—

(1) The facility has reached a degree of completion which would permit its operation at substantially its design level; and

(2) The facility is, in fact, in operation at such level.

Reimbursement allocation means an allocation in writing that evidences an issuer's use of proceeds of a reimbursement bond to reimburse an original expenditure. An allocation made within 30 days after the issue date of a reimbursement bond may be treated as made on the issue date.

Reimbursement bond means the portion of an issue allocated to reimburse an original expenditure that was paid before the issue date.

(d) *General operating rules for reimbursement expenditures.* Except as otherwise provided, a reimbursement allocation is treated as an expenditure of proceeds of a reimbursement bond for the governmental purpose of the original expenditure on the date of the reimbursement allocation only if:

(1) *Official intent.* Not later than 60 days after payment of the original expenditure, the issuer adopts an official intent for the original expenditure that satisfies paragraph (e) of this section.

(2) *Reimbursement period*—(i) *In general.* The reimbursement allocation is made not later than 18 months after the later of—

(A) The date the original expenditure is paid; or

(B) The date the project is placed in service or abandoned, but in no event more than 3 years after the original expenditure is paid.

(ii) *Special rule for small issuers.* In applying paragraph (d)(2)(i) of this section to an issue that satisfies section 148(f)(4)(D)(i) (I) through (IV), the ''18 month'' limitation is changed to ''3 years'' and the ''3-year'' maximum reimbursement period is disregarded.

(iii) *Special rule for long-term construction projects.* In applying paragraph (d)(2)(i) to a construction project for which both the issuer and a licensed architect or engineer certify that at least 5 years is necessary to complete construction of the project, the maximum reimbursement period is changed from ''3 years'' to ''5 years.''

(3) *Nature of expenditure.* The original expenditure is a capital expenditure, a cost of issuance for a bond, an expenditure described in §1.148–6(d)(3)(ii)(B) (relating to certain extraordinary working capital items), a grant (as defined in §1.150–1(f)), a qualified student loan, a qualified mortgage loan, or a qualified veterans' mortgage loan.

(e) *Official intent rules.* An official intent satisfies this paragraph (e) if:

(1) *Form of official intent.* The official intent is made in any reasonable form, including issuer resolution, action by an appropriate representative of the issuer (e.g., a person authorized or designated to declare official intent on behalf of the issuer), or specific legislative authorization for the issuance of obligations for a particular project.

(2) *Project description in official intent*—(i) *In general.* The official intent generally describes the project for which the original expenditure is paid and states the maximum principal amount of obligations expected to be issued for the project. A project includes any property, project, or program (e.g., *highway capital improvement program, hospital equipment acquisition,* or *school building renovation*).

(ii) *Fund accounting.* A project description is sufficient if it identifies, by name and functional purpose, the fund or account from which the original expenditure is paid (e.g., *parks and recreation fund—recreational facility capital improvement program*).

(iii) *Reasonable deviations in project description.* Deviations between a project described in an official intent and the actual project financed with reimbursement bonds do not invalidate the official intent to the extent that the actual project is reasonably related in function to the described project. For example, *hospital equipment* is a reasonable deviation from *hospital building improvements.* In contrast, a *city office building rehabilitation* is not a reasonable deviation from *highway improvements.*

(3) *Reasonableness of official intent.* On the date of the declaration, the issuer must have a reasonable expectation (as defined in §1.148–1(b)) that it will reimburse the original expenditure with proceeds of an obligation. Official intents declared as a matter of course or in amounts substantially in excess of the amounts expected to be necessary for the project (e.g., *blanket declarations*) are not reasonable. Similarly, a pattern of failure to reimburse actual original expenditures covered by official intents (other than in extraordinary circumstances) is evidence of unreasonableness. An official intent declared pursuant to a specific legislative authorization is rebuttably presumed to satisfy this paragraph (e)(3).

(f) *Exceptions to general operating rules*—(1) *De minimis exception.* Paragraphs (d)(1) and (d)(2) of this section do not apply to costs of issuance of any bond or to an amount not in excess of the lesser of $100,000 or 5 percent of the proceeds of the issue.

(2) *Preliminary expenditures exception.* Paragraphs (d)(1) and (d)(2) of this section do not apply to any preliminary expenditures, up to an amount not in excess of 20 percent of the aggregate issue price of the issue or issues that finance or are reasonably expected by the issuer to finance the project for which the preliminary expenditures were incurred. Preliminary expenditures include architectural, engineering, surveying, soil testing, reimbursement bond issuance, and similar costs that are incurred prior to commencement of acquisition, construction, or rehabilitation of a project, other than land acquisition, site preparation, and similar costs incident to commencement of construction.

(g) *Special rules on refundings*—(1) *In general—once financed, not reimbursed.* Except as provided in paragraph (g)(2) of this section, paragraph (d) of this section does not apply to an allocation to pay principal or interest on an obligation or to reimburse an original expenditure paid by another obligation. Instead, such an allocation is analyzed under rules on refunding issues. See §1.148–9.

(2) *Certain proceeds of prior issue used for reimbursement treated as unspent.* In the case of a refunding issue (or series of refunding issues), proceeds of a prior issue purportedly used to reimburse original expenditures are treated as unspent proceeds of the prior issue unless the purported reimbursement was a valid expenditure under applicable law on reimbursement expenditures on the issue date of the prior issue.

(h) *Anti-abuse rules*—(1) *General rule.* A reimbursement allocation is not an expenditure of proceeds of an issue under this section if the allocation employs an abusive arbitrage device under §1.148–10 to avoid the arbitrage restrictions or to avoid the restrictions under sections 142 through 147.

(2) *One-year step transaction rule*—(i) *Creation of replacement proceeds.* A purported reimbursement allocation is invalid and thus is not an expenditure of proceeds of an issue if, within 1 year after the allocation, funds corresponding to the proceeds of a reimbursement bond for which a reimbursement allocation was made are used in a manner that results in the creation of replacement proceeds (as defined in §1.148–1) of that issue or another issue. The preceding sentence does not apply to amounts deposited in a bona fide debt service fund (as defined in §1.148–1).

(ii) *Example.* The provisions of paragraph (h)(2)(i) of this section are illustrated by the following example.

Example. On January 1, 1994, County *A* issues an issue of 7 percent tax-exempt bonds (the *1994 issue*) and makes a purported reimbursement allocation to reimburse an original expenditure for specified capital improvements. *A* immediately deposits funds corresponding to the proceeds subject to the reimbursement allocation in an escrow fund to provide for payment of principal and interest on its outstanding 1991 issue of 9 percent tax-exempt bonds (the *prior issue*). The use of amounts corresponding to the proceeds of the reimbursement bonds to create a sinking fund for another issue within 1 year after the purported reimbursement allocation invalidates the reimbursement allocation. The proceeds retain their character as unspent proceeds of the 7 percent issue upon deposit in the escrow fund. Accordingly, the proceeds are subject to the 7 percent yield restriction of the 1994 issue instead of the 9 percent yield restriction of the prior issue.

(i) *Authority of the Commissioner to prescribe rules.* The Commissioner may by revenue ruling or revenue procedure (see §601.601(d)(2)(ii)(*b*) of this chapter) prescribe rules for the expenditure of proceeds of reimbursement bonds in circumstances that do not otherwise satisfy this section.

(j) *Effective date*—(1) *In general.* Except as otherwise provided, the provisions of this section apply to all allocations of proceeds of reimbursement bonds issued after June 30, 1993.

(2) *Transitional rules*—(i) *Official intent.* An official intent is treated as satisfying the official intent requirement of paragraph (d)(1) of this section if it—

(A) Satisfied the applicable provisions of §1.103–8(a)(5) as in effect prior to July 1, 1993, (as contained in 26 CFR part 1 revised as of April 1, 1993) and was made prior to that date, or

(B) Satisfied the applicable provisions of §1.103–18 as in effect between January 27, 1992, and June 30, 1993, (as contained in 26 CFR part 1 revised as of April 1, 1993) and was made during that period.

(ii) *Certain expenditures of private activity bonds.* For any expenditure that was originally paid prior to August 15, 1993, and that would have qualified for expenditure by reimbursement from the proceeds of a private activity bond under T.D. 7199, section 1.103–8(a)(5), 1972–2 C.B. 45 (see § 601.601(d)(2)(ii)(*b*)) of this chapter, the requirements of that section may be applied in lieu of this section.

(3) *Nature of expenditure.* Paragraph (d)(3) of this section applies to bonds that are sold on or after October 17, 2016.

[T.D. 8476, 58 FR 33551, June 18, 1993; 58 FR 44453, Aug. 23, 1993; T.D. 9777, 81 FR 46598, July 18, 2016]

§ 1.150–4 Change in use of facilities financed with tax-exempt private activity bonds.

(a) *Scope.* This section applies for purposes of the rules for change of use of facilities financed with private activity bonds under sections 150(b)(3) (relating to qualified 501(c)(3) bonds), 150(b)(4) (relating to certain exempt facility bonds and small issue bonds), 150(b)(5) (relating to facilities required to be owned by governmental units or 501(c)(3) organizations), and 150(c).

(b) *Effect of remedial actions*—(1) *In general.* Except as provided in this section, the change of use provisions of sections 150(b) (3) through (5), and 150(c) apply even if the issuer takes a remedial action described in §§ 1.142–2, 1.144–2, or 1.145–2.

(2) *Exceptions*—(i) *Redemption.* If nonqualified bonds are redeemed within 90 days of a deliberate action under § 1.145–2(a) or within 90 days of the date on which a failure to properly use proceeds occurs under § 1.142–2 or § 1.144–2, sections 150(b) (3) through (5) do not apply during the period between that date and the date on which the nonqualified bonds are redeemed.

(ii) *Alternative qualifying use of facility.* If a bond-financed facility is used for an alternative qualifying use under §§ 1.145–2 and 1.141–12(f), sections 150(b) (3) and (5) do not apply because of the alternative use.

(iii) *Alternative use of disposition proceeds.* If disposition proceeds are used for a qualifying purpose under §§ 1.145–2 and 1.141–12(e), 1.142–2(c)(4), or 1.144–2, sections 150(b) (3) through (5) do not apply because of the deliberate action that gave rise to the disposition proceeds after the date on which all of the disposition proceeds have been expended on the qualifying purpose. If all of the disposition proceeds are so expended within 90 days of the date of the deliberate action, however, sections 150(b) (3) through (5) do not apply because of the deliberate action.

(c) *Allocation rules*—(1) *In general.* If a change in use of a portion of the property financed with an issue of qualified private activity bonds causes section 150 (b)(3), (b)(4), or (b)(5) to apply to an issue, the bonds of the issue allocable to that portion under section 150(c)(3) are the same as the nonqualified bonds determined for purposes of §§ 1.142–1, 1.144–1, and 1.145–1, except that bonds allocable to all common areas are also allocated to that portion.

(2) *Special rule when remedial action is taken.* If an issuer takes a remedial action with respect to an issue of private activity bonds under §§ 1.142–2, 1.144–2, or 1.145–2, the bonds of the issue allocable to a portion of property are the same as the nonqualified bonds determined for purposes of those sections.

(d) *Effective dates.* For effective dates of this section, see § 1.141–16.

[T.D. 8712, 62 FR 2304, Jan. 16, 1997]

§ 1.150–5 Filing notices and elections.

(a) *In general.* Notices and elections under the following sections must be filed with the Internal Revenue Service, 1111 Constitution Avenue, NW, Attention: T:GE:TEB:O, Washington, DC 20224 or such other place designated by publication of a notice in the Internal Revenue Bulletin—

(1) Section 1.141–12(d)(4);

(2) Section 1.142(f)(4)-1; and

(3) Section 1.142–2(c)(2).

(b) *Effective dates.* This section applies to notices and elections filed on or after January 19, 2001.

[T.D. 8941, 66 FR 4671, Jan. 18, 2001, as amended by T.D. 9741, 80 FR 65646, Oct. 27, 2015]

REGULATIONS APPLICABLE TO CERTAIN BONDS SOLD PRIOR TO JULY 8, 1997

EDITORIAL NOTE: IRS redesignated the following sections to appear below the undesignated center heading ''Regulations Applicable to Certain Bonds Sold Prior to July 8, 1997'' and preceding the undesignated center heading ''Deductions for Personal Exemptions.'' See 62 FR 25507 and 25513, May 9, 1997 for the specific sections involved in the redesignation.

§§ 1.148–1A—1.148–6A [Reserved]

§§ 1.148–9A—1.148–10A [Reserved]

§ 1.148–11A Effective dates.

(a) through (c)(3) [Reserved]. For guidance see § 1.148–11.

(c)(4) *Retroactive application of overpayment recovery provisions.* An issuer may apply the provisions of § 1.148–3(i) to any issue that is subject to section 148(f) or to sections 103(c)(6) or 103A(i) of the Internal Revenue Code of 1954.

(d) through (h) [Reserved]. For guidance see § 1.148–11.

(i) *Transition rules for certain amendments*—(1) *In general.* Section 1.103–8(a)(5), §§ 1.148–1, 1.148–2, 1.148–3, 1.148–4, .148–5, 1.148–6, 1.148–7, 1.148–8, 1.148–9, 1.148–10, 1.148–11, 1.149(d)–1, and 1.150–1 as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), and §§ 1.148–1A through 1.148–11A, 1.149(d)–1A, and 1.150–1A apply, in whole, but not in part—

(i) To bonds sold after June 6, 1994, and before July 8, 1997;

(ii) To bonds issued before July 1, 1993, that are outstanding on June 7, 1994, if the first time the issuer applies §§ 1.148–1 through 1.148–11 as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), to the bonds under § 1.148–11 (b) or (c) is after June 6, 1994, and before July 8, 1997;

(iii) At the option of the issuer, to bonds to which §§ 1.148–1 through 1.148–11, as in effect on July 1, 1993 (see 26 CFR part 1 as revised April 1, 1994), apply, if the bonds are outstanding on June 7, 1994, and the issuer applies § 1.103–8(a)(5), §§ 1.148–1, 1.148–2, 1.148–3, 1.148–4, 1.148–5, 1.148–6, 1.148–7, 1.148–8, 1.148–9, 1.148–10, 1.148–11, 1.149(d)–1, and 1.150–1 as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), and §§ 1.148–1A through 1.148–11A, 1.149(d)–1A, and 1.150–1A to the bonds before July 8, 1997.

(2) *Special rule.* For purposes of paragraph (i)(1) of this section, any reference to a particular paragraph of §§ 1.148–1T, 1.148–2T, 1.148–3T, 1.148–4T, 1.148–5T, 1.148–6T, 1.148–9T, 1.148–10T, 1.148–11T, 1.149(d)–1T, or 1.150–1T shall be applied as a reference to the corresponding paragraph of §§ 1.148–1A, 1.148–2A, 1.148–3A, 1.148–4A, 1.148–5A, 1.148–6A, 1.148–9A, 1.148–10A, 1.148–11A, 1.149(d)–1A, or 1.150–1A, respectively.

(3) *Identification of certain hedges.* For any hedge entered into after June 18, 1993, and on or before June 6, 1994, that would be a qualified hedge within the meaning of § 1.148–4(h)(2), as in effect on June 7, 1994 (see 26 CFR part 1 as revised April 1, 1997), except that the hedge does not meet the requirements of § 1.148–4A(h)(2)(ix) because the issuer failed to identify the hedge not later than 3 days after which the issuer and the provider entered into the contract, the requirements of § 1.148–4A(h)(2)(ix) are treated as met if the contract is identified by the actual issuer on its books and records maintained for the hedged bonds not later than July 8, 1997.

[T.D. 8538, 59 FR 24046, May 10, 1994. Redesignated and amended by T.D. 8718, 62 FR 25507, 25513, May 9, 1997]

DEDUCTIONS FOR PERSONAL EXEMPTIONS

§ 1.151–1 Deductions for personal exemptions.

(a) *In general.* (1) In computing taxable income, an individual is allowed a deduction for the exemptions specified in section 151. Such exemptions are: (i) The exemptions for an individual taxpayer and spouse (the so-called personal exemptions); (ii) the additional exemptions for a taxpayer attaining the age of 65 years and spouse attaining the age of 65 years (the so-called old-age exemptions); (iii) the additional exemptions for a blind taxpayer and a blind spouse; and (iv) the exemptions for dependents of the taxpayer.

(2) A nonresident alien individual who is a bona fide resident of Puerto Rico during the entire taxable year and subject to tax under section 1 or 1201(b) is allowed as deductions the exemptions specified in section 151, even

though as to the United States such individual is a nonresident alien. See section 876 and the regulations thereunder, relating to alien residents of Puerto Rico.

(b) *Exemptions for individual taxpayer and spouse (so-called personal exemptions).* Section 151(b) allows an exemption for the taxpayer and an additional exemption for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. Thus, a husband is not entitled to an exemption for his wife on his separate return for the taxable year beginning in a calendar year during which she has any gross income (though insufficient to require her to file a return). Since, in the case of a joint return, there are two taxpayers (although under section 6013 there is only one income for the two taxpayers on such return, *i.e.*, their aggregate income), two exemptions are allowed on such return, one for each taxpayer spouse. If in any case a joint return is made by the taxpayer and his spouse, no other person is allowed an exemption for such spouse even though such other person would have been entitled to claim an exemption for such spouse as a dependent if such joint return had not been made.

(c) *Exemptions for taxpayer attaining the age of 65 and spouse attaining the age of 65 (so-called old-age exemptions).* (1) Section 151(c) provides an additional exemption for the taxpayer if he has attained the age of 65 before the close of his taxable year. An additional exemption is also allowed to the taxpayer for his spouse if a joint return is not made by the taxpayer and his spouse and if the spouse has attained the age of 65 before the close of the taxable year of the taxpayer and, for the calendar year in which the taxable year of the taxpayer begins, the spouse has no gross income and is not the dependent of another taxpayer. If a husband and wife make a joint return, an old-age exemption will be allowed as to each taxpayer spouse who has attained the age of 65 before the close of the taxable year for which the joint return is made. The exemptions under section 151(c) are in addition to the exemptions for the taxpayer and spouse under section 151(b).

(2) In determining the age of an individual for the purposes of the exemption for old age, the last day of the taxable year of the taxpayer is the controlling date. Thus, in the event of a separate return by a husband, no additional exemption for old age may be claimed for his spouse unless such spouse has attained the age of 65 on or before the close of the taxable year of the husband. In no event shall the additional exemption for old age be allowed with respect to a spouse who dies before attaining the age of 65 even though such spouse would have attained the age of 65 before the close of the taxable year of the taxpayer. For the purposes of the old-age exemption, an individual attains the age of 65 on the first moment of the day preceding his sixty-fifth birthday. Accordingly, an individual whose sixty-fifth birthday falls on January 1 in a given year attains the age of 65 on the last day of the calendar year immediately preceding.

(d) *Exemptions for the blind.* (1) Section 151(d) provides an additional exemption for the taxpayer if he is blind at the close of his taxable year. An additional exemption is also allowed to the taxpayer for his spouse if the spouse is blind and, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer. The determination of whether the spouse is blind shall be made as of the close of the taxable year of the taxpayer, unless the spouse dies during such taxable year, in which case such determination shall be made as of the time of such death.

(2) The exemptions for the blind are in addition to the exemptions for the taxpayer and spouse under section 151(b) and are also in addition to the exemptions under section 151(c) for taxpayers and spouses attaining the age of 65 years. Thus, a single individual who has attained the age of 65 before the close of his taxable year and who is blind at the close of his taxable year is entitled, in addition to the so-called personal exemption, to two further exemptions, one by reason of his age and

the other by reason of his blindness. If a husband and wife make a joint return, an exemption for the blind will be allowed as to each taxpayer spouse who is blind at the close of the taxable year for which the joint return is made.

(3) A taxpayer claiming an exemption allowed by section 151(d) for a blind taxpayer and a blind spouse shall, if the individual for whom the exemption is claimed is not totally blind as of the last day of the taxable year of the taxpayer (or, in the case of a spouse who dies during such taxable year, as of the time of such death), attach to his return a certificate from a physician skilled in the diseases of the eye or a registered optometrist stating that as of the applicable status determination date in the opinion of such physician or optometrist (i) the central visual acuity of the individual for whom the exemption is claimed did not exceed 20/200 in the better eye with correcting lenses or (ii) such individual's visual acuity was accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees. If such individual is totally blind as of the status determination date there shall be attached to the return a statement by the person or persons making the return setting forth such fact.

(4) Notwithstanding subparagraph (3) of this paragraph, this subparagraph may be applied where the individual for whom an exemption under section 151(d) is claimed is not totally blind, and in the certified opinion of an examining physician skilled in the diseases of the eye there is no reasonable probability that the individual's visual acuity will ever improve beyond the minimum standards described in subparagraph (3) of this paragraph. In this event, if the examination occurs during a taxable year for which the exemption is claimed, and the examining physician certifies that, in his opinion, the condition is irreversible, and a copy of this certification is filed with the return for that taxable year, then a statement described in subparagraph (3) of this paragraph need not be attached to such individual's return for subsequent taxable years so long as the condition remains irreversible. The taxpayer shall retain a copy of the certified opinion in his records, and a statement referring to such opinion shall be attached to future returns claiming the section 151(d) exemption.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7114, 36 FR 9018, May 18, 1971; T.D. 7230, 37 FR 28288, Dec. 22, 1972]

§ 1.151–2 Additional exemptions for dependents.

(a) Section 151(e) allows to a taxpayer an exemption for each dependent (as defined in section 152) whose gross income (as defined in section 61) for the calendar year in which the taxable year of the taxpayer begins is less than the amount provided in section 151(e)(1)(A) applicable to the taxable year of the taxpayer, or who is a child of the taxpayer and who—

(1) The taxable year of the taxpayer begins, or

(2) Is a student, as defined in paragraph (b) of § 1.151–3.

No exemption shall be allowed under section 151(e) for any dependent who has made a joint return with his spouse under section 6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins. The amount provided in section 151(e)(1)(A) is $750 in the case of a taxable year beginning after December 31, 1972; $700 in the case of a taxable year beginning after December 31, 1971, and before January 1, 1973; $650 in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972; $625 in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971; and $600 in the case of a taxable year beginning before January 1, 1970. For special rules in the case of a taxpayer whose taxable year is a fiscal year ending after December 31, 1969, and beginning before January 1, 1973, see section 21(d) and the regulations thereunder.

(b) The only exemption allowed for a dependent of the taxpayer is that provided by section 151(e). The exemptions provided by section 151(c) (old-age exemptions) and section 151(d) (exemptions for the blind) are allowed only for the taxpayer or his spouse. For example, where a taxpayer provides the entire support for his father who meets all the requirements of a dependent, he is entitled to only one exemption for his father (section 151(e)), even though his father is over the age of 65.

[T.D. 7114, 36 FR 9019, May 18, 1971]

§ 1.151–3 Definitions.

(a) *Child*. For purposes of sections 151(e), 152, and the regulations thereunder, the term ''child'' means a son, stepson, daughter, stepdaughter, adopted son, adopted daughter, or for taxable years beginning after December 31, 1958, a child who is a member of an individual's household if the child was placed with the individual by an authorized placement agency for legal adoption pursuant to a formal application filed by the individual with the agency (see paragraph (c)(2) of § 1.152–2), or, for taxable years beginning after December 31, 1969, a foster child (if such foster child satisfies the requirements set forth in paragraph (b) of § 1.152–1 with respect to the taxpayer) of the taxpayer.

(b) *Student*. For purposes of section 151(e) and section 152(d), and the regulations thereunder, the term ''student'' means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins is a full-time student at an educational institution or is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational institution or of a State or political subdivision of a State. An example of ''institutional on-farm training'' is that authorized by 38 U.S.C. 1652 (formerly section 252 of the Veterans' Readjustment Assistance Act of 1952), as described in section 252 of such act. A full-time student is one who is enrolled for some part of 5 calendar months for the number of hours or courses which is considered to be full-time attendance. The 5 calendar months need not be consecutive. School attendance exclusively at night does not constitute full-time attendance. However, full-time attendance at an educational institution may include some attendance at night in connection with a full-time course of study.

(c) *Educational institution*. For purposes of sections 151(e) and 152, and the regulations thereunder, the term ''educational institution'' means a school maintaining a regular faculty and established curriculum, and having an organized body of students in attendance. It includes primary and secondary schools, colleges, universities, normal schools, technical schools, mechanical schools, and similar institutions, but does not include noneducational institutions, on-the-job training, correspondence schools, night schools, and so forth.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7051, 35 FR 11020, July 9, 1970]

§ 1.151–4 Amount of deduction for each exemption under section 151.

The amount allowed as a deduction for each exemption under section 151 is (a) $750 in the case of a taxable year beginning after December 31, 1972; (b) $700 in the case of a taxable year beginning after December 31, 1971, and before January 1, 1973; (c) $650 in the case of a taxable year beginning after December 31, 1970, and before January 1, 1972; (d) $625 in the case of a taxable year beginning after December 31, 1969, and before January 1, 1971; and (e) $600 in the case of a taxable year beginning before January 1, 1970. For special rules in the case of a fiscal year ending after December 31, 1969, and beginning before January 1, 1973, see section 21(d) and the regulations thereunder.

[T.D. 7114, 36 FR 9019, May 18, 1971]

§ 1.152–1 General definition of a dependent.

(a)(1) For purposes of the income taxes imposed on individuals by chapter 1 of the Code, the term ''dependent'' means any individual described in paragraphs (1) through (10) of section 152(a) over half of whose support, for the calendar year in which the taxable year of the taxpayer begins, was received from the taxpayer.

(2)(i) For purposes of determining whether or not an individual received, for a given calendar year, over half of his support from the taxpayer, there shall be taken into account the amount of support received from the taxpayer as compared to the entire amount of support which the individual received from all sources, including support which the individual himself supplied. The term ''support'' includes food, shelter, clothing, medical and dental care, education, and the like. Generally, the amount of an item of support will be the amount of expense incurred by the one furnishing such item. If the item of support furnished an individual is in the form of property or lodging, it will be necessary to measure the amount of such item of support in terms of its fair market value.

(ii) In computing the amount which is contributed for the support of an individual, there must be included any amount which is contributed by such individual for his own support, including income which is ordinarily excludable from gross income, such as benefits received under the Social Security Act (42 U.S.C. ch. 7). For example, a father receives $800 social security benefits, $400 interest, and $1,000 from his son during 1955, all of which sums represent his sole support during that year. The fact that the social security benefits of $800 are not includible in the father's gross income does not prevent such amount from entering into the computation of the total amount contributed for the father's support. Consequently, since the son's contribution of $1,000 was less than one-half of the father's support ($2,200) he may not claim his father as a dependent.

(iii)(*a*) For purposes of determining the amount of support furnished for a child (or children) by a taxpayer for a given calendar year, an arrearage payment made in a year subsequent to a calendar year for which there is an unpaid liability shall not be treated as paid either during that calendar year or in the year of payment, but no amount shall be treated as an arrearage payment to the extent that there is an unpaid liability (determined without regard to such payment) with respect to the support of a child for the taxable year of payment; and

(*b*) Similarly, payments made prior to any calendar year (whether or not made in the form of a lump sum payment in settlement of the parent's liability for support) shall not be treated as made during such calendar year, but payments made during any calendar year from amounts set aside in trust by a parent in a prior year, shall be treated as made during the calendar year in which paid.

(b) Section 152(a)(9) applies to any individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 153, of the taxpayer) who lives with the taxpayer and is a member of the taxpayer's household during the entire taxable year of the taxpayer. An individual is not a member of the taxpayer's household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law. It is not necessary under section 152(a)(9) that the dependent be related to the taxpayer. For example, foster children may qualify as dependents. It is necessary, however, that the taxpayer both maintain and occupy the household. The taxpayer and dependent will be considered as occupying the household for such entire taxable year notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which the dependent is absent for less than six months in the taxable year of the taxpayer, shall be considered temporary absence due to special circumstances. The fact that the dependent dies during the year shall not deprive the taxpayer of the deduction if the dependent lived in the household for the entire part of the year preceding his death. Likewise, the period during the taxable year preceding the birth of an individual shall not prevent such individual from qualifying as a dependent under section 152(a)(9). Moreover, a child who actually becomes a member of the taxpayer's household during the taxable year shall not be prevented from being considered a member of such household for the entire taxable year, if the child is required to remain in a hospital for a period following its birth, and if such child would otherwise have been a member of the taxpayer's household during such period.

(c) In the case of a child of the taxpayer who is under 19 or who is a student, the taxpayer may claim the dependency exemption for such child provided he has furnished more than one-half of the support of such child for the calendar year in which the taxable year of the taxpayer begins, even though the income of the child for such calendar year may be equal to or in excess of the amount determined pursuant to §1.151–2 applicable to such calendar year. In such a case, there may be two exemptions claimed for the child: One on the parent's (or stepparent's) return, and one on the child's return. In determining whether the taxpayer does in fact furnish more than one-half of the support of an individual who is a child, as defined in paragraph (a) of §1.151–3, of the taxpayer and who is a student, as defined in paragraph (b) of §1.151–3, a special rule regarding scholarships applies. Amounts received as scholarships, as defined in paragraph (a) of §1.117–3, for study at an educational institution shall not be considered in determining whether the taxpayer furnishes more than one-half the support of such individual. For example, A has a child who receives a $1,000 scholarship to the X college for 1 year. A contributes $500, which constitutes the balance of the child's support for that year. A may claim the child as a dependent, as the $1,000 scholarship is not counted in determining the support of the child. For purposes of this paragraph, amounts received for tuition payments and allowances by a veteran under the provisions of the Servicemen's Readjustment Act of 1944 (58 Stat. 284) or the Veterans' Readjustment Assistance Act of 1952 (38 U.S.C. ch. 38) are not amounts received as scholarships. See also §1.117–4. For definition of the terms ''child'', ''student'', and ''educational institution'', as used in this paragraph, see §1.151–3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6603, 28 FR 7094, July 11, 1963; T.D. 7099, 36 FR 5337, Mar. 20, 1971; T.D. 7114, 36 FR 9019, May 18, 1971]

§ 1.152–2 Rules relating to general definition of dependent.

(a)(1) Except as provided in subparagraph (2) of this paragraph, to qualify as a dependent an individual must be a citizen or resident of the United States or be a resident of the Canal Zone, the Republic of Panama, Canada, or Mexico, or, for taxable years beginning after December 31, 1971, a national of the United States, at some time during the calendar year in which the taxable year of the taxpayer begins. A resident of the Republic of the Philippines who was born to or legally adopted by the taxpayer in the Philippine Islands before January 1, 1956, at a time when the taxpayer was a member of the Armed Forces of the United States, may also be claimed as a dependent if such resident otherwise qualifies as a dependent. For definition of ''Armed Forces of the United States,'' see section 7701(a)(15).

(2)(i) For any taxable year beginning after December 31, 1957, a taxpayer who is a citizen, or, for any taxable year beginning after December 31, 1971, a national, of the United States is permitted under section 152(b)(3)(B) to treat as a dependent his legally adopted child who lives with him, as a member of his household, for the entire taxable year and who, but for the citizenship, nationality, or residence requirements of section 152(b)(3) and subparagraph (1) of this paragraph, would qualify as a dependent of the taxpayer for such taxable year.

(ii) Under section 152(b)(3)(B) and this subparagraph, it is necessary that the taxpayer both maintain and occupy the household. The taxpayer and his legally adopted child will be considered as occupying the household for the entire taxable year of the taxpayer notwithstanding temporary absences from the household due to special circumstances. A nonpermanent failure to occupy the common abode by reason of illness, education, business, vacation, military service, or a custody agreement under which the legally adopted child is absent for less than six months in the taxable year of the taxpayer shall be considered temporary absence due to special circumstances. The fact that a legally adopted child dies during the year shall not deprive the taxpayer of the deduction if the child lived in the household for the entire part of the year preceding his death. The period during the taxable year preceding the birth of a child shall not prevent such child from qualifying as a dependent under this subparagraph. Moreover, a legally adopted child who actually becomes a member of the taxpayer's household during the taxable year shall not be prevented from being considered a member of such household for the entire taxable year, if the child is required to remain in a hospital for a period following its birth and if such child would otherwise have been a member of the taxpayer's household during such period.

(iii) For purposes of section 152(b)(3)(B) and this subparagraph, any child whose legal adoption by the taxpayer (a citizen or national of the United States) becomes final at any time before the end of the taxable year of the taxpayer shall not be disqualified as a dependent of such taxpayer by reason of his citizenship, nationality, or residence, provided the child lived with the taxpayer and was a member of the taxpayer's household for the entire taxable year in which the legal adoption became final. For example, A, a citizen of the United States who makes his income tax returns on the basis of the calendar year, is employed in Brazil by an agency of the United States Government. In October 1958 he takes into his household C, a resident of Brazil who is not a citizen of the United States, for the purpose of initiating adoption proceedings. C lives with A and is a member of his household for the remainder of 1958 and for the entire calendar year 1959. On July 1, 1959, the adoption proceedings were completed and C became the legally adopted child of A. If C otherwise qualifies as a dependent, he may be claimed as a dependent by A for 1959.

(b)(1) A payment to a spouse (payee spouse) of alimony or separate maintenance is not treated as a payment by the payor spouse for the support of any dependent. Similarly, the distribution of income of an estate or trust to a divorced or legally separated payee spouse is not treated as a payment by the payor spouse for the support of any dependent. The preceding sentence will not apply, however, to the extent that such a distribution is in satisfaction of the amount or portion of income that, by the terms of a divorce decree, a written separation agreement, or the trust instrument is fixed as payable for the support of the minor children of the payor spouse.

(2) Paragraph (b)(1) of this section applies to taxable years beginning on or after October 13, 2020.

(c)(1) For purposes of determining the existence of any of the relationships specified in section 152 (a) or (b)(1), a legally adopted child of an individual shall be treated as a child of such individual by blood.

(2) For any taxable year beginning after December 31, 1958, a child who is a member of an individual's household also shall be treated as a child of such individual by blood if the child was placed with the individual by an authorized placement agency for legal adoption pursuant to a formal application filed by the individual with the agency. For purposes of this subparagraph an authorized placement agency is any agency which is authorized by a State, the District of Columbia, a possession of the United States, a foreign country, or a political subdivision of any of the foregoing to place children for adoption. A taxpayer who claims as a dependent a child placed with him for adoption shall attach to his income tax return a statement setting forth the name of the child for whom the dependency deduction is claimed, the name and address of the authorized placement agency, and the date the formal application was filed with the agency.

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

Example. On March 1, 1959, D, a resident of the United States, made formal application to an authorized child placement agency for the placement of E, a resident of the United States, with him for legal adoption. On June 1, 1959, E was placed with D for legal adoption. During the year 1959 E received over one-half of his support from D. D may claim E as a dependent for 1959. Since E was a resident of the United States, his qualification as a dependent is in no way based on the provisions of section 152(b)(3)(B). Therefore, it is immaterial that E was not a member of D's household during the entire taxable year.

(4) For purposes of determining the existence of any of the relationships specified in section 152 (a) or (b)(1), a foster child of an individual (if such foster child satisfies the requirements set forth in paragraph (b) of §1.152–1 with respect to such individual) shall, for taxable years beginning after December 31, 1969, be treated as a child of

such individual by blood. For purposes of this subparagraph, a foster child is a child who is in the care of a person or persons (other than the parents or adopted parents of the child) who care for the child as their own child. Status as a foster child is not dependent upon or affected by the circumstances under which the child became a member of the household.

(d) In the case of a joint return it is not necessary that the prescribed relationship exist between the person claimed as a dependent and the spouse who furnishes the support; it is sufficient if the prescribed relationship exists with respect to either spouse. Thus, a husband and wife making a joint return may claim as a dependent a daughter of the wife's brother (wife's niece) even though the husband is the one who furnishes the chief support. The relationship of affinity once existing will not terminate by divorce or the death of a spouse. For example, a widower may continue to claim his deceased wife's father (his father-in-law) as a dependent provided he meets the other requirements of section 151.

(e)(1) In defining a qualifying relative for taxable year 2018, the exemption amount in section 152(d)(1)(B) is $4,150. For taxable years 2019 through 2025, the exemption amount, as adjusted for inflation, is set forth in annual guidance published in the Internal Revenue Bulletin. *See* § 601.601(d)(2) of this chapter.

(2) Paragraph (e)(1) of this section applies to taxable years ending after August 28, 2018.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6603, 28 FR 7094, July 11, 1963; T.D. 7051, 35 FR 11020, July 9, 1970; T.D. 7291, 38 FR 33396, Dec. 4, 1973; T.D. 9913, 85 FR 64386, Oct. 13, 2020]

§ 1.152–3 Multiple support agreements.

(a) Section 152(c) provides that a taxpayer shall be treated as having contributed over half of the support of an individual for the calendar year (in cases where two or more taxpayers contributed to the support of such individual) if—

(1) No one person contributed over half of the individual's support,

(2) Each member of the group which collectively contributed more than half of the support of the individual would have been entitled to claim the individual as a dependent but for the fact that he did not contribute more than one-half of such support.

(3) The member of the group claiming the individual as a dependent contributed more than 10 percent of the individual's support, and

(4) Each other person in the group who contributed more than 10 percent of such support furnishes to the taxpayer claiming the dependent a written declaration that such other person will not claim the individual as a dependent for any taxable year beginning in such calendar year.

(b) *Examples.* Application of the rule contained in paragraph (a) of this section may be illustrated by the following examples:

Example 1. During the taxable year, brothers A, B, C, and D contributed the entire support of their mother in the following percentages: A, 30 percent; B, 20 percent; C, 29 percent; and D, 21 percent. Any one of the brothers, except for the fact that he did not contribute more than half of her support, would have been entitled to claim his mother as a dependent. Consequently, any one of the brothers could claim a deduction for the exemption of the mother if he obtained a written declaration (as provided in paragraph (a)(4) of this section) from each of the other brothers. Even though A and D together contributed more than one-half the support of the mother, A, if he wished to claim his mother as a dependent, would be required to obtain written declarations from B, C, and D, since each of those three contributed more than 10 percent of the support and, but for the failure to contribute more than half of the mother's support, would have been entitled to claim his mother as a dependent.

Example 2. During the taxable year, E, an individual who resides with his son, S, received his entire support for that year as follows:

Source	Percentage of total
Social Security	25
N, an unrelated neighbor	11
B, a brother	14
D, a daughter	10
S, a son	40
Total received by E	100

B, D, and S are persons each of whom, but for the fact that none contributed more than half of E's support, could claim E as a dependent for the taxable year. The three together contributed 64 percent of E's support, and, thus, each is a member of the group to be considered for the purpose of section 152(c). B and S are the only members of such group who can meet all the requirements of section 152(c), and either one could claim E as a dependent for his taxable year if he obtained a written declaration (as provided in paragraph (a)(4) of this section) signed by the other, and furnished the other information required by the return with respect to all the contributions to E. Inasmuch as D did not contribute more than 10 percent of E's support, she is not entitled to claim E as a dependent for the taxable year nor is she required to furnish a written declaration with respect to her contributions to E. N contributed over 10 percent of the support of E, but, since he is an unrelated neighbor, he does not qualify as a member of the group for the purpose of the multiple support agreement under section 152(c).

(c)(1) The member of a group of contributors who claims an individual as a dependent for a taxable year beginning before January 1, 2002, under the multiple support agreement provisions of section 152(c) must attach to the member's income tax return for the year of the deduction a written declaration from each of the other persons who contributed more than 10 percent of the support of such individual and who, but for the failure to contribute more than half of the support of the individual, would have been entitled to claim the individual as a dependent.

(2) The taxpayer claiming an individual as a dependent for a taxable year beginning after December 31, 2001, under the multiple support agreement provisions of section 152(c) must provide with the income tax return for the year of the deduction—

(i) A statement identifying each of the other persons who contributed more than 10 percent of the support of the individual and who, but for the failure to contribute more than half of the support of the individual, would have been entitled to claim the individual as a dependent; and

(ii) A statement indicating that the taxpayer obtained a written declaration from each of the persons described in section 152(c)(2) waiving the right to claim the individual as a dependent.

(3) The taxpayer claiming the individual as a dependent for a taxable year beginning after December 31, 2001, must retain the waiver declarations and should be prepared to furnish the waiver declarations and any other information necessary to substantiate the claim, which may include a statement showing the names of all contributors (whether or not members of the group described in section 152(c)(2)) and the amount contributed by each to the support of the claimed dependent.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6603, 28 FR 7094, July 11, 1963; T.D. 8989, 67 FR 20031, Apr. 24, 2002; T.D. 9040, 68 FR 4920, Jan. 31, 2003]

§ 1.152–4 Special rule for a child of divorced or separated parents or parents who live apart.

(a) *In general.* A taxpayer may claim a dependency deduction for a child (as defined in section 152(f)(1)) only if the child is the qualifying child of the taxpayer under section 152(c) or the qualifying relative of the taxpayer under section 152(d). Section 152(c)(4)(B) provides that a child who is claimed as a qualifying child by parents who do not file a joint return together is treated as the qualifying child of the parent with whom the child resides for a longer period of time during the taxable year or, if the child resides with both parents for an equal period of time, of the parent with the higher adjusted gross income. However, a child is treated as the qualifying child or qualifying relative of the noncustodial parent if the custodial parent releases a claim to the exemption under section 152(e) and this section.

(b) *Release of claim by custodial parent*—(1) *In general.* Under section 152(e)(1), notwithstanding section 152(c)(1)(B), (c)(4), or (d)(1)(C), a child is treated as the qualifying child or qualifying relative of the noncustodial parent (as defined in paragraph (d) of this section) if the requirements of paragraphs (b)(2) and (b)(3) of this section are met.

(2) *Support, custody, and parental status*—(i) *In general.* The requirements of this paragraph (b)(2) are met if the parents of the child provide over one-half of the child's support for the calendar year, the child is in the custody of one or both parents for more than one-half of the calendar year, and the parents—

(A) Are divorced or legally separated under a decree of divorce or separate maintenance;

(B) Are separated under a written separation agreement; or

(C) Live apart at all times during the last 6 months of the calendar year whether or not they are or were married.

(ii) *Multiple support agreement.* The requirements of this paragraph (b)(2) are not met if over one-half of the support of the child is treated as having been received from a taxpayer under section 152(d)(3).

(3) *Release of claim to child.* The requirements of this paragraph (b)(3) are met for a calendar year if—

(i) The custodial parent signs a written declaration that the custodial parent will not claim the child as a dependent for any taxable year beginning in that calendar year and the noncustodial parent attaches the declaration to the noncustodial parent's return for the taxable year; or

(ii) A qualified pre-1985 instrument, as defined in section 152(e)(3)(B), applicable to the taxable year beginning in that calendar year, provides that the noncustodial parent is entitled to the dependency exemption for the child and the noncustodial parent provides at least $600 for the support of the child during the calendar year.

(c) *Custody.* A child is in the custody of one or both parents for more than one-half of the calendar year if one or both parents have the right under state law to physical custody of the child for more than one-half of the calendar year.

(d) *Custodial parent*—(1) *In general.* The *custodial parent* is the parent with whom the child resides for the greater number of nights during the calendar year, and the *noncustodial parent* is the parent who is not the custodial parent. A child is treated as residing with neither parent if the child is emancipated under state law. For purposes of this section, a child resides with a parent for a night if the child sleeps—

(i) At the residence of that parent (whether or not the parent is present); or

(ii) In the company of the parent, when the child does not sleep at a parent's residence (for example, the parent and child are on vacation together).

(2) *Night straddling taxable years.* A night that extends over two taxable years is allocated to the taxable year in which the night begins.

(3) *Absences.* (i) Except as provided in paragraph (d)(3)(ii) of this section, for purposes of this paragraph (d), a child who does not reside (within the meaning of paragraph (d)(1) of this section) with a parent for a night is treated as residing with the parent with whom the child would have resided for the night but for the absence.

(ii) A child who does not reside (within the meaning of paragraph (d)(1) of this section) with a parent for a night is treated as not residing with either parent for that night if it cannot be determined with which parent the child would have resided or if the child would not have resided with either parent for the night.

(4) *Special rule for equal number of nights.* If a child is in the custody of one or both parents for more than one-half of the calendar year and the child resides with each parent for an equal number of nights during the calendar year, the parent with the higher adjusted gross income for the calendar year is treated as the custodial parent.

(5) *Exception for a parent who works at night.* If, in a calendar year, due to a parent's nighttime work schedule, a child resides for a greater number of days but not nights with the parent who works at night, that parent is treated as the custodial parent. On a school day, the child is treated as residing at the primary residence registered with the school.

(e) *Written declaration*—(1) *Form of declaration*—(i) *In general.* The written declaration under paragraph (b)(3)(i) of this section must be an unconditional release of the custodial parent's claim to the child as a dependent for the year or years for which the declaration is effective. A declaration is not unconditional if the custodial parent's release of the right to claim the child as a dependent requires the satisfaction of any condition, including the noncustodial parent's meeting of an obligation such as the payment of support. A written declaration must name the noncustodial parent to whom the exemption is released. A written declaration must specify the year or years for which it is effective. A written declaration that specifies all future years is treated as specifying the first taxable year after the taxable year of execution and all subsequent taxable years.

(ii) *Form designated by IRS.* A written declaration may be made on Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, or successor form designated by the IRS. A written declaration not on the form designated by the IRS must conform to the substance of that form and must be a document executed for the sole purpose of serving as a written declaration under this section. A court order or decree or a separation agreement may not serve as a written declaration.

(2) *Attachment to return.* A noncustodial parent must attach a copy of the written declaration to the parent's return for each taxable year in which the child is claimed as a dependent.

(3) *Revocation of written declaration*—(i) *In general.* A parent may revoke a written declaration described in paragraph (e)(1) of this section by providing written notice of the revocation to the other parent. The parent revoking the written declaration must make reasonable efforts to provide actual notice to the other parent. The revocation may be effective no earlier than the taxable year that begins in the first calendar year after the calendar year in which the parent revoking the written declaration provides, or makes reasonable efforts to provide, the written notice.

(ii) *Form of revocation.* The revocation may be made on Form 8332, Release/Revocation of Release of Claim to Exemption for Child by Custodial Parent, or successor form designated by the IRS whether or not the written declaration was made on a form designated by the IRS. A revocation not on that form must conform to the substance of the form and must be a document executed for the sole purpose of serving as a revocation under this section. The revocation must specify the year or years for which the revocation is effective. A revocation that specifies all future years is treated as specifying the first taxable year after the taxable year the revocation is executed and all subsequent taxable years.

(iii) *Attachment to return.* The parent revoking the written declaration must attach a copy of the revocation to the parent's return for each taxable year for which the parent claims a child as a dependent as a result of the revocation. The parent revoking the written declaration must keep a copy of the revocation and evidence of delivery of the notice to the other parent, or of the reasonable efforts to provide actual notice.

(4) *Ineffective declaration or revocation.* A written declaration or revocation that fails to satisfy the requirements of this paragraph (e) has no effect.

(5) *Written declaration executed in a taxable year beginning on or before July 2, 2008.* A written declaration executed in a taxable year beginning on or before July 2, 2008, that satisfies the requirements for the form of a written declaration in effect at the time the written declaration is executed, will be treated as meeting the requirements of paragraph (e)(1) of this section. Paragraph (e)(3) of this section applies without regard to whether a custodial parent executed the written declaration in a taxable year beginning on or before July 2, 2008.

(f) *Coordination with other sections.* If section 152(e) and this section apply, a child is treated as the dependent of both parents for purposes of sections 105(b), 132(h)(2)(B), and 213(d)(5).

(g) *Examples.* The provisions of this section are illustrated by the following examples that assume, unless otherwise provided, that each taxpayer's taxable year is the calendar year, one or both of the child's parents provide over one-half of the child's support for the calendar year, one or both parents have the right under state law to physical custody of the child for more than one-half of the calendar year, and the child otherwise meets the requirements of a qualifying child under section 152(c) or a qualifying relative under section 152(d). In addition, in each of the examples, no qualified pre-1985 instrument or multiple support agreement is in effect. The examples are as follows:

Example 1. (i) B and C are the divorced parents of Child. In 2009, Child resides with B for 210 nights and with C for 155 nights. B executes a Form 8332 for 2009 releasing B's right to claim Child as a dependent for that year, which C attaches to C's 2009 return.

(ii) Under paragraph (d) of this section, B is the custodial parent of Child in 2009 because B is the parent with whom Child resides for the greater number of nights in 2009. Because the requirements of paragraphs (b)(2) and (3) of this section are met, C may claim Child as a dependent.

Example 2. The facts are the same as in *Example 1* except that B does not execute a Form 8332 or similar declaration for 2009. Therefore, section 152(e) and this section do not apply. Whether Child is the qualifying child or qualifying relative of B or C is determined under section 152(c) or (d).

Example 3. (i) D and E are the divorced parents of Child. Under a custody decree, Grandmother has the right under state law to physical custody of Child from January 1 to July 31, 2009.

(ii) Because D and E do not have the right under state law to physical custody of Child for over one-half of the 2009 calendar year, under paragraph (c) of this section, Child is not in the custody of one or both parents for over one-half of the calendar year. Therefore, section 152(e) and this section do not apply, and whether Child is the qualifying child or qualifying relative of D, E, or Grandmother is determined under section 152(c) or (d).

Example 4. (i) The facts are the same as in *Example 3*, except that Grandmother has the right to physical custody of Child from January 1 to March 31, 2009, and, as a result, Child resides with Grandmother during this period. D and E jointly have the right to physical custody of Child from April 1 to December 31, 2009. During this period, Child resides with D for 180 nights and with E for 95 nights. D executes a Form 8332 for 2009 releasing D's right to claim Child as a dependent for that year, which E attaches to E's 2009 return.

(ii) Under paragraph (c) of this section, Child is in the custody of D and E for over one-half of the calendar year, because D and E have the right under state law to physical custody of Child for over one-half of the calendar year.

(iii) Under paragraph (d)(3)(ii) of this section, the nights that Child resides with Grandmother are not allocated to either parent. Child resides with D for a greater number of nights than with E during the calendar year and, under paragraph (d)(1) of this section, D is the custodial parent.

(iv) Because the requirements of paragraphs (b)(2) and (3) of this section are met, section 152(e) and this section apply, and E may claim Child as a dependent.

Example 5. (i) The facts are the same as in *Example 4*, except that D is away on military service from April 10 to June 15, 2009, and September 6 to October 20, 2009. During these periods Child resides with Grandmother in Grandmother's residence. Child would have resided with D if D had not been away on military service. Grandmother claims Child as a dependent on Grandmother's 2009 return.

(ii) Under paragraph (d)(3)(i) of this section, Child is treated as residing with D for the nights that D is away on military service. Because the requirements of paragraphs (b)(2) and (3) of this section are met, section 152(e) and this section apply, and E, not Grandmother, may claim Child as a dependent.

Example 6. F and G are the divorced parents of Child. In May of 2009, Child turns age 18 and is emancipated under the law of the state where Child resides. Therefore, in 2009 and later years, F and G do not have the right under state law to physical custody of Child for over one-half of the calendar year, and Child is not in the custody of F and G for over one-half of the calendar year. Section 152(e) and this section do not apply, and whether Child is the qualifying child or qualifying relative of F or G is determined under section 152(c) or (d).

Example 7. (i) The facts are the same as in *Example 6*, except that Child turns age 18 and is emancipated under state law on August 1, 2009, resides with F from January 1, 2009, through May 31, 2009, and resides with G from June 1, 2009, through December 31, 2009. F executes a Form 8332 releasing F's right to claim Child as a dependent for 2009, which G attaches to G's 2009 return.

(ii) Under paragraph (c) of this section, Child is in the custody of F and G for over one-half of the calendar year.

(iii) Under paragraph (d)(1) of this section, Child is treated as not residing with either parent after Child's emancipation. Therefore, Child resides with F for 151 nights and with G for 61 nights. Because the requirements of paragraphs (b)(2) and (3) of this section are met, section 152(e) and this section apply, and G may claim Child as a dependent.

Example 8. H and J are the divorced parents of Child. Child generally resides with H during the week and with J every other weekend. Child resides with J in H's residence for 10 consecutive nights while H is hospitalized. Under paragraph (d)(1)(i) of this section, Child resides with H for the 10 nights.

Example 9. K and L, who are separated under a written separation agreement, are the parents of Child. In August 2009, K and Child spend 10 nights together in a hotel while on vacation. Under paragraph (d)(1)(ii) of this section, Child resides with K for the 10 nights that K and Child are on vacation.

Example 10. M and N are the divorced parents of Child. On December 31, 2009, Child attends a party at M's residence. After midnight on January 1, 2010, Child travels to N's residence, where Child sleeps. Under paragraph (d)(1) of this section, Child resides with N for the night of December 31, 2009, to January 1, 2010, because Child sleeps at N's residence that night. However, under paragraph (d)(2) of this section, the night of December 31, 2009, to January 1, 2010, is allocated to taxable year 2009 for purposes of determining whether Child resides with M or N for a greater number of nights in 2009.

Example 11. O and P, who never married, are the parents of Child. In 2009, Child spends alternate weeks residing with O and P. During a week that Child is residing with O, O gives Child permission to spend a night at the home of a friend. Under paragraph (d)(3)(i) of this section, the night Child spends at the friend's home is treated as a night that Child resides with O.

Example 12. The facts are the same as in *Example 11*, except that Child also resides at summer camp for 6 weeks. Because Child resides with each parent for alternate weeks, Child would have resided with O for 3 weeks and with P for 3 weeks of the period that Child is at camp. Under paragraph (d)(3)(i) of this section, Child is treated as residing with O for 3 weeks and with P for 3 weeks.

Example 13. The facts are the same as in *Example 12*, except that Child does not spend alternate weeks residing with O and P, and it cannot be determined whether Child would have resided with O or P for the period that Child is at camp. Under paragraph (d)(3)(ii) of this section, Child is treated as residing with neither parent for the 6 weeks.

Example 14. (i) Q and R are the divorced parents of Child. Q works from 11 PM to 7 AM Sunday through Thursday nights. Because of Q's nighttime work schedule, Child resides with R Sunday through Thursday nights and with Q Friday and Saturday nights. Therefore, in 2009, Child resides with R for 261 nights and with Q for 104 nights. Child spends all daytime hours when Child is not in school with Q and Q's address is registered with Child's school as Child's primary residence. Q executes a Form 8332 for 2009 releasing Q's right to claim Child as a dependent for that year, which R attaches to R's 2009 return.

(ii) Under paragraph (d) of this section, Q is the custodial parent of Child in 2009. Child resides with R for a greater number of nights than with Q due to Q's nighttime work schedule, and Child spends a greater number of days with Q. Therefore, paragraph (d)(5) of this section applies rather than paragraph (d)(1) of this section. Because the requirements of paragraphs (b)(2) and (3) of this section are met, R may claim Child as a dependent.

Example 15. (i) In 2009, S and T, the parents of Child, execute a written separation agreement. The agreement provides that Child will live with S and that T will make monthly child support payments to S. In 2009, Child resides with S for 335 nights and with T for 30 nights. S executes a letter declaring that S will not claim Child as a dependent in 2009 and in subsequent alternate years. The letter contains all the information requested on Form 8332, does not require the satisfaction of any condition such as T's payment of support, and has no purpose other than to serve as a written declaration under section 152(e) and this section. T attaches the letter to T's return for 2009 and 2011.

(ii) In 2010, T fails to provide support for Child, and S executes a Form 8332 revoking the release of S's right to claim Child as a dependent for 2011. S delivers a copy of the Form 8332 to T, attaches a copy of the Form 8332 to S's tax return for 2011, and keeps a copy of the Form 8332 and evidence of delivery of the written notice to T.

(iii) T may claim Child as a dependent for 2009 because S releases the right to claim Child as a dependent under paragraph (b)(3) of this section by executing the letter, which conforms to the requirements of paragraph (e)(1) of this section, and T attaches the letter to T's return in accordance with paragraph (e)(2) of this section. In 2010, S revokes the release of the claim in accordance with paragraph (e)(3) of this section, and the revocation takes effect in 2011, the taxable year that begins in the first calendar year after S provides written notice of the revocation to T. Therefore, in 2011, section 152(e) and this section do not apply, and whether Child is the qualifying child or qualifying relative of S or T is determined under section 152(c) or (d).

Example 16. The facts are the same as *Example 15*, except that the letter expressly states that S releases the right to claim Child as a dependent only if T is current in the payment of support for Child at the end of the calendar year. The letter does not qualify as a written declaration under paragraph (b)(3) of this section because S's agreement not to claim Child as a dependent is conditioned on T's payment of support and, under paragraph (e)(1)(i) of this section, a written declaration must be unconditional. Therefore, section 152(e) and this section do not apply, and whether Child is the qualifying child or qualifying relative of S or T for 2009 as well as 2011 is determined under section 152(c) or (d).

Example 17. (i) U and V are the divorced parents of Child. Child resides with U for more nights than with V in 2009 through 2011. In 2009, U provides a written statement to V declaring that U will not claim Child as a dependent, but the statement does not specify the year or years it is effective. V attaches the statement to V's returns for 2009 through 2011.

(ii) Because the written statement does not specify a year or years, under paragraph (e)(1) of this section, it is not a written declaration that conforms to the substance of Form 8332. Under paragraph (e)(4) of this section, the statement has no effect. Section 152(e) and this section do not apply, and whether Child is the qualifying child or qualifying relative of U or V is determined under section 152(c) or (d).

Example 18. (i) W and X are the divorced parents of Child. In 2009, Child resides solely with W. The divorce decree requires X to pay child support to W and requires W to execute a Form 8332 releasing W's right to claim Child as a dependent. W fails to sign a Form 8332 for 2009, and X attaches an unsigned Form 8332 to X's return for 2009.

(ii) The order in the divorce decree requiring W to execute a Form 8332 is ineffective to allocate the right to claim Child as a dependent to X. Furthermore, under paragraph (e)(1) of this section, the unsigned Form 8332 does not conform to the substance of Form 8332, and under paragraph (e)(4) of this section, the Form 8332 has no effect. Therefore, section 152(e) and this section do not apply, and whether Child is the qualifying child or qualifying relative of W or X is determined under section 152(c) or (d).

(iii) If, however, W executes a Form 8332 for 2009, and X attaches the Form 8332 to X's return, then X may claim Child as a dependent in 2009.

Example 19. (i) Y and Z are the divorced parents of Child. In 2003, Y and Z enter into a separation agreement, which is incorporated into a divorce decree, under which Y, the custodial parent, releases Y's right to claim Child as a dependent for all future years. The separation agreement satisfies the requirements for the form of a written declaration in effect at the time it is executed. Z attaches a copy of the separation agreement to Z's returns for 2003 through 2009.

(ii) Under paragraph (e)(1)(ii) of this section, a separation agreement may not serve as a written declaration. However, under paragraph (e)(5) of this section, a written declaration executed in a taxable year beginning on or before July 2, 2008, that satisfies the requirements for the form of a written declaration in effect at the time the written declaration is executed, will be treated as meeting the requirements of paragraph (e)(1) of this section. Therefore, the separation agreement may serve as the written declaration required by paragraph (b)(3)(i) of this section for 2009, and Z may claim Child as a dependent in 2009 and later years.

Example 20. (i) The facts are the same as in *Example 19*, except that in 2009 Y executes a Form 8332 revoking the release of Y's right to claim Child as a dependent for 2010. Y complies with all the requirements of paragraph (e)(3) of this section.

(ii) Although Y executes the separation agreement releasing Y's right to claim Child as a dependent in a taxable year beginning on or before July 2, 2008, under paragraph (e)(5) of this section, Y's execution of the Form 8332 in 2009 is effective to revoke the release. Therefore, section 152(e) and this section do not apply in 2010, and whether Child is the qualifying child or qualifying relative of Y or Z is determined under section 152(c) or (d).

(h) *Effective/applicability date.* This section applies to taxable years beginning after July 2, 2008.

[T.D. 9408, 73 FR 37801, July 2, 2008]

§ 1.153–1 Determination of marital status.

For the purpose of determining the right of an individual to claim an exemption for his spouse under section 151(b), the determination of whether such individual is married shall be made as of the close of his taxable year, unless his spouse dies during such year, in which case the determination shall be made as of the time of such death. An individual legally separated from his spouse under a decree of divorce or separate maintenance shall not be considered as married. The provisions of this section may be illustrated by the following examples:

Example 1. A, who files his returns on the basis of a calendar year, married B on December 31, 1956. B, who had never previously married, had no gross income for the calendar year 1956 nor was she the dependent of another taxpayer for such year. A may claim an exemption for B for 1956.

Example 2. C and his wife, D, were married in 1940. They remained married until July 1956 at which time D was granted a decree of divorce. C, who files his income tax returns on a calendar year basis, cannot claim an exemption for D on his 1956 return as C and D were not married on the last day of C's taxable year. Had D died instead of being divorced, C could have claimed an exemption for D for 1956 as their marital status would have been determined as of the date of D's death.

§ 1.154 Statutory provisions; cross references.

SEC. 154. *Cross references.* (1) For definitions of ''husband'' and ''wife'', as used in section 152(b)(4), see section 7701(a)(17).

(2) For deductions of estates and trusts, in lieu of the exemptions under section 151, see section 642(b).

(3) For exemptions of nonresident aliens, see section 873(b)(3).

(4) For exemptions of citizens deriving income mainly from sources within possessions of the United States, see section 931(e).

(Sec. 154 as amended by sec. 103(c)(2), Foreign Investors Tax Act 1966 (80 Stat. 1551))

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 7332, 39 FR 44216, Dec. 23, 1974]

ITEMIZED DEDUCTIONS FOR INDIVIDUALS AND CORPORATIONS

§ 1.161–1 Allowance of deductions.

Section 161 provides for the allowance as deductions, in computing taxable income under section 63(a), of the items specified in Part VI (section 161 and following), Subchapter B, Chapter 1 of the Code, subject to the exceptions provided in Part IX (section 261 and following), of such Subchapter B, relating to items not deductible. Double deductions are not permitted. Amounts deducted under one provision of the Internal Revenue Code of 1954 cannot again be deducted under any other provision thereof. See also section 7852(c), relating to the taking into account, both in computing a tax under Subtitle A of the Internal Revenue Code of 1954 and a tax under Chapter 1 or 2 of the Internal Revenue Code of 1939, of the same item of deduction.

§ 1.162–1 Business expenses.

(a) *In general.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other than section 162. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. See paragraph (a) of § 1.161–3. Among the items included in business expenses are management expenses, commissions (but see section 263 and the regulations thereunder), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see § 1.162–2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. See section 1054 and the regulations thereunder. A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy. See section 162(c), (f), and (g) and the regulations thereunder. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business. In the case of any sports program to which section 114 (relating to sports programs conducted for the American National Red Cross) applies, expenses described in section 114(a)(2) shall be allowable as deductions under section 162(a) only to the extent that such expenses exceed the amount excluded from gross income under section 114(a).

(b) *Cross references.* (1) For charitable contributions by individuals and corporations not deductible under section 162, see § 1.162–15.

(2) For items not deductible, see sections 261–276, inclusive, and the regulations thereunder.

(3) For research and experimental expenditures, see section 174 and regulations thereunder.

(4) For soil and water conservation expenditures, see section 175 and regulations thereunder.

(5) For expenditures attributable to grant or loan by United States for encouragement of exploration for, or development or mining of, critical and strategic minerals or metals, see section 621 and regulations thereunder.

(6) For treatment of certain rental payments with respect to public utility property, see section 167(1) and § 1.167(1)–3.

(7) For limitations on the deductibility of miscellaneous itemized deductions, see section 67 and §§1.67–1T through 1.67–4T.

(8) For the timing of deductions with respect to notional principal contracts. see §1.446–3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6690, 28 FR 12253, Nov. 19, 1963; T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7315, 39 FR 20203, June 7, 1974; T.D. 7345, 40 FR 7437, Feb. 20, 1975; T.D. 8189, 53 FR 9881, Mar. 28, 1988; T.D. 8491, 58 FR 53128, Oct. 14, 1993]

§ 1.162–2 Traveling expenses.

(a) Traveling expenses include travel fares, meals and lodging, and expenses incident to travel such as expenses for sample rooms, telephone and telegraph, public stenographers, etc. Only such traveling expenses as are reasonable and necessary in the conduct of the taxpayer's business and directly attributable to it may be deducted. If the trip is undertaken for other than business purposes, the travel fares and expenses incident to travel are personal expenses and the meals and lodging are living expenses. If the trip is solely on business, the reasonable and necessary traveling expenses, including travel fares, meals and lodging, and expenses incident to travel, are business expenses. For the allowance of traveling expenses as deductions in determining adjusted gross income, see section 62(2)(B) and the regulations thereunder.

(b)(1) If a taxpayer travels to a destination and while at such destination engages in both business and personal activities, traveling expenses to and from such destination are deductible only if the trip is related primarily to the taxpayer's trade or business. If the trip is primarily personal in nature, the traveling expenses to and from the destination are not deductible even though the taxpayer engages in business activities while at such destination. However, expenses while at the destination which are properly allocable to the taxpayer's trade or business are deductible even though the traveling expenses to and from the destination are not deductible.

(2) Whether a trip is related primarily to the taxpayer's trade or business or is primarily personal in nature depends on the facts and circumstances in each case. The amount of time during the period of the trip which is spent on personal activity compared to the amount of time spent on activities directly relating to the taxpayer's trade or business is an important factor in determining whether the trip is primarily personal. If, for example, a taxpayer spends one week while at a destination on activities which are directly related to his trade or business and subsequently spends an additional five weeks for vacation or other personal activities, the trip will be considered primarily personal in nature in the absence of a clear showing to the contrary.

(c) Where a taxpayer's wife accompanies him on a business trip, expenses attributable to her travel are not deductible unless it can be adequately shown that the wife's presence on the trip has a bona fide business purpose. The wife's performance of some incidental service does not cause her expenses to qualify as deductible business expenses. The same rules apply to any other members of the taxpayer's family who accompany him on such a trip.

(d) Expenses paid or incurred by a taxpayer in attending a convention or other meeting may constitute an ordinary and necessary business expense under section 162 depending upon the facts and circumstances of each case. No distinction will be made between self-employed persons and employees. The fact that an employee uses vacation or leave time or that his attendance at the convention is voluntary will not necessarily prohibit the allowance of the deduction. The allowance of deductions for such expenses will depend upon whether there is a sufficient relationship between the taxpayer's trade of business and his attendance at the convention or other meeting so that he is benefiting or advancing the interests of his trade or business by such attendance. If the convention is for political, social or other purposes unrelated to the taxpayer's trade or business, the expenses are not deductible.

(e) Commuters' fares are not considered as business expenses and are not deductible.

(f) For rules with respect to the reporting and substantiation of traveling and other business expenses of employees for taxable years beginning after December 31, 1957, see § 1.162–17.

§ 1.162–3 Materials and supplies.

(a) *In general*—(1) *Non-incidental materials and supplies*. Except as provided in paragraphs (d), (e), and (f) of this section, amounts paid to acquire or produce materials and supplies (as defined in paragraph (c) of this section) are deductible in the taxable year in which the materials and supplies are first used in the taxpayer's operations or are consumed in the taxpayer's operations.

(2) *Incidental materials and supplies*. Amounts paid to acquire or produce incidental materials and supplies (as defined in paragraph (c) of this section) that are carried on hand and for which no record of consumption is kept or of which physical inventories at the beginning and end of the taxable year are not taken, are deductible in the taxable year in which these amounts are paid, provided taxable income is clearly reflected.

(3) *Use or consumption of rotable and temporary spare parts*. Except as provided in paragraphs (d), (e), and (f) of this section, for purposes of paragraph (a)(1) of this section, rotable and temporary spare parts (defined under paragraph (c)(2) of this section) are first used in the taxpayer's operations or are consumed in the taxpayer's operations in the taxable year in which the taxpayer disposes of the parts.

(b) *Coordination with other provisions of the Internal Revenue Code*. Nothing in this section changes the treatment of any amount that is specifically provided for under any provision of the Internal Revenue Code (Code) or regulations other than section 162(a) or section 212 and the regulations under those sections. For example, see § 1.263(a)–3, which requires taxpayers to capitalize amounts paid to improve tangible property and section 263A and the regulations under section 263A, which require taxpayers to capitalize the direct and allocable indirect costs, including the cost of materials and supplies, of property produced by the taxpayer and property acquired for resale. See also § 1.471–1, which requires taxpayers to include in inventory certain materials and supplies.

(c) *Definitions*—(1) *Materials and supplies*. For purposes of this section, *materials and supplies* means tangible property that is used or consumed in the taxpayer's operations that is not inventory and that—

(i) Is a component acquired to maintain, repair, or improve a unit of tangible property (as determined under § 1.263(a)–3(e)) owned, leased, or serviced by the taxpayer and that is not acquired as part of any single unit of tangible property;

(ii) Consists of fuel, lubricants, water, and similar items, reasonably expected to be consumed in 12 months or less, beginning when used in the taxpayer's operations;

(iii) Is a unit of property as determined under § 1.263(a)–3(e) that has an economic useful life of 12 months or less, beginning when the property is used or consumed in the taxpayer's operations;

(iv) Is a unit of property as determined under § 1.263(a)–3(e) that has an acquisition cost or production cost (as determined under section 263A) of $200 or less (or other amount as identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter); or

(v) Is identified in published guidance in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) as materials and supplies for which treatment is permitted under this section.

(2) *Rotable and temporary spare parts*. For purposes of this section, rotable spare parts are materials and supplies under paragraph (c)(1)(i) of this section that are acquired for installation on a unit of property, removable from that unit of property, generally repaired or improved, and either reinstalled on the same or other property or stored for later installation. Temporary spare parts are materials and supplies under paragraph (c)(1)(i) of this section that are used temporarily until a new or repaired part can be installed and then are removed and stored for later installation.

(3) *Standby emergency spare parts*. Standby emergency spare parts are materials and supplies under paragraph (c)(1)(i) of this section that are—

(i) Acquired when particular machinery or equipment is acquired (or later acquired and set aside for use in particular machinery or equipment);

(ii) Set aside for use as replacements to avoid substantial operational time loss caused by emergencies due to particular machinery or equipment failure;

(iii) Located at or near the site of the installed related machinery or equipment so as to be readily available when needed;

(iv) Directly related to the particular machinery or piece of equipment they serve;

(v) Normally expensive;

(vi) Only available on special order and not readily available from a vendor or manufacturer;

(vii) Not subject to normal periodic replacement;

(viii) Not interchangeable in other machines or equipment;

(ix) [Reserved]

(x) Not acquired in quantity (generally only one is on hand for each piece of machinery or equipment); and

(xi) Not repaired and reused.

(4) *Economic useful life*—(i) *General rule*. The economic useful life of a unit of property is not necessarily the useful life inherent in the property but is the period over which the property may reasonably be expected to be useful to the taxpayer or, if the taxpayer is engaged in a trade or business or an activity for the production of income, the period over which the property may reasonably be expected to be useful to the taxpayer in its trade or business or for the production of income, as applicable. The factors that must be considered in determining this period are provided under §1.167(a)–1(b).

(ii) *Taxpayers with an applicable financial statement*. For taxpayers with an applicable financial statement (as defined in paragraph (c)(4)(iii) of this section), the economic useful life of a unit of property, solely for the purposes of applying the provisions of this paragraph (c), is the useful life initially used by the taxpayer for purposes of determining depreciation in its applicable financial statement, regardless of any salvage value of the property. If a taxpayer does not have an applicable financial statement for the taxable year in which a unit of property was originally acquired or produced, the economic useful life of the unit of property must be determined under paragraph (c)(4)(i) of this section. Further, if a taxpayer treats amounts paid for a unit of property as an expense in its applicable financial statement on a basis other than the useful life of the property or if a taxpayer does not depreciate the unit of property on its applicable financial statement, the economic useful life of the unit of property must be determined under paragraph (c)(4)(i) of this section. For example, if a taxpayer has a policy of treating as an expense on its applicable financial statement amounts paid for a unit of property costing less than a certain dollar amount, notwithstanding that the unit of property has a useful life of more than one year, the economic useful life of the unit of property must be determined under paragraph (c)(4)(i) of this section.

(iii) *Definition of applicable financial statement*. The taxpayer's applicable financial statement is the taxpayer's financial statement listed in paragraphs (c)(4)(iii)(A) through (C) of this section that has the highest priority (including within paragraph (c)(4)(iii)(B) of this section). The financial statements are, in descending priority—

(A) A financial statement required to be filed with the Securities and Exchange Commission (SEC) (the 10–K or the Annual Statement to Shareholders);

(B) A certified audited financial statement that is accompanied by the report of an independent certified public accountant (or in the case of a foreign entity, by the report of a similarly qualified independent professional), that is used for—

(*1*) Credit purposes;

(*2*) Reporting to shareholders, partners, or similar persons; or

(*3*) Any other substantial non-tax purpose; or

(C) A financial statement (other than a tax return) required to be provided to the federal or a state government or any federal or state agency (other than the SEC or the Internal Revenue Service).

(5) *Amount paid.* For purposes of this section, in the case of a taxpayer using an accrual method of accounting, the terms *amount paid* and *payment* mean a liability incurred (within the meaning of §1.446–1(c)(1)(ii)). A liability may not be taken into account under this section prior to the taxable year during which the liability is incurred.

(6) *Produce.* For purposes of this section, *produce* means construct, build, install, manufacture, develop, create, raise, or grow. This definition is intended to have the same meaning as the definition used for purposes of section 263A(g)(1) and §1.263A–2(a)(1)(i), except that improvements are excluded from the definition in this paragraph (c)(6) and are separately defined and addressed in §1.263(a)–3. Amounts paid to produce materials and supplies are subject to section 263A.

(d) *Election to capitalize and depreciate certain materials and supplies*—(1) *In general.* A taxpayer may elect to treat as a capital expenditure and to treat as an asset subject to the allowance for depreciation the cost of any rotable spare part, temporary spare part, or standby emergency spare part as defined in paragraph (c)(2) or (c)(3) of this section. Except as specified in paragraph (d)(2) of this section, an election made under this paragraph (d) applies to amounts paid during the taxable year to acquire or produce any rotable, temporary, or standby emergency spare part to which paragraph (a) of this section would apply (but for the election under this paragraph (d)). Any property for which this election is made shall not be treated as a material or a supply.

(2) *Exceptions.* A taxpayer may not elect to capitalize and depreciate under this paragraph (d) any amount paid to acquire or produce a rotable, temporary, or standby emergency spare part defined in paragraph (c)(2) or (c)(3) of this section if—

(i) The rotable, temporary, or standby emergency spare part is intended to be used as a component of a unit of property under paragraph (c)(1)(iii), (iv), or (v) of this section;

(ii) The rotable, temporary, or standby emergency spare part is intended to be used as a component of a property described in paragraph (c)(1)(i) and the taxpayer cannot or has not elected to capitalize and depreciate that property under this paragraph (d); or

(iii) The amount is paid to acquire or produce a rotable or temporary spare part and the taxpayer uses the optional method of accounting for rotable and temporary spare parts under paragraph (e) to of this section.

(3) *Manner of electing.* A taxpayer makes the election under this paragraph (d) by capitalizing the amounts paid to acquire or produce a rotable, temporary, or standby emergency spare part in the taxable year the amounts are paid and by beginning to depreciate the costs when the asset is placed in service by the taxpayer for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the Treasury Regulations. Section 1.263(a)–2 provides for the treatment of amounts paid to acquire or produce real or personal tangible property. A taxpayer must make the election under this paragraph (d) in its timely filed original Federal tax return (including extensions) for the taxable year the asset is placed in service by the taxpayer for purposes of determining depreciation. Sections 301.9100–1 through 301.9100–3 of this chapter provide the rules governing extensions of the time to make regulatory elections. In the case of an S corporation or a partnership, the election is made by the S corporation or partnership, and not by the shareholders or partners. A taxpayer may make an election for each rotable, temporary, or standby emergency spare part that qualifies for the election under this paragraph (d). This election does not apply to an asset or a portion thereof placed in service and disposed of in the same taxable year. A taxpayer may revoke an election made under this paragraph (d) or made under §1.162–3T(d), as contained in 26 CFR part 1, revised as of April 1, 2013, only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer acted reasonably and in good faith and the revocation will not prejudice the

interests of the Government. See generally § 301.9100–3 of this chapter. The manner of electing and revoking the election to capitalize under this paragraph (d) or under § 1.162–3T(d), as contained in 26 CFR part 1, revised as of April 1, 2013, may be modified through guidance of general applicability (see §§ 601.601(d)(2) and 601.602 of this chapter). An election may not be made or revoked through the filing of an application for change in accounting method or, before obtaining the Commissioner's consent to make the late election or to revoke the election, by filing an amended Federal tax return.

(e) *Optional method of accounting for rotable and temporary spare parts*—(1) *In general*. This paragraph (e) provides an optional method of accounting for rotable and temporary spare parts (the optional method for rotable parts). A taxpayer may use the optional method for rotable parts, instead of the general rule under paragraph (a)(3) of this section, to account for its rotable and temporary spare parts as defined in paragraph (c)(2) of this section. A taxpayer that uses the optional method for rotable parts must use this method for all of its pools of rotable and temporary spare parts used in the same trade or business and for which it uses this method for its books and records. If a taxpayer uses the optional method for rotable parts for pools of rotable and temporary spare parts for which the taxpayer does not use the optional method for its books and records, then the taxpayer must use the optional method for all its pools in the same trade or business, whether rotable or temporary. The optional method for rotable parts is a method of accounting under section 446(a). Under the optional method for rotable parts, the taxpayer must apply the rules in this paragraph (e) to each rotable or temporary spare part (part) upon the taxpayer's initial installation, removal, repair, maintenance or improvement, reinstallation, and disposal of each part.

(2) *Description of optional method for rotable parts*—(i) *Initial installation*. The taxpayer must deduct the amount paid to acquire or produce the part in the taxable year that the part is first installed on a unit of property for use in the taxpayer's operations.

(ii) *Removal from unit of property*. In each taxable year in which the part is removed from a unit of property to which it was initially or subsequently installed, the taxpayer must—

(A) Include in gross income the fair market value of the part; and

(B) Include in the basis of the part the fair market value of the part included in income under paragraph (e)(2)(ii)(A) of this section and the amount paid to remove the part from the unit of property.

(iii) *Repair, maintenance, or improvement of part*. The taxpayer may not currently deduct and must include in the basis of the part any amounts paid to maintain, repair, or improve the part in the taxable year these amounts are paid.

(iv) *Reinstallation of part*. The taxpayer must deduct the amounts paid to reinstall the part and those amounts included in the basis of the part under paragraphs (e)(2)(ii)(B) and (e)(2)(iii) of this section, to the extent that those amounts have not been previously deducted under this paragraph (e)(2)(iv), in the taxable year that the part is reinstalled on a unit of property.

(v) *Disposal of the part*. The taxpayer must deduct the amounts included in the basis of the part under paragraphs (e)(2)(ii)(B) and (e)(2)(iii) of this section, to the extent that those amounts have not been previously deducted under paragraph (e)(2)(iv) of this section, in the taxable year in which the part is disposed of by the taxpayer.

(f) *Application of de minimis safe harbor*. If a taxpayer elects to apply the de minimis safe harbor under § 1.263(a)–1(f) to amounts paid for the production or acquisition of tangible property, then the taxpayer must apply the de minimis safe harbor to amounts paid for all materials and supplies that meet the requirements of § 1.263(a)–1(f), except for those materials and supplies that the taxpayer elects to capitalize and depreciate under paragraph (d) of this section or for which the taxpayer properly uses the optional method of accounting for rotable and temporary spare parts under paragraph (e) of this section. If the taxpayer properly applies the de minimis safe harbor under

§ 1.263(a)–1(f) to amounts paid for materials and supplies, then these amounts are not treated as amounts paid for materials and supplies under this section. See § 1.263(a)–1(f)(5) for the time and manner of electing the de minimis safe harbor and § 1.263(a)–1(f)(3)(iv) for the treatment of safe harbor amounts.

(g) *Sale or disposition of materials and supplies.* Upon sale or other disposition, materials and supplies as defined in this section are not treated as a capital asset under section 1221 or as property used in the trade or business under section 1231. Any asset for which the taxpayer makes the election to capitalize and depreciate under paragraph (d) of this section shall not be treated as a material or supply, and the recognition and character of the gain or loss for such depreciable asset are determined under other applicable provisions of the Code.

(h) *Examples.* The rules of this section are illustrated by the following examples, in which it is assumed, unless otherwise stated, that the property is not an incidental material or supply, that the taxpayer computes its income on a calendar year basis, that the taxpayer does not make the election to apply paragraph (d) of this section, or use the method of accounting described in paragraph (e) of this section, and that the taxpayer has not elected to apply the de minimis safe harbor under § 1.263(a)–1(f). The following examples illustrate only the application of this section and, unless otherwise stated, do not address the treatment under other provisions of the Code (for example, section 263A).

Example 1 Non-rotable components. A owns a fleet of aircraft that it operates in its business. In Year 1, A purchases a stock of spare parts, which it uses to maintain and repair its aircraft. A keeps a record of consumption of these spare parts. In Year 2, A uses the spare parts for the repair and maintenance of one of its aircraft. Assume each aircraft is a unit of property under § 1.263(a)–3(e) and that spare parts are not rotable or temporary spare parts under paragraph (c)(2) of this section. Assume these repair and maintenance activities do not improve the aircraft under § 1.263(a)–3. These parts are materials and supplies under paragraph (c)(1)(i) of this section because they are components acquired and used to maintain and repair A's aircraft. Under paragraph (a)(1) of this section, the amounts that A paid for the spare parts in Year 1 are deductible in Year 2, the taxable year in which the spare parts are first used to repair and maintain the aircraft.

Example 2 Rotable spare parts; disposal method. B operates a fleet of specialized vehicles that it uses in its service business. Assume that each vehicle is a unit of property under § 1.263(a)–3(e). At the time that it acquires a new type of vehicle, B also acquires a substantial number of rotable spare parts that it will keep on hand to quickly replace similar parts in B's vehicles as those parts break down or wear out. These rotable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles. In Year 1, B acquires several vehicles and a number of rotable spare parts to be used as replacement parts in these vehicles. In Year 2, B repairs several vehicles by using these rotable spare parts to replace worn or damaged parts. In Year 3, B removes these rotable spare parts from its vehicles, repairs the parts, and reinstalls them on other similar vehicles. In Year 5, B can no longer use the rotable parts it acquired in Year 1 and disposes of them as scrap. Assume that B does not improve any of the rotable spare parts under § 1.263(a)–3. Under paragraph (c)(1)(i) of this section, the rotable spare parts acquired in Year 1 are materials and supplies. Under paragraph (a)(3) of this section, rotable spare parts are generally used or consumed in the taxable year in which the taxpayer disposes of the parts. Therefore, under paragraph (a)(1) of this section, the amounts that B paid for the rotable spare parts in Year 1 are deductible in Year 5, the taxable year in which B disposes of the parts.

Example 3 Rotable spare parts; application of optional method of accounting. C operates a fleet of specialized vehicles that it uses in its service business. Assume that each vehicle is a unit of property under § 1.263(a)–3(e). At the time that it acquires a new type of vehicle, C also acquires a substantial number of rotable spare parts that it will keep on hand to replace similar parts in C's vehicles as those parts break down or wear out. These rotable parts are removable from the vehicles and are repaired so that they can be reinstalled on the same or similar vehicles. C uses the optional method of accounting for all its rotable and temporary spare parts under paragraph (e) of this section. In Year 1, C acquires several vehicles and a number of rotable spare parts (the "Year 1 rotable parts") to be used as replacement parts in these vehicles. In Year 2, C repairs several vehicles and uses the Year 1 rotable parts to replace worn or damaged parts. In Year 3, C pays amounts to remove these Year 1 rotable parts from its vehicles. In Year 4, C pays amounts to maintain, repair, or improve the Year 1 rotable parts. In Year 5, C pays amounts to reinstall the Year 1 rotable parts on other similar vehicles. In Year 8, C removes the Year 1 rotable parts from these vehicles and stores these parts for possible later use. In Year 9, C disposes of the Year 1 rotable parts. Under paragraph (e) of this section, C must deduct the amounts paid to acquire and install the Year 1 rotable parts in Year 2, the taxable year in which the rotable parts are first installed by C in C's vehicles. In Year 3, when C removes the Year 1 rotable parts from its vehicles, C must include in its gross income the fair market value of each part. Also, in Year 3, C must include in the basis of each Year 1 rotable part the fair market value of the rotable part and the amount paid to remove the rotable part from the vehicle. In Year 4, C must include in the basis of each Year 1 rotable part the amounts paid to maintain, repair, or improve each rotable part. In Year 5, the year that C reinstalls the Year 1 rotable parts (as repaired or improved) in other vehicles, C must deduct the reinstallation costs and the amounts previously included in the basis of each part. In Year 8, the year that C removes the Year 1 rotable parts from the vehicles, C must include in income the fair market value of each rotable part removed. In addition, in Year 8, C must include in the basis of each part the fair market value of that part and the amount paid to remove each rotable part from the vehicle. In Year 9, the year that C disposes of the Year 1 rotable parts, C may deduct the amounts remaining in the basis of each rotable part.

Example 4 Rotable part acquired as part of a single unit of property; not material or supply. D operates a fleet of aircraft. In Year 1, D acquires a new aircraft, which includes two new aircraft engines. The aircraft costs $500,000 and has an economic useful life of more than 12 months, beginning when it is placed in service. In Year 5, after the aircraft is operated for several years in D's business, D removes the engines from the aircraft, repairs or improves the engines, and either reinstalls the engines on a similar aircraft or stores the engines for later reinstallation. Assume the aircraft purchased in Year 1, including its two engines, is a unit of property under §1.263(a)–3(e). Because the engines were acquired as part of the aircraft, a single unit of property, the engines are not materials or supplies under paragraph (c)(1)(i) of this section nor rotable or temporary spare parts under paragraph (c)(2) of this section. Accordingly, D may not apply the rules of this section to the aircraft engines upon the original acquisition of the aircraft nor after the removal of the engines from the aircraft for use in the same or similar aircraft. Rather, D must apply the rules under §§1.263(a)–2 and 1.263(a)–3 to the aircraft, including its engines, to determine the treatment of amounts paid to acquire, produce, or improve the unit of property.

Example 5 Consumable property. E operates a fleet of aircraft that carries freight for its customers. E has several storage tanks on its premises, which hold jet fuel for its aircraft. Assume that once the jet fuel is placed in E's aircraft, the jet fuel is reasonably expected to be consumed within 12 months or less. On December 31, Year 1, E purchases a two-year supply of jet fuel. In Year 2, E uses a portion of the jet fuel purchased on December 31, Year 1, to fuel the aircraft used in its business. The jet fuel that E purchased in Year 1 is a material or supply under paragraph (c)(1)(ii) of this section because it is reasonably expected to be consumed within 12 months or less from the time it is placed in E's aircraft. Under paragraph (a)(1) of this section, E may deduct in Year 2 the amounts paid for the portion of jet fuel used in the operation of E's aircraft in Year 2.

Example 6 Unit of property that costs $200 or less. F operates a business that rents out a variety of small individual items to customers (rental items). F maintains a supply of rental items on hand. In Year 1, F purchases a large quantity of rental items to use in its rental business. Assume that each rental item is a unit of property under §1.263(a)–3(e) and costs $200 or less. In Year 2, F begins using all the rental items purchased in Year 1 by providing them to customers of its rental business. F does not sell or exchange these items on established retail markets at any time after the items are used in the rental business. The rental items are materials and supplies under paragraph (c)(1)(iv) of this section. Under paragraph (a)(1) of this section, the amounts that F paid for the rental items in Year 1 are deductible in Year 2, the taxable year in which the rental items are first used in F's business.

Example 7 Unit of property that costs $200 or less. G provides billing services to its customers. In Year 1, G pays amounts to purchase 50 scanners to be used by its employees. Assume each scanner is a unit of property under §1.263(a)–3(e) and costs less than $200. In Year 1, G's employees begin using 35 of the scanners, and F stores the remaining 15 scanners for use in a later taxable year. The scanners are materials and supplies under paragraph (c)(1)(iv) of this section. Under paragraph (a)(1) of this section, the amounts G paid for 35 of the scanners are deductible in Year 1, the taxable year in which G first uses each of those scanners. The amounts that G paid for each of the remaining 15 scanners are deductible in the taxable year in which each machine is first used in G's business.

Example 8 Materials and supplies that cost less than $200; de minimis safe harbor. Assume the same facts as in *Example 7* except that G's scanners qualify for the de minimis safe harbor under §1.263(a)–1(f), and G properly elects to apply the de minimis safe harbor under §1.263(a)–1(f) to amounts paid in Year 1. G must apply the de minimis safe harbor under §1.263(a)–1(f) to amounts paid for the scanners, rather than treat these amounts as costs of materials and supplies under this section. In accordance with §1.263(a)–1(f)(3)(iv), G may deduct the amounts paid for all 50 scanners under §1.162–1 in the taxable year the amounts are paid.

Example 9 Unit of property that costs $200 or less; bulk purchase. H provides consulting services to its customers. In Year 1, H pays $500 to purchase one box of 10 toner cartridges to use as needed for H's printers. Assume each toner cartridge is a unit of property under §1.263(a)–3(e). In Year 1, H's employees place 8 of the toner cartridges in printers in H's office, and store the remaining 2 cartridges for use in a later taxable year. The toner cartridges are materials and supplies under paragraph (c)(1)(iv) of this section because even though purchased in one box costing more than $200, the allocable cost of each unit of property equals $50. Therefore, under paragraph (a)(1) of this section, the $400 paid by H for 8 of the cartridges is deductible in Year 1, the taxable year in which H first uses each of those cartridges. The amounts paid by H for each of the remaining 2 cartridges ($50 each) are deductible in the taxable year in which each cartridge is first used in H's business.

Example 10 Materials and supplies used in improvements; coordination with §1.263(a)–3. J owns various machines that are used in its business. Assume that each machine is a unit of property under §1.263(a)–3(e). In Year 1, J purchases a supply of spare parts for its machines. J acquired the parts to use in the repair or maintenance of the machines under §1.162–4 or in the improvement of the machines under §1.263(a)–3. The spare parts are not rotable or temporary spare parts under paragraph (c)(2) of this section. In Year 2, J uses all of these spare parts in an activity that improves a machine under §1.263(a)–3. Under paragraph (c)(1)(i) of this section, the spare parts purchased by J in Year 1 are materials and supplies. Under paragraph (a)(1) of this section, the amounts paid for the spare parts are otherwise deductible as materials and supplies in Year 2, the taxable year in which J uses those parts. However, because these materials and supplies are used to improve J's machine, J is required to capitalize the amounts paid for those spare parts under §1.263(a)–3.

Example 11 Cost of producing materials and supplies; coordination with section 263A. K is a manufacturer that produces liquid waste as part of its operations. K determines that its current liquid waste disposal process is inadequate. To remedy the problem, in Year 1, K constructs a leaching pit to provide a draining area for the liquid waste. Assume the leaching pit is a unit of property under §1.263(a)–3(e) and has an economic useful life of 12 months or less, starting on the date that K begins to use the leaching pit as a draining area. At the end of this period, K's factory will be connected to the local sewer system. In Year 2, K starts using the leaching pit in its operations. The amounts paid to construct the leaching pit (including the direct and allocable indirect costs of property produced under section 263A) are amounts paid for a material or supply under paragraph (c)(1)(iii) of this section. However, the amounts paid to construct the leaching pit may be subject to capitalization under section 263A if these amounts comprise the direct or allocable indirect costs of property produced by K.

Example 12 Costs of acquiring materials and supplies for production of property; coordination with section 263A. In Year 1, L purchases jigs, dies, molds, and patterns for use in the manufacture of L's products. Assume each jig, die, mold, and pattern is a unit of property under §1.263(a)–3(e). The economic useful life of each jig, die, mold, and pattern is 12 months or less, beginning when each item is used in the manufacturing process. The jigs, dies, molds, and patterns are not components acquired to maintain, repair, or improve any of L's equipment under paragraph (c)(1)(i) of this section. L begins using the jigs, dies, molds and patterns in Year 2 to manufacture its products. These items are materials and supplies under paragraph (c)(1)(iii) of this section. Under paragraph (a)(1) of this section, the amounts paid for the items are otherwise deductible in Year 2, the taxable year in which L first uses those items. However, the amounts paid for these materials and supplies may be subject to capitalization under section 263A if these amounts comprise the direct or allocable indirect costs of property produced by L.

Example 13 Election to capitalize and depreciate. M is in the mining business. M acquires certain temporary spare parts, which it keeps on hand to avoid operational time loss in the event it must make temporary repairs to a unit of property that is subject to depreciation. These parts are not used to improve property under §1.263(a)–3(d). These temporary spare parts are used until a new or repaired part can be installed and then are removed and stored for later temporary installation. M does not use the optional method of accounting for rotable and temporary spare parts in paragraph (e) of this section for any of its rotable or temporary spare parts. The temporary spare parts are materials and supplies under paragraph (c)(1)(i) of this section. Under paragraphs (a)(1) and (a)(3) of this section, the amounts paid for the temporary spare parts are deductible in the taxable year in which they are disposed of by M. However, because it is unlikely that the temporary spare parts will be disposed of in the near future, M would prefer to treat the amounts paid for the spare parts as capital expenditures subject to depreciation. M may elect under paragraph (d) of this section to treat the cost of each temporary spare part as a capital expenditure and as an asset subject to an allowance for depreciation. M makes this election by capitalizing the amounts paid for each spare part in the taxable year that M acquires the spare parts and by beginning to recover the costs of each part on its timely filed Federal tax return for the taxable year in which the part is placed in service for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the Treasury Regulations. See §1.263(a)–2(g) for the treatment of capital expenditures.

Example 14 Election to apply de minimis safe harbor. (i) N provides consulting services to its customers. In Year 1, N pays amounts to purchase 50 laptop computers. Each laptop computer is a unit of property under §1.263(a)–3(e), costs $400, and has an economic useful life of more than 12 months. Also in Year 1, N purchases 50 office chairs to be used by its employees. Each office chair is a unit of property that costs $100. N has an applicable financial statement (as defined in §1.263(a)–1(f)(4)) and N has a written accounting policy at the beginning Year 1 to expense amounts paid for units of property costing $500 or less. N treats amounts paid for property costing $500 or less as an expense on its applicable financial statement in Year 1.

(ii) The laptop computers are not materials or supplies under paragraph (c) of this section. Therefore, the amounts N pays for the computers must generally be capitalized under §1.263(a)–2(d) as amounts paid for the acquisition of tangible property. The office chairs are materials and supplies under paragraph (c)(1)(iv) of this section. Thus, under paragraph (a)(1) of this section, the amounts paid for the office chairs are deductible in the taxable year in which they are first used in N's business. However, under paragraph (f) of this section, if N properly elects to apply the de minimis safe harbor under §1.263(a)–1(f) to amounts paid in Year 1, then N must apply the de minimis safe harbor under §1.263(a)–1(f) to amounts paid for the computers and the office chairs, rather than treat the office chairs as the costs of materials and supplies under §1.162–3. Under the de minimis safe harbor, N may not capitalize the amounts paid for the computers under §1.263(a)–2 nor treat the office chairs as materials and supplies under §1.162–3. Instead, in accordance with §1.263(a)–1(f)(3)(iv), under §1.162–1, N may deduct the amounts paid for the computers and the office chairs in the taxable year paid.

(i) *Accounting method changes*. Except as otherwise provided in this section, a change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446–1(e) and follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(j) *Effective/applicability date*—(1) *In general*. This section generally applies to amounts paid or incurred in taxable years beginning on or after January 1, 2014. However, a taxpayer may apply paragraph (e) of this section (the optional method of accounting for rotable and temporary spare parts) to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (j)(2) and (j)(3) of this section, §1.162–3 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section*—(i) *In general*. Except for paragraph (e) of this section, a taxpayer may choose to apply this section to amounts paid or incurred in taxable years beginning on or after January 1, 2012. A taxpayer may choose to apply paragraph (e) of this section (the optional method of accounting for rotable and temporary spare parts) to taxable years beginning on or after January 1, 2012.

(ii) *Transition rule for election to capitalize materials and supplies on 2012 and 2013 returns*. If under paragraph (j)(2)(i) of this section, a taxpayer chooses to make the election to capitalize and depreciate certain materials and supplies under paragraph (d) of this section for its taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (d)(3) of this section on its timely filed original Federal tax return for the applicable taxable year, the taxpayer must make the election specified in paragraph (d)(3) of this section for the applicable taxable year by filing an amended Federal tax return for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date.

(3) *Optional application of TD 9564.* Except for §1.162–3T(e), a taxpayer may choose to apply §1.162–3T as contained in TD 9564 (76 FR 81060) December 27, 2011, to amounts paid or incurred (to acquire or produce property) in taxable years beginning on or after January 1, 2012, and before January 1, 2014. In applying §1.162–3T(d)(3), as contained in 26 CFR part 1, revised as of April 1, 2013, a taxpayer makes the election under §1.162–3T(d) by capitalizing the amounts paid to acquire or produce a material or supply in the taxable year the amounts are paid and by beginning to depreciate the costs when the asset is placed in service by the taxpayer for purposes of determining depreciation under the applicable provisions of the Internal Revenue Code and the Treasury Regulations. The election under §1.162–3T(d), as contained in 26 CFR part 1, revised as of April 1, 2013, does not apply to an asset or a portion thereof placed in service and disposed of in the same taxable year. A taxpayer may choose to apply §1.162–3T(e) (the optional method of accounting for rotable and temporary spare parts) 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. 9636, 78 FR 57701, Sept. 19, 2013, as amended at 79 FR 42190, July 21, 2014]

§ 1.162–4 Repairs.

(a) *In general.* A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized. Optionally, §1.263(a)–3(n) provides an election to capitalize amounts paid for repair and maintenance consistent with the taxpayer's books and records.

(b) *Accounting method changes.* A change to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and the accompanying regulations apply. A taxpayer seeking to change to a method of accounting permitted in this section must secure the consent of the Commissioner in accordance with §1.446–1(e) and follow the administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to change its accounting method.

(c) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (c)(2) and (c)(3) of this section, §1.162–4 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section.* A taxpayer may choose to apply this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply §1.162–4T 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. 9636, 78 FR 57705, Sept. 19, 2013, as amended at 79 FR 42191, July 21, 2014]

§ 1.162–5 Expenses for education.

(a) *General rule.* Expenditures made by an individual for education (including research undertaken as part of his educational program) which are not expenditures of a type described in paragraph (b) (2) or (3) of this section are deductible as ordinary and necessary business expenses (even though the education may lead to a degree) if the education—

(1) Maintains or improves skills required by the individual in his employment or other trade or business, or

(2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

(b) *Nondeductible educational expenditures*—(1) *In general.* Educational expenditures described in subparagraphs (2) and (3) of this paragraph are personal expenditures or constitute an inseparable aggregate of personal and capital expenditures and, therefore, are not deductible as ordinary and necessary business expenses even though the education may maintain or improve skills required by the individual in his employment or other trade or business or may meet the express requirements of the individual's employer or of applicable law or regulations.

(2) *Minimum educational requirements.* (i) The first category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business. The minimum education necessary to qualify for a position or other trade or business must be determined from a consideration of such factors as the requirements of the employer, the applicable law and regulations, and the standards of the profession, trade, or business involved. The fact that an individual is already performing service in an employment status does not establish that he has met the minimum educational requirements for qualification in that employment. Once an individual has met the minimum educational requirements for qualification in his employment or other trade or business (as in effect when he enters the employment or trade or business), he shall be treated as continuing to meet those requirements even though they are changed.

(ii) The minimum educational requirements for qualification of a particular individual in a position in an educational institution is the minimum level of education (in terms of aggregate college hours or degree) which under the applicable laws or regulations, in effect at the time this individual is first employed in such position, is normally required of an individual initially being employed in such a position. If there are no normal requirements as to the minimum level of education required for a position in an educational institution, then an individual in such a position shall be considered to have met the minimum educational requirements for qualification in that position when he becomes a member of the faculty of the educational institution. The determination of whether an individual is a member of the faculty of an educational institution must be made on the basis of the particular practices of the institution. However, an individual will ordinarily be considered to be a member of the faculty of an institution if (*a*) he has tenure or his years of service are being counted toward obtaining tenure; (*b*) the institution is making contributions to a retirement plan (other than Social Security or a similar program) in respect of his employment; or (*c*) he has a vote in faculty affairs.

(iii) The application of this subparagraph may be illustrated by the following examples:

Example 1. General facts:State X requires a bachelor's degree for beginning secondary school teachers which must include 30 credit hours of professional educational courses. In addition, in order to retain his position, a secondary school teacher must complete a fifth year of preparation within 10 years after beginning his employment. If an employing school official certifies to the State Department of Education that applicants having a bachelor's degree and the required courses in professional education cannot be found, he may hire individuals as secondary school teachers if they have completed a minimum of 90 semester hours of college work. However, to be retained in his position, such an individual must obtain his bachelor's degree and complete the required professional educational courses within 3 years after his employment commences. Under these facts, a bachelor's degree, without regard to whether it includes 30 credit hours of professional educational courses, is considered to be the minimum educational requirement for qualification as a secondary school teacher in State X. This is the case notwithstanding the number of teachers who are actually hired without such a degree. The following are examples of the application of these facts in particular situations:

Situation 1. A, at the time he is employed as a secondary school teacher in State X, has a bachelor's degree including 30 credit hours of professional educational courses. After his employment, A completes a fifth college year of education and, as a result, is issued a standard certificate. The fifth college year of education undertaken by A is not education required to meet the minimum educational requirements for qualification as a secondary school teacher. Accordingly, the expenditures for such education are deductible unless the expenditures are for education which is part of a program of study being pursued by A which will lead to qualifying him in a new trade or business.

Situation 2. Because of a shortage of applicants meeting the stated requirements, B, who has a bachelor's degree, is employed as a secondary school teacher in State X even though he has only 20 credit hours of professional educational courses. After his employment, B takes an additional 10 credit hours of professional educational courses. Since these courses do not constitute education required to meet the minimum educational requirements for qualification as a secondary school teacher which is a bachelor's degree and will not lead to qualifying B in a new trade or business, the expenditures for such courses are deductible.

Situation 3. Because of a shortage of applicants meeting the stated requirements, C is employed as a secondary school teacher in State X although he has only 90 semester hours of college work toward his bachelor's degree. After his employment, C undertakes courses leading to a bachelor's degree. These courses (including any courses in professional education) constitute education required to meet the minimum educational requirements for qualification as a secondary school teacher. Accordingly, the expenditures for such education are not deductible.

Situation 4. Subsequent to the employment of A, B, and C, but before they have completed a fifth college year of education, State X changes its requirements affecting secondary school teachers to provide that beginning teachers must have completed 5 college years of preparation. In the cases of A, B, and C, a fifth college year of education is not considered to be education undertaken to meet the minimum educational requirements for qualifications as a secondary school teacher. Accordingly, expenditures for a fifth year of college will be deductible unless the expenditures are for education which is part of a program being pursued by A, B, or C which will lead to qualifying him in a new trade or business.

Example 2. D, who holds a bachelor's degree, obtains temporary employment as an instructor at University Y and undertakes graduate courses as a candidate for a graduate degree. D may become a faculty member only if he obtains a graduate degree and may continue to hold a position as instructor only so long as he shows satisfactory progress towards obtaining this graduate degree. The graduate courses taken by D constitute education required to meet the minimum educational requirements for qualification in D's trade or business and, thus, the expenditures for such courses are not deductible.

Example 3. E, who has completed 2 years of a normal 3-year law school course leading to a bachelor of laws degree (LL.B.), is hired by a law firm to do legal research and perform other functions on a full-time basis. As a condition to continued employment, E is required to obtain an LL.B. and pass the State bar examination. E completes his law school education by attending night law school, and he takes a bar review course in order to prepare for the State bar examination. The law courses and bar review course constitute education required to meet the minimum educational requirements for qualification in E's trade or business and, thus, the expenditures for such courses are not deductible.

(3) *Qualification for new trade or business.* (i) The second category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business. In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment. For this purpose, all teaching and related duties shall be considered to involve the same general type of work. The following are examples of changes in duties which do not constitute new trades or businesses:

(*a*) Elementary to secondary school classroom teacher.

(*b*) Classroom teacher in one subject (such as mathematics) to classroom teacher in another subject (such as science).

(*c*) Classroom teacher to guidance counselor.

(*d*) Classroom teacher to principal.

(ii) The application of this subparagraph to individuals other than teachers may be illustrated by the following examples:

Example 1. A, a self-employed individual practicing a profession other than law, for example, engineering, accounting, etc., attends law school at night and after completing his law school studies receives a bachelor of laws degree. The expenditures made by A in attending law school are nondeductible because this course of study qualifies him for a new trade or business.

Example 2. Assume the same facts as in example (1) except that A has the status of an employee rather than a self-employed individual, and that his employer requires him to obtain a bachelor of laws degree. A intends to continue practicing his nonlegal profession as an employee of such employer. Nevertheless, the expenditures made by A in attending law school are not deductible since this course of study qualifies him for a new trade or business.

Example 3. B, a general practitioner of medicine, takes a 2-week course reviewing new developments in several specialized fields of medicine. B's expenses for the course are deductible because the course maintains or improves skills required by him in his trade or business and does not qualify him for a new trade or business.

Example 4. C, while engaged in the private practice of psychiatry, undertakes a program of study and training at an accredited psychoanalytic institute which will lead to qualifying him to practice psychoanalysis. C's expenditures for such study and training are deductible because the study and training maintains or improves skills required by him in his trade or business and does not qualify him for a new trade or business.

(c) *Deductible educational expenditures*—(1) *Maintaining or improving skills*. The deduction under the category of expenditures for education which maintains or improves skills required by the individual in his employment or other trade or business includes refresher courses or courses dealing with current developments as well as academic or vocational courses provided the expenditures for the courses are not within either category of nondeductible expenditures described in paragraph (b) (2) or (3) of this section.

(2) *Meeting requirements of employer*. An individual is considered to have undertaken education in order to meet the express requirements of his employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his established employment relationship, status, or rate of compensation only if such requirements are imposed for a bona fide business purpose of the individual's employer. Only the minimum education necessary to the retention by the individual of his established employment relationship, status, or rate of compensation may be considered as undertaken to meet the express requirements of the taxpayer's employer. However, education in excess of such minimum education may qualify as education undertaken in order to maintain or improve the skills required by the taxpayer in his employment or other trade or business (see subparagraph (1) of this paragraph). In no event, however, is a deduction allowable for expenditures for education which, even though for education required by the employer or applicable law or regulations, are within one of the categories of nondeductible expenditures described in paragraph (b) (2) and (3) of this section.

(d) *Travel as a form of education*. Subject to the provisions of paragraph (b) and (e) of this section, expenditures for travel (including travel while on sabbatical leave) as a form of education are deductible only to the extent such expenditures are attributable to a period of travel that is directly related to the duties of the individual in his employment or other trade or business. For this purpose, a period of travel shall be considered directly related to the duties of an individual in his employment or other trade or business only if the major portion of the activities during such period is of a nature which directly maintains or improves skills required by the individual in such employment or other trade or business. The approval of a travel program by an employer or the fact that travel is accepted by an employer in the fulfillment of its requirements for retention of rate of compensation, status or employment, is not determinative that the required relationship exists between the travel involved and the duties of the individual in his particular position.

(e) *Travel away from home*. (1) If an individual travels away from home primarily to obtain education the expenses of which are deductible under this section, his expenditures for travel, meals, and lodging while away from home are deductible. However, if as an incident of such trip the individual engages in some personal activity such as sightseeing, social visiting, or entertaining, or other recreation, the portion of the expenses attributable to such personal activity constitutes nondeductible personal or living expenses and is not allowable as a deduction. If the individual's travel away from home is primarily personal, the individual's expenditures for travel, meals and lodging (other than meals and lodging during the time spent in participating in deductible education pursuits) are not deductible. Whether a particular trip is primarily person or primarily to obtain education the expenses of which are deductible under this section depends upon all the facts and circumstances of each case. An important factor to be taken into consideration in making the determination is the relative amount of time devoted to personal activity as compared with the time devoted to educational pursuits. The rules set forth in this paragraph are subject to the provisions of section 162(a)(2), relating to deductibility of certain traveling expenses, and section 274 (c) and (d), relating to allocation of certain foreign travel expenses and substantiation required, respectively, and the regulations thereunder.

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

Example 1. A, a self-employed tax practitioner, decides to take a 1-week course in new developments in taxation, which is offered in City X, 500 miles away from his home. His primary purpose in going to X is to take the course, but he also takes a side trip to City Y (50 miles from X) for 1 day, takes a sightseeing trip while in X, and entertains some personal friends. A's transportation expenses to City X and return to his home are deductible but his transportation expenses to City Y are not deductible. A's expenses for meals and lodging while away from home will be allocated between his educational pursuits and his personal activities. Those expenses which are entirely personal, such as sightseeing and entertaining friends, are not deductible to any extent.

Example 2. The facts are the same as in example (1) except that A's primary purpose in going to City X is to take a vacation. This purpose is indicated by several factors, one of which is the fact that he spends only 1 week attending the tax course and devotes 5 weeks entirely to personal activities. None of A's transportation expenses are deductible and his expenses for meals and lodging while away from home are not deductible to the extent attributable to personal activities. His expenses for meals and lodging allocable to the week attending the tax course are, however, deductible.

Example 3. B, a high school mathematics teacher in New York City, in the summertime travels to a university in California in order to take a mathematics course the expense of which is deductible under this section. B pursues only one-fourth of a full course of study and the remainder of her time is devoted to personal activities the expense of which is not deductible. Absent a showing by B of a substantial nonpersonal reason for taking the course in the university in California, the trip is considered taken primarily for personal reasons and the cost of traveling from New York City to California and return would not be deductible. However, one-fourth of the cost of B's meals and lodging while attending the university in California may be considered properly allocable to deductible educational pursuits and, therefore, is deductible.

[T.D. 6918, 32 FR 6679, May 2, 1967]

§ 1.162–7 Compensation for personal services.

(a) There may be included among the ordinary and necessary expenses paid or incurred in carrying on any trade or business a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services.

(b) The test set forth in paragraph (a) of this section and its practical application may be further stated and illustrated as follows:

(1) Any amount paid in the form of compensation, but not in fact as the purchase price of services, is not deductible. An ostensible salary paid by a corporation may be a distribution of a dividend on stock. This is likely to occur in the case of a corporation having few shareholders, practically all of whom draw salaries. If in such a case the salaries are in excess of those ordinarily paid for similar services and the excessive payments correspond or bear a close relationship to the stockholdings of the officers or employees, it would seem likely that the salaries are not paid wholly for services rendered, but that the excessive payments are a distribution of earnings upon the stock. An ostensible salary may be in part payment for property. This may occur, for example, where a partnership sells out to a corporation, the former partners agreeing to continue in the service of the corporation. In such a case it may be found that the salaries of the former partners are not merely for services, but in part constitute payment for the transfer of their business.

(2) The form or method of fixing compensation is not decisive as to deductibility. While any form of contingent compensation invites scrutiny as a possible distribution of earnings of the enterprise, it does not follow that payments on a contingent basis are to be

treated fundamentally on any basis different from that applying to compensation at a flat rate. Generally speaking, if contingent compensation is paid pursuant to a free bargain between the employer and the individual made before the services are rendered, not influenced by any consideration on the part of the employer other than that of securing on fair and advantageous terms the services of the individual, it should be allowed as a deduction even though in the actual working out of the contract it may prove to be greater than the amount which would ordinarily be paid.

(3) In any event the allowance for the compensation paid may not exceed what is reasonable under all the circumstances. It is, in general, just to assume that reasonable and true compensation is only such amount as would ordinarily be paid for like services by like enterprises under like circumstances. The circumstances to be taken into consideration are those existing at the date when the contract for services was made, not those existing at the date when the contract is questioned.

(4) For disallowance of deduction in the case of certain transfers of stock pursuant to employees stock options, see section 421 and the regulations thereunder.

§ 1.162–8 Treatment of excessive compensation.

The income tax liability of the recipient in respect of an amount ostensibly paid to him as compensation, but not allowed to be deducted as such by the payor, will depend upon the circumstances of each case. Thus, in the case of excessive payments by corporations, if such payments correspond or bear a close relationship to stockholdings, and are found to be a distribution of earnings or profits, the excessive payments will be treated as a dividend. If such payments constitute payment for property, they should be treated by the payor as a capital expenditure and by the recipient as part of the purchase price. In the absence of evidence to justify other treatment, excessive payments for salaries or other compensation for personal services will be included in gross income of the recipient.

§ 1.162–9 Bonuses to employees.

Bonuses to employees will constitute allowable deductions from gross income when such payments are made in good faith and as additional compensation for the services actually rendered by the employees, provided such payments, when added to the stipulated salaries, do not exceed a reasonable compensation for the services rendered. It is immaterial whether such bonuses are paid in cash or in kind or partly in cash and partly in kind. Donations made to employees and others, which do not have in them the element of compensation or which are in excess of reasonable compensation for services, are not deductible from gross income.

§ 1.162–10 Certain employee benefits.

(a) *In general.* Amounts paid or accrued by a taxpayer on account of injuries received by employees and lump sum amounts paid or accrued as compensation for injuries, are proper deductions as ordinary and necessary expenses. Such deductions are limited to the amount not compensated for by insurance or otherwise. Amounts paid or accrued within the taxable year for dismissal wages, unemployment benefits, guaranteed annual wages, vacations, or a sickness, accident, hospitalization, medical expense, recreational, welfare, or similar benefit plan, are deductible under section 162(a) if they are ordinary and necessary expenses of the trade or business. However, except as provided in paragraph (b) of this section, such amounts shall not be deductible under section 162(a) if, under any circumstances, they may be used to provide benefits under a stock bonus, pension, annuity, profit-sharing, or other deferred compensation plan of the type referred to in section 404(a). In such an event, the extent to which these amounts are deductible from gross income shall be governed by the provisions of section 404 and the regulations issued thereunder.

(b) *Certain negotiated plans.* (1) Subject to the limitations set forth in subparagraphs (2) and (3) of this paragraph, contributions paid by an employer under a plan under which such contributions are held in a welfare trust for the purpose of paying (either from principal or income or both) for the benefit of employees, their families, and dependents, at least medical or hospital care, and pensions on retirement or death of employees, are deductible when paid as business expenses under section 162(a).

(2) For the purpose of subparagraph (1) of this paragraph, the word ''plan'' means any plan established prior to January 1, 1954, as a result of an agreement between employee representatives and the Government of the United States, during a period of Government operation, under seizure powers, of a major part of the productive facilities of the industry in which the employer claiming the deduction is engaged. The phrase ''plan established prior to January 1, 1954, as a result of an agreement'' is intended primarily to cover a trust established under the terms of such an agreement. It also includes a trust established under a plan of an employer, or group of employers, who, by reason of producing the same commodity, are in competition with the employers whose facilities were seized and who would therefore be expected to establish such a trust as a reasonable measure to maintain a sound position in the labor market producing the commodity. For example, if a trust was established under such an agreement in the bituminous coal industry, a similar trust established in the anthracite coal industry within a reasonable time, but before January 1, 1954, would qualify under subparagraph (1) of this paragraph.

(3) If any trust described in subparagraph (2) of this paragraph becomes qualified for exemption from tax under the provisions of section 501(a), the deductibility of contributions by an employer to such trust on or after any date of such qualification shall no longer be governed by the provisions of section 162, even though the trust may later lose its exemption from tax under section 501(a).

(c) *Other plans providing deferred compensation.* For rules relating to the deduction of amounts paid to or under a stock bonus, pension, annuity, or profit-sharing plan or amounts paid or accrued under any other plan deferring the receipt of compensation, see section 404 and the regulations thereunder.

§ 1.162–10T Questions and answers relating to the deduction of employee benefits under the Tax Reform Act of 1984; certain limits on amounts deductible (temporary).

Q–1: How does the amendment of section 404(b) by the Tax Reform Act of 1984 affect the deduction of employee benefits under section 162 of the Internal Revenue Code?

A–1: As amended by the Tax Reform Act of 1984, section 404(b) clarifies that section 404(a) and (d) (in the case of employees and nonemployees, respectively) shall govern the deduction of contributions paid or compensation paid or incurred under a plan, or method or arrangement, deferring the receipt of compensation or providing for deferred benefits. Section 404(a) and (d) requires that such a contribution or compensation be paid or incurred for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of these sections. However, notwithstanding the above, section 404 does not apply to contributions paid or accrued with respect to a ''welfare benefit fund'' (as defined in section 419(e)) after July 18, 1984, in taxable years of employers (and payors) ending after that date.

Also, section 463 shall govern the deduction of vacation pay by a taxpayer that has elected the application of such section. Section 404(b), as amended, generally applies to contributions paid and compensation paid or incurred after July 18, 1984, in taxable years of employers (and payors) ending after that date. See Q&A–3 of § 1.404(b)–1T. For rules relating to the deduction of contributions attributable to the provision of deferred benefits, see section 404 (a), (b) and (d) and § 1.404(a)–1T, § 1.404(b)–1T and § 1.404(d)–1T. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419,

§ 1.419–1T and § 1.419A–2T. For rules relating to the deduction of vacation pay for which an election is made under section 463, see § 301.9100–16T of this chapter and § 1.463–1T.

Q–2: How does the enactment of section 419 by the Tax Reform Act of 1984 affect the deduction of employee benefits under section 162?

A–2: As enacted by the Tax Reform Act of 1984, section 419 shall govern the deduction of contributions paid or accrued by an employer (or a person receiving services under section 419(g)) with respect to a ''welfare benefit fund'' (within the meaning of section 419(e)) after December 31, 1985, in taxable years of the employer (or person receiving the services) ending after that date. Section 419(a) requires that such a contribution be paid or accrued for purposes of section 162 or 212 and satisfy the requirements for deductibility under either of those sections. Generally, subject to a binding contract exception (as described in section 511(e)(5) of the Tax Reform Act of 1984), section 419 shall also govern the deduction of the contribution of a facility (or other contribution used to acquire or improve a facility) to a welfare benefit fund after June 22, 1984. See Q&A–11 of § 1.419–1T. In the case of a welfare benefit fund maintained pursuant to a collective bargaining agreement, section 419 applies to the extent provided under the special effective date rule described in Q&A–2 of § 1.419–1T and the special rules of § 1.419A–2T. For rules relating to the deduction of contributions paid or accrued with respect to a welfare benefit fund, see section 419 and § 1.419–1T.

[T.D. 8073, 51 FR 4319, Feb. 4, 1986, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

§ 1.162–11 Rentals.

(a) *Acquisition of a leasehold.* If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. For disallowance of deduction for income taxes paid by a lessee corporation pursuant to a lease arrangement with the lessor corporation, see section 110 and the regulations thereunder. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in amortizing the costs incurred after July 28, 1958 of acquiring a lease. See § 1.197–2 for rules governing the amortization of costs to acquire limited interests in section 197 intangibles.

(b) *Improvements by lessee on lessor's property*—(1) In general. The cost to a taxpayer of erecting buildings or making permanent improvements on property of which the taxpayer is a lessee is a capital expenditure. For the rules regarding improvements to leased property when the improvements are tangible property, see § 1.263(a)–3(f). For the rules regarding depreciation or amortization deductions for leasehold improvements, see § 1.167(a)–4.

(2) *Effective/applicability date*—(i) *In general.* This paragraph (b) applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (b)(2)(ii) and (b)(2)(iii) of this section, § 1.162–11(b) 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 this paragraph.* A taxpayer may choose to apply this paragraph (b) to taxable years beginning on or after January 1, 2012.

(iii) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.162–11T(b) 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. 6520, 25 FR 13692, Dec. 24, 1960, as amended by T.D. 8865, 65 FR 3825, Jan. 25, 2000; T.D. 9564, 76 FR 81084, Dec. 27, 2011; T.D. 9636, 78 FR 57706, Sept. 19, 2013]

§ 1.162–12 Expenses of farmers.

(a) *Farms engaged in for profit.* A farmer who operates a farm for profit is entitled to deduct from gross income as necessary expenses all amounts actually expended in the carrying on of the business of farming. The cost of ordinary tools of short life or small cost, such as hand tools, including shovels, rakes, etc., may be deducted. The purchase of feed and other costs connected with raising livestock may be treated as expense deductions insofar as such costs represent actual outlay, but not including the value of farm produce grown upon the farm or the labor of the taxpayer. For rules regarding the capitalization of expenses of producing property in the trade or business of farming, see section 263A and the regulations thereunder. For taxable years beginning after July 12, 1972, where a farmer is engaged in producing crops and the process of gathering and disposal of such crops is not completed within the taxable year in which such crops were planted, expenses deducted may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. For taxable years beginning on or before July 12, 1972, where a farmer is engaged in producing crops which take more than a year from the time of planting to the process of gathering and disposal, expenses deducted may, with the consent of the Commissioner (see section 446 and the regulations thereunder), be determined upon the crop method, and such deductions must be taken in the taxable year in which the gross income from the crop has been realized. If a farmer does not compute income upon the crop method, the cost of seeds and young plants which are purchased for further development and cultivation prior to sale in later years may be deducted as an expense for the year of purchase, provided the farmer follows a consistent practice of deducting such costs as an expense from year to year. The preceding sentence does not apply to the cost of seeds and young plants connected with the planting of timber (see section 611 and the regulations thereunder). For rules regarding the capitalization of expenses of producing property in the trade or business of farming, see section 263A of the Internal Revenue Code and §1.263A–4. The cost of farm machinery, equipment, and farm buildings represents a capital investment and is not an allowable deduction as an item of expense. Amounts expended in the development of farms, orchards, and ranches prior to the time when the productive state is reached may, at the election of the taxpayer, be regarded as investments of capital. For the treatment of soil and water conservation expenditures as expenses which are not chargeable to capital account, see section 175 and the regulations thereunder. For taxable years beginning after December 31, 1959, in the case of expenditures paid or incurred by farmers for fertilizer, lime, etc., see section 180 and the regulations thereunder. Amounts expended in purchasing work, breeding, dairy, or sporting animals are regarded as investments of capital, and shall be depreciated unless such animals are included in an inventory in accordance with §1.61–4. The purchase price of an automobile, even when wholly used in carrying on farming operations, is not deductible, but is regarded as an investment of capital. The cost of gasoline, repairs, and upkeep of an automobile if used wholly in the business of farming is deductible as an expense; if used partly for business purposes and partly for the pleasure or convenience of the taxpayer or his family, such cost may be apportioned according to the extent of the use for purposes of business and pleasure or convenience, and only the proportion of such cost justly attributable to business purposes is deductible as a necessary expense.

(b) *Farms not engaged in for profit; taxable years beginning before January 1, 1970*—(1) *In general*. If a farm is operated for recreation or pleasure and not on a commercial basis, and if the expenses incurred in connection with the farm are in excess of the receipts therefrom, the entire receipts from the sale of farm products may be ignored in rendering a return of income, and the expenses incurred, being regarded as personal expenses, will not constitute allowable deductions.

(2) *Effective date*. The provisions of this paragraph shall apply with respect to taxable years beginning before January 1, 1970.

(3) *Cross reference*. For provisions relating to activities not engaged in for profit, applicable to taxable years beginning after December 31, 1969, see

section 183 and the regulations thereunder.

[T.D. 7198, 37 FR 13679, July 13, 1972, as amended by T.D. 8729, 62 FR 44546, Aug. 22, 1997; T.D. 8897, 65 FR 50643, Aug. 21, 2000]

§ 1.162–13 Depositors' guaranty fund.

Banking corporations which pursuant to the laws of the State in which they are doing business are required to set apart, keep, and maintain in their banks the amount levied and assessed against them by the State authorities as a ''Depositors' guaranty fund,'' may deduct from their gross income the amount so set apart each year to this fund provided that such fund, when set aside and carried to the credit of the State banking board or duly authorized State officer, ceases to be an asset of the bank and may be withdrawn in whole or in part upon demand by such board or State officer to meet the needs of these officers in reimbursing depositors in insolvent banks, and provided further that no portion of the amount thus set aside and credited is returnable under the laws of the State to the assets of the banking corporation. If, however, such amount is simply set up on the books of the bank as a reserve to meet a contingent liability and remains an asset of the bank, it will not be deductible except as it is actually paid out as required by law and upon demand of the proper State officers.

§ 1.162–14 Expenditures for advertising or promotion of good will.

A corporation which has, for the purpose of computing its excess profits tax credit under Subchapter E, Chapter 2, or Subchapter D, Chapter 1 of the Internal Revenue Code of 1939, elected under section 733 or section 451 (applicable to the excess profits tax imposed by Subchapter E of Chapter 2, and Subchapter D of Chapter 1, respectively) to charge to capital account for taxable years in its base period expenditures for advertising or the promotion of good will which may be regarded as capital investments, may not deduct similar expenditures for the taxable year. See section 263(b). Such a taxpayer has the burden of proving that expenditures for advertising or the promotion of good will which it seeks to deduct in the taxable year may not be regarded as capital investments under the provisions of the regulations prescribed under section 733 or section 451 of the Internal Revenue Code of 1939. See 26 CFR, 1938 ed., 35.733–2 (Regulations 112) and 26 CFR (1939) 40.451–2 (Regulations 130). For the disallowance of deductions for the cost of advertising in programs of certain conventions of political parties, or in publications part of the proceeds of which directly or indirectly inures (or is intended to inure) to or for the use of a political party or political candidate, see § 1.276–1.

[T.D. 6996, 34 FR 835, Jan. 18, 1969]

§ 1.162–15 Contributions, dues, etc.

(a) *Payments and transfers to entities described in section 170(c)*—(1) *In general.* A payment or transfer to or for the use of an entity described in section 170(c) that bears a direct relationship to the taxpayer's trade or business and that is made with a reasonable expectation of financial return commensurate with the amount of the payment or transfer may constitute an allowable deduction as a trade or business expense rather than a charitable contribution deduction under section 170. For payments or transfers in excess of the amount deductible under section 162(a), see § 1.170A–1(h).

(2) *Examples.* The following examples illustrate the rules of paragraph (a)(1) of this section:

(i) *Example 1. A*, an individual, is a sole proprietor who manufactures musical instruments and sells them through a website. *A* makes a $1,000 payment to a local church (which is a charitable organization described in section 170(c)) for a half-page advertisement in the church's program for a concert. In the program, the church thanks its concert supporters, including *A*. *A*'s advertisement includes the URL for the website through which *A* sells its instruments. *A* reasonably expects that the advertisement will attract new customers to *A*'s website and will help *A* to sell more musical instruments. *A* may treat the $1,000 payment as an expense of carrying on a trade or business under section 162.

(ii) *Example 2. P*, a partnership, operates a chain of supermarkets, some of which are located in State N. *P* operates a promotional program in which it sets aside the proceeds from one percent of its sales each year, which it pays to one or more charities described in section 170(c). The funds are earmarked for use in projects that improve conditions in State N. *P* makes the final determination on which charities receive payments. *P* advertises the program. *P* reasonably believes the program will generate a significant degree of name recognition and goodwill in the communities where it operates and thereby increase its revenue. As part of the program, *P* makes a $1,000 payment to a charity described in section 170(c). *P* may treat the $1,000 payment as an expense of carrying on a trade or business under section 162. This result is unchanged if, under State N's tax credit program, *P* expects to receive a $1,000 income tax credit on account of *P*'s payment, and under State N law, the credit can be passed through to *P*'s partners.

(3) *Safe harbors for C corporations and specified passthrough entities making payments in exchange for State or local tax credits*—(i) *Safe harbor for C corporations.* If a C corporation makes a payment to or for the use of an entity described in section 170(c) and receives or expects to receive in return a State or local tax credit that reduces a State or local tax imposed on the C corporation, the C corporation may treat such payment as meeting the requirements of an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of the credit received or expected to be received.

(ii) *Safe harbor for specified passthrough entities*—(A) *Definition of specified passthrough entity.* For purposes of this paragraph (a)(3)(ii), an entity is a specified passthrough entity if each of the following requirements is satisfied—

(*1*) The entity is a business entity other than a C corporation and is regarded for all Federal income tax purposes as separate from its owners under §301.7701–3 of this chapter;

(*2*) The entity operates a trade or business within the meaning of section 162;

(*3*) The entity is subject to a State or local tax incurred in carrying on its trade or business that is imposed directly on the entity; and

(*4*) In return for a payment to an entity described in section 170(c), the entity described in paragraph (a)(3)(ii)(A)(*1*) of this section receives or expects to receive a State or local tax credit that the entity applies or expects to apply to offset a State or local tax described in paragraph (a)(3)(ii)(A)(*3*) of this section.

(B) *Safe harbor.* Except as provided in paragraph (a)(3)(ii)(C) of this section, if a specified passthrough entity makes a payment to or for the use of an entity described in section 170(c), and receives or expects to receive in return a State or local tax credit that reduces a State or local tax described in paragraph (a)(3)(ii)(A)(*3*) of this section, the specified passthrough entity may treat such payment as an ordinary and necessary business expense for purposes of section 162(a) to the extent of the amount of credit received or expected to be received.

(C) *Exception.* The safe harbor described in this paragraph (a)(3)(ii) does not apply if the credit received or expected to be received reduces a State or local income tax.

(iii) *Definition of payment.* For purposes of this paragraph (a)(3), payment is defined as a payment of cash or cash equivalent.

(iv) *Examples.* The following examples illustrate the rules of paragraph (a)(3) of this section.

(A) *Example 1. C corporation that receives or expects to receive dollar-for-dollar State or local tax credit. A,* a C corporation engaged in a trade or business, makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, *A* expects to receive a dollar-for-dollar State tax credit to be applied to *A*'s State corporate income tax liability. Under paragraph (a)(3)(i) of this section, *A* may treat the $1,000 payment as an expense of carrying on a trade or business under section 162.

(B) *Example 2. C corporation that receives or expects to receive percentage-based State or local tax credit. B,* a C corporation engaged in a trade or business, makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, *B* expects to receive a local tax credit equal to 80 percent of the amount of this payment ($800) to be applied to *B*'s local real property tax liability. Under paragraph (a)(3)(i) of this section, *B* may treat $800 as an expense of carrying on a trade or business under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(i) of this section.

(C) *Example 3. Partnership that receives or expects to receive dollar-for-dollar State or local tax credit. P* is a limited liability company classified as a partnership for Federal income tax purposes under §301.7701–3 of this chapter. *P* is engaged in a trade or business and makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, *P* expects to receive a dollar-for-dollar State tax credit to be applied to *P*'s State excise tax liability incurred by *P* in carrying on its trade or business. Under applicable State law, the State's excise tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of this section, *P* may treat the $1,000 as an expense of carrying on a trade or business under section 162.

(D) *Example 4. S corporation that receives or expects to receive percentage-based State or local tax credit. S* is an S corporation engaged in a trade or business and is owned by individuals *C* and *D*. *S* makes a payment of $1,000 to an entity described in section 170(c). In return for the payment, *S* expects to receive a local tax credit equal to 80 percent of the amount of this payment ($800) to be applied to *S*'s local real property tax liability incurred by *S* in carrying on its trade or business. Under applicable local law, the real property tax is imposed at the entity level (not the owner level). Under paragraph (a)(3)(ii) of this section, *S* may treat $800 of the payment as an expense of carrying on a trade or business under section 162. The treatment of the remaining $200 will depend upon the facts and circumstances and is not affected by paragraph (a)(3)(ii) of this section.

(v) *Applicability of section 170 to payments in exchange for State or local tax benefits.* For rules regarding the availability of a charitable contribution deduction under section 170 where a taxpayer makes a payment or transfers property to or for the use of an entity described in section 170(c) and receives or expects to receive a State or local tax benefit in return for such payment, see §1.170A–1(h)(3).

(4) *Applicability dates.* Paragraphs (a)(1) and (2) of this section, regarding the application of section 162 to taxpayers making payments or transfers to entities described in section 170(c), apply to payments or transfers made on or after December 17, 2019. Section 1.162–15(a), as it appeared in the April 1, 2020 edition of 26 CFR part 1, generally applies to payments or transfers made prior to December 17, 2019. However, taxpayers may choose to apply paragraphs (a)(1) and (2) of this section to payments and transfers made on or after January 1, 2018. Paragraph (a)(3) of this section, regarding the safe harbors for C corporations and specified passthrough entities making payments to section 170(c) entities in exchange for State or local tax credits, applies to payments made by these entities on or after December 17, 2019. However, taxpayers may choose to apply the safe harbors of paragraph (a)(3) to payments made on or after January 1, 2018.

(b) *Other contributions.* Donations to organizations other than those described in section 170 which bear a direct relationship to the taxpayer's business and are made with a reasonable expectation of a financial return commensurate with the amount of the donation may constitute allowable deductions as business expenses, provided the donation is not made for a purpose for which a deduction is not allowable by reason of the provisions of paragraph (b)(1)(i) or (c) of §1.162–20. For example, a transit company may donate a sum of money to an organization (of a class not referred to in section 170) intending to hold a convention in the city in which it operates, with a reasonable expectation that the holding of such convention will augment its income through a greater number of people using its transportation facilities.

(c) *Dues.* Dues and other payments to an organization, such as a labor union or a trade association, which otherwise meet the requirements of the regulations under section 162, are deductible in full. For limitations on the deductibility of dues and other payments, see paragraph (b) and (c) of § 1.162–20.

(d) *Cross reference.*—For provisions dealing with expenditures for institutional or ''good will'' advertising, see § 1.162–20(a)(2).

[T.D. 6819, 30 FR 5580, Apr. 20, 1965, as amended by T.D. 9907, 85 FR 48472, Aug. 11, 2020]

§ 1.162–16 Cross reference.

For special rules relating to expenses in connection with subdividing real property for sale, see section 1237 and the regulations thereunder.

§ 1.162–17 Reporting and substantiation of certain business expenses of employees.

(a) *Introductory.* The purpose of the regulations in this section is to provide rules for the reporting of information on income tax returns by taxpayers who pay or incur ordinary and necessary business expenses in connection with the performance of services as an employee and to furnish guidance as to the type of records which will be useful in compiling such information and in its substantiation, if required. The rules prescribed in this section do not apply to expenses paid or incurred for incidentals, such as office supplies for the employer or local transportation in connection with an errand. Employees incurring such incidental expenses are not required to provide substantiation for such amounts. The term ''ordinary and necessary business expenses'' means only those expenses which are ordinary and necessary in the conduct of the taxpayer's business and are directly attributable to such business. The term does not include nondeductible personal, living or family expenses.

(b) *Expenses for which the employee is required to account to his employer*—(1) *Reimbursements equal to expenses.* The employee need not report on his tax return (either itemized or in total amount) expenses for travel, transportation, entertainment, and similar purposes paid or incurred by him solely for the benefit of his employer for which he is required to account and does account to his employer and which are charged directly or indirectly to the employer (for example, through credit cards) or for which the employee is paid through advances, reimbursements, or otherwise, provided the total amount of such advances, reimbursements, and charges is equal to such expenses. In such a case the taxpayer need only state in his return that the total of amounts charged directly or indirectly to his employer through credit cards or otherwise and received from the employer as advances or reimbursements did not exceed the ordinary and necessary business expenses paid or incurred by the employee.

(2) *Reimbursements in excess of expenses.* In case the total of amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, exceeds the ordinary and necessary business expenses paid or incurred by the employee and the employee is required to and does account to his employer for such expenses, the taxpayer must include such excess in income and state on his return that he has done so.

(3) *Expenses in excess of reimbursements.* If the employee's ordinary and necessary business expenses exceed the total of the amounts charged directly or indirectly to the employer and received from the employer as advances, reimbursements, or otherwise, and the employee is required to and does account to his employer for such expenses, the taxpayer may make the statement in his return required by subparagraph (1) of this paragraph unless he wishes to claim a deduction for such excess. If, however, he wishes to secure a deduction for such excess, he must submit a statement showing the following information as part of his tax return:

(i) The total of any charges paid or borne by the employer and of any other amounts received from the employer for payment of expenses whether by means of advances, reimbursements or otherwise; and

(ii) The nature of his occupation, the number of days away from home on business, and the total amount of ordinary and necessary business expenses paid or incurred by him (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

(4) To ''account'' to his employer as used in this section means to submit an expense account or other required written statement to the employer showing the business nature and the amount of all the employee's expenses (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses. For this purpose, the Commissioner in his discretion may approve reasonable business practices under which mileage, per diem in lieu of subsistence, and similar allowances providing for ordinary and necessary business expenses in accordance with a fixed scale may be regarded as equivalent to an accounting to the employer.

(c) *Expenses for which the employee is not required to account to his employer.* If the employee is not required to account to his employer for his ordinary and necessary business expenses, e.g., travel, transportation, entertainment, and similar items, or, though required, fails to account for such expenses, he must submit, as a part of his tax return, a statement showing the following information:

(1) The total of all amounts received as advances or reimbursements from his employer in connection with the ordinary and necessary business expenses of the employee, including amounts charged directly or indirectly to the employer through credit cards or otherwise; and

(2) The nature of his occupation, the number of days away from home on business, and the total amount of ordinary and necessary business expenses paid or incurred by him (including those charged directly or indirectly to the employer through credit cards or otherwise) broken down into such broad categories as transportation, meals and lodging while away from home overnight, entertainment expenses, and other business expenses.

(d) *Substantiation of items of expense.* (1) Although the Commissioner may require any taxpayer to substantiate such information concerning expense accounts as may appear to be pertinent in determining tax liability, taxpayers ordinarily will not be called upon to substantiate expense account information except those in the following categories:

(i) A taxpayer who is not required to account to his employer, or who does not account;

(ii) A taxpayer whose expenses exceed the total of amounts charged to his employer and amounts received through advances, reimbursements or otherwise and who claims a deduction on his return for such excess;

(iii) A taxpayer who is related to his employer within the meaning of section 267(b); and

(iv) Other taxpayers in cases where it is determined that the accounting procedures used by the employer for the reporting and substantiation of expenses by employees are not adequate.

(2) The Code contemplates that taxpayers keep such records as will be sufficient to enable the Commissioner to correctly determine income tax liability. Accordingly, it is to the advantage of taxpayers who may be called upon to substantiate expense account information to maintain as adequate and detailed records of travel, transportation, entertainment, and similar business expenses as practical since the burden of proof is upon the taxpayer to show that such expenses were not only paid or incurred but also that they constitute ordinary and necessary business expenses. One method for substantiating expenses incurred by an employee in connection with his employment is through the preparation of a daily diary or record of expenditures, maintained in sufficient detail to enable him to readily identify the amount and nature of any expenditure, and the preservation of supporting documents, especially in connection with large or exceptional expenditures. Nevertheless, it is recognized that by reason of the nature of certain expenses or the circumstances under which they are incurred, it is often difficult for an employee to maintain detailed records or to preserve supporting documents

for all his expenses. Detailed records of small expenditures incurred in traveling or for transportation, as for example, tips, will not be required.

(3) Where records are incomplete or documentary proof is unavailable, it may be possible to establish the amount of the expenditures by approximations based upon reliable secondary sources of information and collateral evidence. For example, in connection with an item of traveling expense a taxpayer might establish that he was in a travel status a certain number of days but that it was impracticable for him to establish the details of all his various items of travel expense. In such a case rail fares or plane fares can usually be ascertained with exactness and automobile costs approximated on the basis of mileage covered. A reasonable approximation of meals and lodging might be based upon receipted hotel bills or upon average daily rates for such accommodations and meals prevailing in the particular community for comparable accommodations. Since detailed records of incidental items are not required, deductions for these items may be based upon a reasonable approximation. In cases where a taxpayer is called upon to substantiate expense account information, the burden is on the taxpayer to establish that the amounts claimed as a deduction are reasonably accurate and constitute ordinary and necessary business expenses paid or incurred by him in connection with his trade or business. In connection with the determination of factual matters of this type, due consideration will be given to the reasonableness of the stated expenditures for the claimed purposes in relation to the taxpayer's circumstances (such as his income and the nature of his occupation), to the reliability and accuracy of records in connection with other items more readily lending themselves to detailed recordkeeping, and to all of the facts and circumstances in the particular case.

(e) *Applicability*. (1) Except as provided in subparagraph (2) of this paragraph, the provisions of the regulations in this section are supplemental to existing regulations relating to information required to be submitted with income tax returns, and shall be applicable with respect to taxable years beginning after December 31, 1957, notwithstanding any existing regulation to the contrary.

(2) With respect to taxable years ending after December 31, 1962, but only in respect of periods after such date, the provisions of the regulations in this section are superseded by the regulations under section 274(d) to the extent inconsistent therewith. See § 1.274–5.

(3) For taxable years beginning on or after January 1, 1989, the provisions of this section are superseded by the regulations under section 62(c) to the extent this section is inconsistent with those regulations. See § 1.62–2.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6630, 27 FR 12935, Dec. 29, 1962; T.D. 8276, 54 FR 51026, Dec. 12, 1989; T.D. 8324, 55 FR 51695, Dec. 17, 1990]

§ 1.162–18 Illegal bribes and kickbacks.

(a) *Illegal payments to government officials or employees*—(1) *In general*. No deduction shall be allowed under section 162(a) for any amount paid or incurred, directly or indirectly, to an official or employee of any government, or of any agency or other instrumentality of any government, if—

(i) In the case of a payment made to an official or employee of a government other than a foreign government described in subparagraph (3) (ii) or (iii) of this paragraph, the payment constitutes an illegal bribe or kickback, or

(ii) In the case of a payment made to an official or employee of a foreign government described in subparagraph (3) (ii) or (iii) of this paragraph, the making of the payment would be unlawful under the laws of the United States (if such laws were applicable to the payment and to the official or employee at the time the expenses were paid or incurred).

No deduction shall be allowed for an accrued expense if the eventual payment thereof would fall within the prohibition of this section. The place where the expenses are paid or incurred is immaterial. For purposes of subdivision (ii) of this subparagraph, lawfulness, or unlawfulness of the payment under the laws of the foreign country is immaterial.

(2) *Indirect payment*. For purposes of this paragraph, an indirect payment to an individual shall include any payment which inures to his benefit or promotes his interests, regardless of the medium in which the payment is made and regardless of the identity of the immediate recipient or payor. Thus, for example, payment made to an agent, relative, or independent contractor of an official or employee, or even directly into the general treasury of a foreign country of which the beneficiary is an official or employee, may be treated as an indirect payment to the official or employee, if in fact such payment inures or will inure to his benefit or promotes or will promote his financial or other interests. A payment made by an agent or independent contractor of the taxpayer which benefits the taxpayer shall be treated as an indirect payment by the taxpayer to the official or employee.

(3) *Official or employee of a government*. Any individual officially connected with—

(i) The Government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico,

(ii) The government of a foreign country, or

(iii) A political subdivision of, or a corporation or other entity serving as an agency or instrumentality of, any of the above,

in whatever capacity, whether on a permanent or temporary basis, and whether or not serving for compensation, shall be included within the term ''official or employee of a government'', regardless of the place of residence or post of duty of such individual. An independent contractor would not ordinarily be considered to be an official or employee. For purposes of section 162(c) and this paragraph, the term ''foreign country'' shall include any foreign nation, whether or not such nation has been accorded diplomatic recognition by the United States. Individuals who purport to act on behalf of or as the government of a foreign nation, or an agency or instrumentality thereof, shall be treated under this section as officials or employees of a foreign government, whether or not such individuals in fact control such foreign nation, agency, or instrumentality, and whether or not such individuals are accorded diplomatic recognition. Accordingly, a group in rebellion against an established government shall be treated as officials or employees of a foreign government, as shall officials or employees of the government against which the group is in rebellion.

(4) *Laws of the United States*. The term ''laws of the United States'', to which reference is made in paragraph (a)(1)(ii) of this section, shall be deemed to include only Federal statutes, including State laws which are assimilated into Federal law by Federal statute, and legislative and interpretative regulations thereunder. The term shall also be limited to statutes which prohibit some act or acts, for the violation of which there is a civil or criminal penalty.

(5) *Burden of proof*. In any proceeding involving the issue of whether, for purposes of section 162(c)(1), a payment made to a government official or employee constitutes an illegal bribe or kickback (or would be unlawful under the laws of the United States) the burden of proof in respect of such issue shall be upon the Commissioner to the same extent as he bears the burden of proof in civil fraud cases under section 7454 (*i.e.*, he must prove the illegality of the payment by clear and convincing evidence).

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

Example. X Corp. is in the business of selling hospital equipment in State Y. During 1970, X Corp. employed A who at the time was employed full time by State Y as Superintendent of Hospitals. The purpose of A's employment by X Corp. was to procure for it an improper advantage over other concerns in the making of sales to hospitals in respect of which A, as Superintendent, had authority. X Corp. paid A $5,000 during 1970. The making of this payment was illegal under the laws of State Y. Under section 162(c)(1), X Corp. is precluded from deducting as a trade or business expense the $5,000 paid to A.

(b) *Other illegal payments*—(1) *In general*. No deduction shall be allowed under section 162(a) for any payment (other than a payment described in paragraph (a) of this section) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under the laws of the United States (as defined in paragraph (a)(4) of this section), or under any State law (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss (including a suspension) of license or privilege to engage in a trade or business (whether or not such penalty or loss is actually imposed upon the taxpayer). For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. This paragraph applies only to payments made after December 30, 1969.

(2) *State law.* For purposes of this paragraph, State law means a statute of a State or the District of Columbia.

(3) *Generally enforced.* For purposes of this paragraph, a State law shall be considered to be generally enforced unless it is never enforced or the only persons normally charged with violations thereof in the State (or the District of Columbia) enacting the law are infamous or those whose violations are extraordinarily flagrant. For example, a criminal statute of a State shall be considered to be generally enforced unless violations of the statute which are brought to the attention of appropriate enforcement authorities do not result in any enforcement action in the absence of unusual circumstances.

(4) *Burden of proof.* In any proceeding involving the issue of whether, for purposes of section 162(c)(2), a payment constitutes an illegal bribe, illegal kickback, or other illegal payment the burden of proof in respect of such issue shall be upon the Commissioner to the same extent as he bears the burden of proof in civil fraud cases under section 7454 (*i.e.*, he must prove the illegality of the payment by clear and convincing evidence).

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

Example. X Corp., a calendar-year taxpayer, is engaged in the ship repair business in State Y. During 1970, repairs on foreign ships accounted for a substantial part of its total business. It was X Corp.'s practice to kick back approximately 10 percent of the repair bill to the captain and chief engineer of all foreign-owned vessels, which kickbacks are illegal under a law of State Y (which is generally enforced) and potentially subject X Corp. to fines. During 1970, X Corp. paid $50,000 in such kickbacks. On X Corp.'s return for 1970, a deduction under section 162 was taken for the $50,000. The deduction of the $50,000 of illegal kickbacks during 1970 is disallowed under section 162(c)(2), whether or not X Corp. is prosecuted with respect to the kickbacks.

(c) *Kickbacks, rebates, and bribes under medicare and medicaid.* No deduction shall be allowed under section 162(a) for any kickback, rebate, or bribe (whether or not illegal) made on or after December 10, 1971, by any provider of services, supplier, physician, or other person who furnishes items or services for which payment is or may be made under the Social Security Act, as amended, or in whole or in part out of Federal funds under a State plan approved under such Act, if such kickback, rebate, or bribe is made in connection with the furnishing of such items or services or the making or receipt of such payments. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer.

[T.D. 7345, 40 FR 7437, Feb. 20, 1975; 40 FR 8948, Mar. 4, 1975]

§ 1.162–19 Capital contributions to Federal National Mortgage Association.

(a) *In general.* The initial holder of stock of the Federal National Mortgage Association (FNMA) 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 treat the excess, if any, of the issuance price (the amount of capital contributions evidenced by a share of stock) over the fair market value of the stock as of the issue date of such stock as an ordinary and necessary business expense paid or incurred during the year in which occurs the date of issuance of the stock. To the extent that a sale to FNMA of mortgage paper gives rise to the issuance of a share of FNMA stock during a taxable year beginning after December 31, 1959, such sale is to be treated in a manner consistent with the purpose for, and the legislative intent underlying the enactment of, the provisions of section 8, Act of September 14, 1960 (Pub. L. 86–779, 74 Stat. 1003). Thus, for the purpose of determining an initial holder's gain or loss from the sale to FNMA of mortgage paper, with respect to which a share of FNMA stock is issued in a taxable year beginning after December 31, 1959 (irrespective of when the sale is made), the amount realized by the initial holder from the sale of the mortgage paper is the amount of the ''FNMA purchase price''. The ''FNMA purchase price'' is the gross amount of the consideration agreed upon between FNMA and the initial holder for the purchase of the mortgage paper, without regard to any deduction therefrom as, for example, a deduction representing a capital contribution or a purchase or marketing fee. The date of issuance of the stock is the date which appears on the stock certificates of the initial holder as the date of issue. The initial holder is the original purchaser who is issued stock of the Federal National Mortgage Association pursuant to section 303(c) of the Act, and who appears on the books of FNMA as the initial holder. In determining the period for which the initial holder has held such stock, such period shall begin with the date of issuance.

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

Example 1. A, a banking institution which reports its income on a calendar year basis, sold mortgage paper with an outstanding principal balance of $12,500 to FNMA on October 17, 1960. The FNMA purchase price was $11,500. A's basis for the mortgage paper was $10,500. In accordance with the terms of the contract, FNMA deducted $375 ($250 representing capital contribution and $125 representing purchase and marketing fee) from the amount of the purchase price. FNMA credited A's account with the amount of the capital contribution. A stock certificate evidencing two shares of FNMA common stock of $100 par value was mailed to A and FNMA deducted $200 from A's account, leaving a net balance of $50 in such account. The stock certificate, bearing an issue date of November 1, 1960, was received by A on November 7, 1960. The fair market value of a share of FNMA stock on October 17, 1960, was $65, on November 1, 1960, was $67, and on November 7, 1960, was $68. A may deduct $66 the difference between the issuance price ($200) and the fair market value ($134) of the two shares of stock on the date of issuance (November 1, 1960), as a business expense for the taxable year 1960. The basis of each share of stock issued as of November 1, 1960 will be $67. See section 1054 and § 1.1054–1. A's gain from the sale of the mortgage paper is $875 computed as follows:

Amount realized in FNMA purchase price		$11,500
A's basis in mortgage paper	$10,500	
Purchase and marketing fee	125	
		10,625
Gain on sale		875

Example 2. Assume the same facts as in Example (1), and, in addition, that A sold to FNMA on December 15, 1960, additional mortgage paper having an outstanding principal balance of $12,500. FNMA deducted from the FNMA purchase price $250 representing capital contribution and credited A's account with this amount. A then had a total credit of $300 to his account consisting of the $50 balance from the transaction described in Example (1) and $250 from the December 15th transaction. A stock certificate evidencing three shares of FNMA common stock of $100 par value was mailed to A and FNMA deducted $300 from A's account. The stock certificate, bearing an issue date of January 1, 1961, was received by A on January 9, 1961. The fair market value of a share of FNMA stock on January 1, 1961, was $69. A may deduct $93, the difference between the issuance price ($300) and the fair market value ($207) of the three shares of stock on the date of issuance (January 1, 1961), as a business expense for the taxable year 1961. The gain or loss on the sale of mortgage paper on December 15, 1960, is reportable for the taxable year 1960.

[T.D. 6690, 28 FR 12253, Nov. 19, 1963]

§ 1.162–20 Expenditures attributable to lobbying, political campaigns, attempts to influence legislation, etc., and certain advertising.

(a) *In general*—(1) *Scope of section.* This section contains rules governing the deductibility or nondeductibility of expenditures for lobbying purposes, for the promotion or defeat of legislation, for political campaign purposes (including the support of or opposition to any candidate for public office) or for carrying on propaganda (including advertising) related to any of the foregoing purposes. For rules applicable to such expenditures in respect of taxable years beginning before January 1, 1963, and for taxable years beginning after December 31, 1962, see paragraphs (b) and (c), respectively, of this section. This section also deals with expenditures for institutional or ''good will'' advertising.

(2) *Institutional or ''good will'' advertising.* Expenditures for institutional or ''good will'' advertising which keeps the taxpayer's name before the public are generally deductible as ordinary and necessary business expenses provided the expenditures are related to the patronage the taxpayer might reasonably expect in the future. For example, a deduction will ordinarily be allowed for the cost of advertising which keeps the taxpayer's name before the public in connection with encouraging contributions to such organizations as the Red Cross, the purchase of United States Savings Bonds, or participation in similar causes. In like fashion, expenditures for advertising which presents views on economic, financial, social, or other subjects of a general nature, but which does not involve any of the activities specified in paragraph (b) or (c) of this section for which a deduction is not allowable, are deductible if they otherwise meet the requirements of the regulations under section 162.

(b) *Taxable years beginning before January 1, 1963*—(1) *In general.* (i) For taxable years beginning before January 1, 1963, expenditures for lobbying purposes, for the promotion or defeat of legislation, for political campaign purposes (including the support of or opposition to any candidate for public office), or for carrying on propaganda (including advertising) related to any of the foregoing purposes are not deductible from gross income. For example, the cost of advertising to promote or defeat legislation or to influence the public with respect to the desirability or undesirability of proposed legislation is not deductible as a business expense, even though the legislation may directly affect the taxpayer's business.

(ii) If a substantial part of the activities of an organization, such as a labor union or a trade association, consists of one or more of the activities specified in the first sentence of this subparagraph, deduction will be allowed only for such portion of the dues or other payments to the organization as the taxpayer can clearly establish is attributable to activities other than those so specified. The determination of whether such specified activities constitute a substantial part of an organization's activities shall be based on all the facts and circumstances. In no event shall special assessments or similar payments (including an increase in dues) made to any organization for any of such specified purposes be deductible. For other provisions relating to the deductibility of dues and other payments to an organization, such as a labor union or a trade association, see paragraph (c) of §1.162–15.

(2) *Expenditures for promotion or defeat of legislation.* For purposes of this paragraph, expenditures for the promotion or the defeat of legislation include, but shall not be limited to, expenditures for the purpose of attempting to—

(i) Influence members of a legislative body directly, or indirectly by urging or encouraging the public to contact such members for the purpose of proposing, supporting, or opposing legislation, or

(ii) Influence the public to approve or reject a measure in a referendum, initiative, vote on a constitutional amendment, or similar procedure.

(c) *Taxable years beginning after December 31, 1962*—(1) *In general.* For taxable years beginning after December 31, 1962, certain types of expenses incurred with respect to legislative matters are deductible under section 162(a) if they otherwise meet the requirements of the regulations under section 162. These deductible expenses are described in subparagraph (2) of this paragraph. All other expenditures for lobbying purposes, for the promotion or defeat of legislation (see paragraph (b)(2) of this section), for political campaign purposes (including the support of or opposition to any candidate for public office), or for carrying on propaganda (including advertising) relating to any of the foregoing purposes are not deductible from gross income for such taxable years. For the disallowance of deductions for bad debts and worthless securities of a political party, see §1.271–1. For the disallowance of deductions for certain indirect political contributions, such as the cost of certain advertising and the cost of admission to certain dinners, programs, and inaugural events, see § 1.276–1.

(2) *Appearances, etc., with respect to legislation*—(i) *General rule*. Pursuant to the provisions of section 162(e), expenses incurred with respect to legislative matters which may be deductible are those ordinary and necessary expenses (including, but not limited to, traveling expenses described in section 162(a)(2) and the cost of preparing testimony) paid or incurred by the taxpayer during a taxable year beginning after December 31, 1962, in carrying on any trade or business which are in direct connection with—

(*a*) Appearances before, submission of statements to, or sending communications to, the committees, or individual members of Congress or of any legislative body of a State, a possession of the United States, or a political subdivision of any of the foregoing with respect to legislation or proposed legislation of direct interest to the taxpayer, or

(*b*) Communication of information between the taxpayer and an organization of which he is a member with respect to legislation or proposed legislation of direct interest to the taxpayer and to such organization.

For provisions relating to dues paid or incurred with respect to an organization of which the taxpayer is a member, see subparagraph (3) of this paragraph.

(ii) *Legislation or proposed legislation of direct interest to the taxpayer—(a) Legislation or proposed legislation*. The term ''legislation or proposed legislation'' includes bills and resolutions introduced by a member of Congress or other legislative body referred to in subdivision (i)(*a*) of this subparagraph for consideration by such body as well as oral or written proposals for legislative action submitted to the legislative body or to a committee or member of such body.

(*b*) *Direct interest*—(*1*) *In general*. (*i*) Legislation or proposed legislation is of direct interest to a taxpayer if the legislation or proposed legislation is of such a nature that it will, or may reasonably be expected to, affect the trade or business of the taxpayer. It is immaterial whether the effect, or expected effect, on the trade or business will be beneficial or detrimental to the trade or business or whether it will be immediate. If legislation or proposed legislation has such a relationship to a trade or business that the expenses of any appearance or communication in connection with the legislation meets the ordinary and necessary test of section 162(a), then such legislation ordinarily meets the direct interest test of section 162(e). However, if the nature of the legislation or proposed legislation is such that the likelihood of its having an effect on the trade or business of the taxpayer is remote or speculative, the legislation or proposed legislation is not of direct interest to the taxpayer. Legislation or proposed legislation which will not affect the trade or business of the taxpayer is not of direct interest to the taxpayer even though such legislation will affect the personal, living, or family activities or expenses of the taxpayer. Legislation or proposed legislation is not of direct interest to a taxpayer merely because it may affect business in general; however, if the legislation or proposed legislation will, or may reasonably be expected to, affect the taxpayer's trade or business it will be of direct interest to the taxpayer even though it also will affect the trade or business of other taxpayers or business in general. To meet the direct interest test, it is not necessary that all provisions of the legislation or proposed legislation have an effect, or expected effect, on the taxpayer's trade or business. The test will be met if one of the provisions of the legislation has the specified effect. Legislation or proposed legislation will be considered to be of direct interest to a membership organization if it is of direct interest to the organization, as such, or if it is of direct interest to one or more of its members.

(*ii*) Legislation which would increase or decrease the taxes applicable to the trade or business, increase or decrease the operating costs or earnings of the trade or business, or increase or decrease the administrative burdens connected with the trade or business meets the direct interest test. Legislation which would increase the social security benefits or liberalize the right to such benefits meets the direct interest test because such changes in the social security benefits may reasonably be expected to affect the retirement benefits which the employer will be asked to provide his employees or to increase his taxes. Legislation which would impose a retailer's sales tax is of direct interest to a retailer because, although the tax may be passed on to his customers, collection of the tax will impose additional burdens on the retailer, and because the increased cost of his products to the consumer may reduce the demand for them. Legislation which would provide an income tax credit or exclusion for shareholders is of direct interest to a corporation, because those tax benefits may increase the sources of capital available to the corporation. Legislation which would favorably or adversely affect the business of a competitor so as to affect the taxpayer's competitive position is of direct interest to the taxpayer. Legislation which would improve the school system of a community is of direct interest to a membership organization comprised of employers in the community because the improved school system is likely to make the community more attractive to prospective employees of such employers. On the other hand, proposed legislation relating to Presidential succession in the event of the death of the President has only a remote and speculative effect on any trade or business and therefore does not meet the direct interest test. Similarly, if a corporation is represented before a congressional committee to oppose an appropriation bill merely because of a desire to bring increased Government economy with the hope that such economy will eventually cause a reduction in the Federal income tax, the legislation does not meet the direct interest test because any effect it may have upon the corporation's trade or business is highly speculative.

(*2*) *Appearances, etc., by expert witnesses.* (*i*) An appearance or communication (of a type described in paragraph (c)(2)(i)(*a*) of this section) by an individual in connection with legislation or proposed legislation shall be considered to be with respect to legislation of direct interest to such individual if the legislation is in a field in which he specializes as an employee, if the appearance or communication is not on behalf of his employer, and if it is customary for individuals in his type of employment to publicly express their views in respect of matters in their field of competence. Expenses incurred by such an individual in connection with such an appearance of communication, including traveling expenses properly allocable thereto, represent ordinary and necessary business expenses and are, therefore, deductible under section 162. For example, if a university professor who teaches in the field of money and banking appears, on his own behalf, before a legislative committee to testify on proposed legislation regarding the banking system, his expenses incurred in connection with such appearance are deductible under section 162 since university professors customarily take an active part in the development of the law in their field of competence and publicly communicate the results of their work.

(*ii*) An appearance or communication (of a type described in paragraph (c)(2)(i)(*a*) of this section) by an employee or self-employed individual in connection with legislation or proposed legislation shall be considered to be with respect to legislation of direct interest to such person if the legislation is in the field in which he specializes in his business (or as an employee) and if the appearance or communication is made pursuant to an invitation extended to him individually for the purpose of receiving his expert testimony. Expenses incurred by an employee or self-employed individual in connection with such an appearance or communication, including traveling expenses properly allocable thereto, represent ordinary and necessary business expenses and are, therefore, deductible under section 162. For example, if a self-employed individual is personally invited by a congressional committee to testify on proposed legislation in the field in which he specializes in his business, his expenses incurred in connection with such appearance are deductible under section 162. If a self-employed individual makes an appearance, on his own behalf, before a legislative committee without having been extended an invitation his expenses will be deductible to the extent otherwise provided in this paragraph.

(*3*) *Nominations, etc.* A taxpayer does not have a direct interest in matters such as nominations, appointments, or the operation of the legislative body.

(iii) *Allowable expenses.* To be deductible under section 162(a), expenditures which meet the tests of deductibility under the provisions of this paragraph must also qualify as ordinary and necessary business expenses under section 162(a) and, in addition, be in direct connection with the carrying on of the activities specified in subdivision (i)(*a*) or (i)(*b*) of this subparagraph. For example, a taxpayer appearing before a committee of the Congress to present testimony concerning legislation or proposed legislation in which he has a direct interest may deduct the ordinary and necessary expenses directly connected with his appearance, such as traveling expenses described in section 162(a)(2), and the cost of preparing testimony.

(3) *Deductibility of dues and other payments to an organization.* If a substantial part of the activities of an organization, such as a labor union or a trade association, consists of one or more of the activities to which this paragraph relates (legislative matters, political campaigns, etc.), exclusive of any activity constituting an appearance or communication with respect to legislation or proposed legislation of direct interest to the organization (see subparagraph (c)(2)(ii)(*b*)(*1*)), a deduction will be allowed only for such portion of the dues or other payments to the organization as the taxpayer can clearly establish is attributable to activities to which this paragraph does not relate and to any activity constituting an appearance or communication with respect to legislation or proposed legislation of direct interest to the organization. The determination of whether a substantial part of an organization's activities consists of one or more of the activities to which this paragraph relates (exclusive of appearances or communications with respect to legislation or proposed legislation of direct interest to the organization) shall be based on all the facts and circumstances. In no event shall a deduction be allowed for that portion of a special assessment or similar payment (including an increase in dues) made to any organization for any activity to which this paragraph relates if the activity does not constitute an appearance or communication with respect to legislation or proposed legislation of direct interest to the organization. If an organization pays or incurs expenses allocable to legislative activities which meet the tests of subdivisions (i) and (ii) of subparagraph (2) of this paragraph (appearances or communications with respect to legislation or proposed legislation of direct interest to the organization), on behalf of its members, the dues paid by a taxpayer are deductible to the extent used for such activities. Dues paid by a taxpayer will be considered to be used for such an activity, and thus deductible, although the legislation or proposed legislation involved is not of direct interest to the taxpayer, if, pursuant to the provisions of subparagraph (2)(ii)(*b*)(*1*) of this paragraph, the legislation or proposed legislation is of direct interest to the organization, as such, or is of direct interest to one or more members of the organization. For other provisions relating to the deductibility of dues and other payments to an organization, such as a labor union or a trade association, see paragraph (c) of §1.162–15.

(4) *Limitations.* No deduction shall be allowed under section 162(a) for any amount paid or incurred (whether by way of contribution, gift, or otherwise) in connection with any attempt to influence the general public, or segments thereof, with respect to legislative matters, elections, or referendums. For example, no deduction shall be allowed for any expenses incurred in connection with ''grassroot'' campaigns or any other attempts to urge or encourage the public to contact members of a legislative body for the purpose of proposing, supporting, or opposing legislation.

(5) *Expenses paid or incurred after December 31, 1993, in connection with influencing legislation other than certain local legislation.* The provisions of paragraphs (c)(1) through (3) of this section are superseded for expenses paid or incurred after December 31, 1993, in connection with influencing legislation (other than certain local legislation) to the extent inconsistent with section 162(e)(1)(A) (as limited by section 162(e)(2)) and §§ 1.162–20(d) and 1.162–29.

(d) *Dues allocable to expenditures after 1993.* No deduction is allowed under section 162(a) for the portion of dues or other similar amounts paid by the taxpayer to an organization exempt from tax (other than an organization described in section 501(c)(3)) which the organization notifies the taxpayer under section 6033(e)(1)(A)(ii) is allocable to expenditures to which section 162(e)(1) applies. The first sentence of this paragraph (d) applies to dues or other similar amounts whether or not paid on or before December 31, 1993. Section 1.162–20(c)(3) is superseded to the extent inconsistent with this paragraph (d).

[T.D. 6819, 30 FR 5581, Apr. 20, 1965, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 8602, 60 FR 37573, July 21, 1995]

§ 1.162–21 Denial of deduction for certain fines, penalties, and other amounts.

(a) *Deduction Disallowed.* Except as otherwise provided in this section, no deduction is allowed under chapter 1 of the Internal Revenue Code (Code) for any amount that is paid or incurred—

(1) By suit, settlement agreement (agreement), or otherwise, as defined in paragraph (e)(5) of this section;

(2) To, or at the direction of, a government, as defined in paragraph (e)(1) of this section, or a governmental entity, as defined in paragraph (e)(2) of this section; and

(3) In relation to the violation, or investigation or inquiry by such government or governmental entity into the potential violation, of any civil or criminal law.

(i) An amount that is paid or incurred in relation to the violation of any civil or criminal law includes a fine or penalty.

(ii) An investigation or inquiry into the potential violation of any law does not include routine investigations or inquiries, such as audits or inspections, of regulated businesses that are not related to any evidence of wrongdoing or suspected wrongdoing, but are conducted to ensure compliance with the rules and regulations applicable to those businesses.

(b) *Exception for restitution, remediation, and amounts paid to come into compliance with a law*—(1) *In general.* Paragraph (a) of this section does not apply to amounts paid or incurred for restitution (including remediation) or to come into compliance with a law, as defined in paragraphs (e)(4) of this section, provided that both the identification and the establishment requirements of paragraphs (b)(2) and (b)(3) of this section are met.

(2) *Identification requirement*—(i) *In general.* A court order (order) or an agreement, as defined in paragraph (e)(5) of this section, identifies a payment by stating the nature of, or purpose for, each payment each taxpayer is obligated to pay and the amount of each payment identified.

(ii) *Meeting the identification requirement.* The identification requirement is met if an order or agreement specifically states the amount of the payment described in paragraph (b)(2)(i) of this section and that the payment constitutes restitution, remediation, or an amount paid to come into compliance with a law. If the order or agreement uses a different form of the required words (such as ''remediate'' or ''comply with a law'') and describes the purpose for which restitution or remediation will be paid or the law with which the taxpayer must comply, the order or agreement will be treated as stating that the payment constitutes restitution, remediation, or an amount paid to come into compliance with a law. Similarly, if an order or agreement specifically describes the damage done, harm suffered, or manner of noncompliance with a law and describes the action required of the taxpayer to provide restitution, remediation, or to come into compliance with any law, as defined in paragraph (e)(4) of this section, the order or agreement will be treated as stating that the payment constitutes restitution, remediation, or an amount paid to come into compliance with any law. Meeting the establishment requirement of paragraph (b)(3) of this section alone is not sufficient to meet the identification requirement of paragraph (b)(2) of this section.

(iii) *Payment amount not identified.* (A) If the order or agreement identifies a payment as restitution, remediation, or to come into compliance with a law but does not identify some or all of the amount the taxpayer must pay or incur, the identification requirement may be met for any payment amount not identified if the order or agreement describes the damage done, harm suffered, or manner of noncompliance with a law, and describes the action required of the taxpayer, such as paying or incurring costs to provide services or to provide property.

(B) If the order or agreement identifies a lump-sum payment or multiple damages award as restitution, remediation, or to come into compliance with a law but does not allocate some or all of the amount the taxpayer must pay or incur among restitution, remediation, or to come into compliance with a law, or does not allocate the total payment amount among multiple taxpayers, the identification requirement may be met for any payment amount not specifically allocated if the order or agreement describes the damage done, harm suffered, or manner of noncompliance with a law, and describes the action required of the taxpayer, such as paying or incurring costs to provide services or to provide property.

(3) *Establishment requirement*—(i) *Meeting the establishment requirement.* The establishment requirement is met if the taxpayer, using documentary evidence, proves the taxpayer's legal obligation, pursuant to the order or agreement, to pay the amount identified as restitution, remediation, or to come into compliance with a law; the amount paid or incurred; the date the amount was paid or incurred; and that, based on the origin of the liability and the nature and purpose of the amount paid or incurred, the amount the taxpayer paid or incurred was for restitution or remediation, as defined in paragraph (e)(4)(i) of this section or to come into compliance with any law, as defined in paragraph (e)(4)(ii) of this section. If the amount is paid or incurred to a segregated fund or account, as described in paragraphs (e)(4)(i)(A)(*2*) and (*3*), (e)(4)(i)(B), or (e)(4)(i)(C) of this section, the taxpayer may meet the establishment requirement even if each ultimate recipient, or each ultimate use, of the payment is not designated or is unknown. A taxpayer will not meet the establishment requirement if the taxpayer fails to prove that the taxpayer paid or incurred the amount identified as restitution, remediation, or to come into compliance with a law; the amount paid; the date the amount was paid or incurred; or that the amount the taxpayer paid or incurred was for the nature and purpose identified in the order or agreement as required by paragraph (b)(2)(i) of this section, or was made for the damage done, harm suffered, noncompliance, or to provide property or services as described in (b)(2)(iii) of this section. Meeting the identification requirement of paragraph (b)(2) of this section is not sufficient to meet the establishment requirement of paragraph (b)(3) of this section.

(ii) *Substantiating the establishment requirement.* The documentary evidence described in paragraph (b)(3)(i) of this section includes, but is not limited to, receipts; the legal or regulatory provision related to the violation or potential violation of any law; documents issued by the government or governmental entity relating to the investigation or inquiry, including court pleadings filed by the government or governmental entity requesting restitution, remediation, or demanding that defendant take action to come into compliance with the law; judgment; decree; documents describing how the amount to be paid was determined; and correspondence exchanged between the taxpayer and the government or governmental entity before the order or agreement became binding under applicable law, determined without regard to whether all appeals have been exhausted or the time for filing an appeal has expired.

(c) *Other exceptions*—(1) *Suits between private parties.* Paragraph (a) of this section does not apply to any amount paid or incurred by reason of any order or agreement in a suit in which no government or governmental entity is a party or any order or agreement in a suit pursuant to which a government or governmental entity enforces its rights as a private party.

(2) *Taxes and related interest.* Paragraph (a) of this section does not apply to amounts paid or incurred as otherwise deductible taxes or related interest. However, if penalties are imposed relating to such taxes, paragraph (a) of this section applies to disallow a deduction for such penalties and interest payments related to such penalties.

(3) *Failure to pay title 26 tax.* In the case of any amount paid or incurred as restitution for failure to pay tax imposed under title 26 of the United States Code, paragraph (a) of this section does not disallow a deduction for title 26 taxes, such as excise and employment taxes, which are equal to or less than the deduction otherwise allowed under chapter 1 of the Code if the tax had been timely paid.

(d) *Application of general principles of Federal income tax law*—(1) *Taxable year of deduction.* If, under paragraph (b) or (c) of this section, the taxpayer is allowed a deduction for the amount paid or incurred pursuant to an order or agreement, the deduction is taken into account under the rules of section 461 and the related regulations, or under a provision specifically applicable to the allowed deduction, such as §1.468B–3(c).

(2) *Tax benefit rule applies.* If the deduction allowed under paragraphs (b) or (c) of this section results in a tax benefit to the taxpayer, the taxpayer must include in income, under sections 61 and 111, the recovery of any amount deducted in a prior taxable year to the extent the prior year's deduction reduced the taxpayer's tax liability.

(i) A tax benefit to the taxpayer includes a reduction in the taxpayer's tax liability for a prior taxable year or the creation of a net operating loss carryback or carryover.

(ii) A taxpayer's recovery of any amount deducted in a prior taxable year includes, but is not limited to—

(A) Receiving a refund, recoupment, rebate, reimbursement, or otherwise recovering some or all of the amount the taxpayer paid or incurred, or

(B) Being relieved of some or all of the payment liability under the order or agreement.

(e) *Definitions.* For section 162(f) and §1.162–21, the following definitions apply:

(1) *Government.* A *government* means—

(i) The government of the United States, a State, or the District of Columbia;

(ii) The government of a territory of the United States, including American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the U.S. Virgin Islands;

(iii) The government of a foreign country;

(iv) An Indian tribal government, as defined in section 7701(a)(40), or a subdivision of an Indian tribal government, as determined in accordance with section 7871(d); or

(v) A political subdivision (such as a local government unit) of a government described in paragraph (e)(1)(i), (ii), or (iii) of this section.

(2) *Governmental entity.* A *governmental entity* means—

(i) A corporation or other entity serving as an agency or instrumentality of a government (as defined in paragraph (e)(1) of this section), or

(ii) A nongovernmental entity treated as a governmental entity as described in paragraph (e)(3) of this section.

(3) *Nongovernmental entity treated as a governmental entity.* A *nongovernmental entity treated as a governmental entity* is an entity that—

(i) Exercises self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange, as defined in section 1256(g)(7); or

(ii) Exercises self-regulatory powers, including adopting, administering, or enforcing rules and imposing sanctions, as part of performing an essential governmental function.

(4) *Restitution, remediation of property, and amounts paid to come into compliance with a law*—(i) *Amounts for restitution or remediation.* An amount is paid or incurred for restitution or remediation pursuant to paragraph (b)(1) of this section if it is paid or incurred to restore, in whole or in part, the person,

as defined in section 7701(a)(1); government; governmental entity; property; environment; wildlife; or natural resources harmed, injured, or damaged by the violation or potential violation of any law described in paragraph (a)(3) of this section to the same or substantially similar position or condition as existed prior to such harm, injury or damage.

(A) *Environment, wildlife, or natural resources.* Restitution or remediation of the environment, wildlife, or natural resources includes amounts paid or incurred for the purpose of conserving soil, air, or water resources, protecting or restoring the environment or an ecosystem, improving forests, or providing a habitat for fish, wildlife, or plants. The amounts must be paid or incurred—

(*1*) To, or at the direction of, a government or governmental entity to be used exclusively for the restitution or remediation of a harm to the environment, wildlife, or natural resources;

(*2*) To a segregated fund or account established by a government or governmental entity and, pursuant to the order or agreement, the amounts are not disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes; or

(*3*) To a segregated fund or account established at the direction of a government or governmental entity.

(*4*) Paragraph (e)(4)(i)(A) of this section applies only if there is a strong nexus or connection between the purpose of the payment and the harm to the environment, natural resources, or wildlife that the taxpayer has caused or is alleged to have caused.

(B) *Disgorgement or forfeiture.* Provided the identification and establishment requirements of paragraphs (b)(2) and (b)(3) of this section are met, restitution may include amounts paid or incurred as disgorgement or forfeiture, if paid or incurred at the direction of a government or governmental entity directly to the person, as defined in section 7701(a)(1), harmed by the violation or potential violation of any law or to, or at the direction of, the government or governmental entity, to establish a segregated fund or account for the benefit of such harmed person. This paragraph (e)(4)(i)(B) does not apply if the order or agreement identifies the payment amount as in excess of the taxpayer's net profits or, pursuant to the order or agreement, the amounts are disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes.

(C) *Segregated funds or accounts.* Provided the identification and establishment requirements of paragraphs (b)(2) and (b)(3) of this section are met, restitution or remediation may include amounts paid or incurred, pursuant to an order or agreement, to a segregated fund or account to restore, in whole or in part, the person, as defined in section 7701(a)(1); government; governmental entity; property; environment; wildlife; or natural resources harmed, injured, or damaged by the violation or potential violation of any law described in paragraph (a)(3) of this section. This paragraph (e)(4)(i)(C) does not apply if, pursuant to the order or agreement, the amounts are disbursed to the general account of the government or governmental entity for general enforcement efforts or other discretionary purposes.

(ii) *Amounts to come into compliance with a law.* An amount is paid or incurred to come into compliance with a law that the taxpayer has violated, or is alleged to have violated, by performing services; taking action, such as modifying equipment; providing property; or doing any combination thereof to come into compliance with that law.

(iii) *Amounts not included.* Regardless of whether the order or agreement identifies them as such, restitution, remediation, and amounts paid to come into compliance with a law do not include any amount paid or incurred—

(A) As reimbursement to a government or governmental entity for investigation costs or litigation costs incurred in such government or governmental entity's investigation into, or litigation concerning, the violation or potential violation of any law; or

(B) At the taxpayer's election, in lieu of a fine or penalty.

(5) *Suit, agreement, or otherwise.* A suit, agreement, or otherwise includes, but is not limited to, suits; settlement

agreements; orders; non-prosecution agreements; deferred prosecution agreements; judicial proceedings; administrative adjudications; decisions issued by officials, committees, commissions, or boards of a government or governmental entity; and any legal actions or hearings which impose a liability on the taxpayer or pursuant to which the taxpayer assumes liability.

(f) *Examples*. The application of this section is illustrated by the following examples.

(1) *Example 1*. (i) *Facts*. Corp. A enters into an agreement with State Y's environmental enforcement agency (Agency) for violating state environmental laws. Pursuant to the agreement, Corp. A pays $40X to the Agency in civil penalties, $80X in restitution for the environmental harm that the taxpayer has caused, $50X for remediation of contaminated sites, and $60X to conduct comprehensive upgrades to Corp. A's operations to come into compliance with the state environmental laws.

(ii) *Analysis*. The identification requirement is satisfied for those amounts the agreement identifies as restitution, remediation, or to come into compliance with a law. If Corp. A meets the establishment requirement, as provided in paragraph (b)(3), paragraph (a) of this section will not disallow Corp. A's deduction for $80X in restitution and $50X for remediation. Under paragraph (a) of this section, Corp. A may not deduct the $40X in civil penalties. Paragraph (a) of this section will not disallow Corp. A's deduction for the $60X paid to come into compliance with the state environmental laws. See section 161, concerning items allowed as deductions, and section 261, concerning items for which no deduction is allowed, and the regulations related to sections 161 and 261.

(2) *Example 2*. (i) *Facts*. Corp. A enters into an agreement with State T's securities agency (Agency) for violating a securities law by inducing B to make a $100X investment in Corp. C stock, which B lost when the Corp. C stock became worthless. As part of the agreement, Corp. A agrees to pay $100X to B as restitution for B's investment loss, incurred as a result of Corp. A's actions. The agreement specifically states that the $100X payment by Corp. A to B is restitution. The agreement also requires Corp. A to pay a $40X penalty for violating Agency law. Corp. A pays the $140X.

(ii) *Analysis*. Corp. A's $100X payment to B is identified in the agreement as restitution. If Corp. A establishes, as provided in paragraph (b)(3) of this section, that the amount paid was for that purpose, paragraph (a) of this section will not disallow Corp. A's deduction for the $100X payment. Under paragraph (a) of this section, Corp. A may not deduct its $40X payment to the Agency because it was paid for Corp. A's violation of Agency law.

(3) *Example 3*. (i) *Facts*. Corp. B is under investigation by State X's environmental enforcement agency for a potential violation of State X's law governing emissions standards. Corp. B enters into an agreement with State X under which it agrees to upgrade the engines in a fleet of vehicles that Corp. B operates to come into compliance with State X's law. Although the agreement does not provide the specific amount Corp. B will incur to upgrade the engines to come into compliance with State X's law, it identifies that Corp. B must upgrade existing engines to lower certain emissions. Under the agreement, Corp. B also agrees to construct a nature center in a local park for the benefit of the community. Instead of paying $12X, to come into compliance with State X's law, Corp. B pays $15X to upgrade the engines to a standard higher than that which the law requires. Corp. B presents evidence to establish that it would cost $12X to upgrade the engines to come into compliance with State X's law.

(ii) *Analysis*. Because the agreement describes the specific action Corp. B must take to come into compliance with State X's law, and Corp. B provides evidence, as described in paragraph (b)(3)(ii) of this section, to establish that the agreement obligates it to incur costs to come into compliance with a law, paragraph (a) of this section will not disallow Corp. B's deduction for the $12X Corp. B incurs to come into compliance. Corp. B may also deduct the $3X if it is otherwise deductible under chapter 1 of the Code. However, Corp. B may not deduct the amounts paid to construct the nature center because no facts exist to establish that the amount was paid either to come into compliance with a law or as restitution or remediation.

(4) *Example 4.* (i) *Facts.* Corp. D enters into an agreement with governmental entity, Trade Agency, for engaging in unfair trade practices in violation of Trade Agency laws. The agreement requires Corp. D to pay $80X to a Trade Agency fund, through disgorgement of net profits, to be used exclusively to pay restitution to the consumers harmed by Corp. D's violation of Trade Agency law. Corp. D pays $80X to Trade Agency fund and Trade Agency disburses all amounts in the restitution fund to the harmed consumers.

(ii) *Analysis.* The agreement identifies the $80X payment to the fund as restitution. Trade Agency uses the funds exclusively to provide restitution to the harmed consumers and does not use it for discretionary or general enforcement purposes. If Corp. D establishes, as provided in paragraph (b)(3) of this section, that the $80X constitutes restitution under paragraph (e)(4)(i)(B) of this section, paragraph (a) of this section does not apply.

(5) *Example 5.* (i) *Facts.* B, a regulated banking institution, is subject to the supervision of, and annual examinations by governmental entity, R. In the ordinary course of its business, B is required to pay annual assessment fees to R, which fees are used to support R in supervising and examining banking institutions to ensure a safe and sound banking system. Following an annual examination conducted in the ordinary course of B's business, R issues a letter to B identifying concerns with B's internal compliance functions. B takes corrective action to address R's concerns by investing in its internal compliance functions. R does not conduct an investigation or inquiry into B's potential violation of any law.

(ii) *Analysis.* The payment of annual assessment fees by B to R in the ordinary course of business is not related to the violation of any law or the investigation or inquiry into the potential violation of any law. In addition, B's costs of taking the corrective action are not related to the violation of any law or the investigation or inquiry into the potential violation of any law as described in section 162(f)(1). Paragraph (a) of this section will not disallow the deduction of the annual assessment fees and the cost of the corrective actions.

(6) *Example 6.* (i) *Facts.* B, a regulated banking institution, is subject to the supervision of, and annual examinations by governmental entity, R. Following an annual examination conducted in the ordinary course of B's business, R pursues an enforcement action against B for violation of banking laws. B and R enter a settlement agreement, pursuant to which B agrees to undertake certain improvements to come into compliance with banking laws and to pay R $20X for violation of banking laws. B pays the $20X.

(ii) *Analysis.* If the agreement meets the identification requirement of paragraph (b)(2) of this section and B meets the establishment requirement of paragraph (b)(3) of this section, paragraph (a) of this section will not disallow the deduction of the costs of the corrective actions to come into compliance with banking laws. However, B may not deduct the $20X paid to R because the amount was not paid to come into compliance with a law or as restitution or remediation.

(7) *Example 7.* (i) *Facts.* Corp. C contracts with governmental entity, Q, to design and build a rail project within five years. Corp. C does not complete the project. Q sues Corp. C for breach of contract and damages of $10X. A jury finds Corp. C breached the contract and Corp. C pays $10X to Q.

(ii) *Analysis.* The suit arose out of a proprietary contract, wherein Q enforced its rights as a private party. Paragraph (a) of this section will not disallow Corp. C's deduction of the payment of $10X pursuant to this suit.

(8) *Example 8.* (i) *Facts.* Corp. C contracts with governmental entity, Q, to design and build a rail project within five years. Site conditions cause construction delays and Corp. C asks Q to pay $50X in excess of the contracted amount to complete the project. After Q pays for the work, it learns that, at the time it entered the contract with Corp. C, Corp. C knew that certain conditions at the project site would make it challenging to complete the project

within five years. Q sues Corp. C for withholding critical information during contract negotiations in violation of the False Claims Act (FCA). The court enters a judgment in favor of Q pursuant to which Corp. C will pay Q $50X in restitution and $150X in treble damages. Corp. C pays the $200X.

(ii) *Analysis.* The suit pertains to Corp. C's violation of the FCA. The order identifies the $50X Corp. C is required to pay as restitution, as described in paragraph (b)(2) of this section. If Corp. C establishes, as provided in paragraph (b)(3) of this section, that the amount paid was for restitution, paragraph (a) of this section will not disallow Corp. C's deduction for the $50X payment. Under paragraph (a) of this section, Corp. C may not deduct the $150X paid for the treble damages imposed for violation of the FCA because the order did not identify all or part of the payment as restitution.

(9) *Example 9.* (i) *Facts.* Corp. T operates a truck fleet company incorporated in State A. State A requires that all vehicles registered in State A have a vehicle emissions test every two years. Corp. T's 40 trucks take the emissions test on March 1 for which it pays the $15 per vehicle. Under State A law, if a vehicle fails the emissions test, the vehicle owner has 30 days to certify to State A that the vehicle has been repaired and has passed the emissions test. State A imposes a $1X penalty per vehicle for failure to comply with this 30-day rule. Twenty trucks pass; twenty trucks fail. Corp. T does not submit the required certification to State A for the twenty trucks that failed the emissions test. State A imposes a $40X penalty against Corp. T. Corp. T pays the $40X.

(ii) *Analysis.* Emissions tests are conducted in the ordinary course of operating a truck fleet company and, therefore, paragraph (a) of this section does not apply to the $600 Corp. T pays for the emissions tests. However, Corp. T may not deduct the $40X penalty for failure to comply with State A requirements because the amount is required to be paid to a government in relation to the violation of a law.

(10) *Example 10.* (i) *Facts.* Corp. G operates a chain of 20 grocery stores in County X. Under County X health and food safety code and regulations, Corp. G is subject to annual inspections for which Corp. G is required to pay an inspection fee of $40 per store. Pursuant to the annual inspection, the County X health inspector finds violations of County X's health and food safety code and regulations in three of Corp. G's 20 stores. County X bills Corp. G $800 for the annual inspection fees for the 20 stores and a $1,000 fine for each of the three stores, for a total fine of $3,000, for violations of the health and food safety code. Corp. G pays the fees and fines.

(ii) *Analysis.* Paragraph (a) of this section will not disallow Corp. G's deduction for the $800 inspection fees paid in the ordinary course of a regulated business. Under paragraph (a) of this section, Corp. G may not deduct the $3,000 fine for violation of the County X health code and food safety ordinances because it was paid to a government in relation to the violation of a law.

(11) *Example 11.* (i) *Facts.* Corp. G operates a chain of grocery stores in County X. Under County X health and food safety code and regulations, Corp. G is subject to annual inspections. Pursuant to an annual inspection, the County X health inspector finds that the refrigeration system in one of Corp. G's stores does not keep food at the temperature required by the health and food safety code and regulations. The County X health inspector issues a warning letter instructing Corp. G to correct the violation and bring the refrigeration system into compliance with the law before a reinspection in 60 days or face the imposition of fines if it fails to comply. Corp. G pays $10,000 to bring its refrigeration system into compliance with the law.

(ii) *Analysis.* Provided the identification and establishment requirements of paragraphs (b)(2) and (b)(3), respectively, of this section are met, paragraph (a) of this section will not disallow Corp. G's deduction for the $10,000 it pays to bring its refrigeration system into compliance with the law.

(12) *Example 12.* (i) *Facts.* Corp. G operates a chain of grocery stores in County X. Under County X health and food safety code and regulations, Corp. G is subject to annual inspections. Pursuant to an annual inspection, the

County X health inspector finds that the refrigeration system in one of Corp. G's stores does not keep food at the temperature required by the health and food safety code and regulations. The County X health inspector issues a warning letter instructing Corp. G to correct the violation and bring the refrigeration system into compliance with the law before a reinspection in 60 days or face the imposition of fines if it fails to comply. The County X health inspector later reinspects the refrigeration system. Corp. G pays a reinspection fee of $80. During the reinspection, the health inspector finds that Corp. G did not bring its refrigeration system into compliance with the law. The health inspector issues a citation imposing a $250 fine on Corp. G. Corp. G pays the $250 fine.

(ii) *Analysis.* Paragraph (a) of this section will disallow Corp. G's deduction for the $80 inspection fee because it is paid in relation to the investigation or inquiry by County X into the potential violation of a law. Paragraph (a) of this section will also disallow Corp. G's deduction for the $250 fine paid for violation of the law.

(13) *Example 13.* (i) *Facts.* Accounting Firm was convicted of embezzling $500X from Bank in violation of State X law. The court issued an order requiring Accounting Firm to pay $100X in restitution to Bank. The court also issued an order of forfeiture and restitution for $400X, which was seized by the State X officials. Accounting Firm paid $100X to Bank. The $400X seized was deposited with Fund within the State X treasury and, at the discretion of the State X Attorney General, was used to support law enforcement programs.

(ii) *Analysis.* Although the order identified the amount forfeited as restitution, paragraph (a) of this section will disallow Accounting Firm's deduction for the $400X forfeited because, under paragraph (e)(4)(i)(B)(I) of this section, it does not constitute restitution. If Accounting Firm establishes, as provided in paragraph (b)(3) of this section, that the $100X constitutes restitution under paragraph (e)(4)(i), paragraph (a) of this section will not disallow Accounting Firm's deduction for the $100X paid, provided the $100X is otherwise deductible under chapter 1.

(g) *Applicability date.* The rules of this section apply to taxable years beginning on or after January 19, 2021, except that such rules do not apply to amounts paid or incurred under any order or agreement pursuant to a suit, agreement, or otherwise, which became binding under applicable law before such date, determined without regard to whether all appeals have been exhausted or the time for filing appeals has expired.

[T.D. 9946, 86 FR 4984, Jan. 19, 2021]

§ 1.162–22 Treble damage payments under the antitrust laws.

(a) *In general.* In the case of a taxpayer who after December 31, 1969, either is convicted in a criminal action of a violation of the Federal antitrust laws or enters a plea of guilty or *nolo contendere* to an indictment or information charging such a violation, and whose conviction or plea does not occur in a new trial following an appeal of a conviction on or before such date, no deduction shall be allowed under section 162(a) for two-thirds of any amount paid or incurred after December 31, 1969, with respect to—

(1) Any judgment for damages entered against the taxpayer under section 4 of the Clayton Act (15 U.S.C. 15), as amended, on account of such violation or any related violation of the Federal antitrust laws, provided such related violation occurred prior to the date of the final judgment of such conviction, or

(2) Settlement of any action brought under such section 4 on account of such violation or related violation.

For the purposes of this section, where a civil judgment has been entered or a settlement made with respect to a violation of the antitrust laws and a criminal proceeding is based upon the same violation, the criminal proceeding need not have been brought prior to the civil judgment or settlement. If, in his return for any taxable year, a taxpayer claims a deduction for an amount paid or incurred with respect to a judgment or settlement described in the first sentence of this paragraph and is subsequently convicted of a violation of the antitrust laws which makes a portion of such amount unallowable, then the taxpayer shall file an amended return for such taxable year on which the amount of the deduction is appropriately reduced. Attorney's fees, court costs, and other amounts paid or incurred in connection with a controversy under such section 4 which meet the requirements of section 162 are deductible under that section. For purposes of subparagraph (2) of this paragraph, the amount paid or incurred in settlement shall not include amounts attributable to the plaintiff's costs of suit and attorney's fees, to the extent that such costs or fees have actually been paid.

(b) *Conviction.* For purposes of paragraph (a) of this section, a taxpayer is convicted of a violation of the antitrust laws if a judgment of conviction (whether or not a final judgment) with respect to such violation has been entered against him, provided a subsequent final judgment of acquittal has not been entered or criminal prosecution with respect to such violation terminated without a final judgment of conviction. During the pendency of an appeal or other action directly contesting a judgment of conviction, the taxpayer should file a protective claim for credit or refund to avoid being barred by the period of limitations on credit or refund under section 6511.

(c) *Related violation.* For purposes of this section, a violation of the Federal antitrust laws is related to a subsequent violation if (1) with respect to the subsequent violation the United States obtains both a judgment in a criminal proceeding and an injunction against the taxpayer, and (2) the taxpayer's actions which constituted the prior violation would have contravened such injunction if such injunction were applicable at the time of the prior violation.

(d) *Settlement following a dismissal of an action or amendment of the complaint.* For purposes of paragraph (a)(2) of this section, an amount may be considered as paid in settlement of an action even though the action is dismissed or otherwise disposed of prior to such settlement or the complaint is amended to eliminate the claim with respect to the violation or related violation.

(e) *Antitrust laws.* The term ''antitrust laws'' as used in section 162(g) and this section shall include the Federal acts enumerated in paragraph (1) of section 1 of the Clayton Act (15 U.S.C. 12), as amended.

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

Example 1. In 1970, the United States instituted a criminal prosecution against X Co., Y Co., A, the president of X Co., and B, the president of Y Co., under section 1 of the Sherman Anti-Trust Act, 15 U.S.C. 1. In the indictment, the defendants were charged with conspiring to fix and maintain prices of electrical transformers from 1965 to 1970. All defendants entered pleas of nolo contendere to these charges. These pleas were accepted and judgments of conviction entered. In a companion civil suit, the United States obtained an injunction prohibiting the defendants from conspiring to fix and maintain prices in the electrical transformer market. Thereafter, Z Co. sued X Co. and Y Co. for $300,000 in treble damages under section 4 of the Clayton Act. Z Co.'s complaint alleged that the criminal conspiracy between X Co. and Y Co. forced Z Co. to pay excessive prices for electrical transformers. X Co. and Y Co. each paid Z Co. $85,000 in full settlement of Z Co.'s action. Of each $85,000 paid, $10,000 was attributable to court costs and attorney's fees actually paid by Z Co. Under section 162(g), X Co. and Y Co. are each precluded from deducting as a trade or business expense more than $35,000 of the $85,000 paid to Z Co. in settlement—

$$\$10{,}000 + [(\$85{,}000 - \$10{,}000) \div 3]$$

Example 2. Assume the same facts as in example (1) except that Z Co.'s claim for treble damages was based on a conspiracy to fix and maintain prices in the sale of electrical transformers during 1963. Although the criminal prosecution of the defendants did not involve 1963 (a year barred by the applicable criminal statute of limitations when the prosecution was instituted), Z Co.'s pleadings alleged that the civil statute of limitations had been tolled by the defendants' fraudulent concealment of their conspiracy. Since the United States has obtained both a judgment in a criminal proceeding and an injunction against the defendants in connection with their activities from 1965 to 1970, and the alleged actions of the defendants in 1963 would have contravened such injunction if it were applicable in 1963, the alleged violation in 1963 is related to the violation from 1965 to 1970. Accordingly, the tax consequences to X Co. and Y Co. of the payments of $85,000 in settlement of Z Co.'s claim against X Co. and Y Co. are the same as in example (1).

Example 3. Assume the same facts as in example (1) except that Z Co.'s claim for treble damages was based on a conspiracy to fix and maintain prices with respect to electrical insulators for high-tension power poles. Since the civil action was not based on the same violation of the Federal antitrust laws as the criminal action, or on a related violation (a violation which would have contravened the injunction if it were applicable), X Co. and Y Co. are not precluded by section 162(g) from deducting as a trade or business expense the entire $85,000 paid by each in settlement of the civil action.

[T.D. 7217, 37 FR 23916, Nov. 10, 1972]

§ 1.162–24 Travel expenses of state legislators.

(a) *In general.* For purposes of section 162(a), in the case of any taxpayer who is a state legislator at any time during the taxable year and who makes an election under section 162(h) for the taxable year—

(1) The taxpayer's place of residence within the legislative district represented by the taxpayer is the taxpayer's home for that taxable year;

(2) The taxpayer is deemed to have expended for living expenses (in connection with the taxpayer's trade or business as a legislator) an amount determined by multiplying the number of legislative days of the taxpayer during the taxable year by the greater of—

(i) The amount generally allowable with respect to those days to employees of the state of which the taxpayer is a legislator for per diem while away from home, to the extent the amount does not exceed 110 percent of the amount described in paragraph (a)(2)(ii) of this section; or

(ii) The Federal per diem with respect to those days for the taxpayer's state capital; and

(3) The taxpayer is deemed to be away from home in the pursuit of a trade or business on each legislative day.

(b) *Legislative day.* For purposes of section 162(h)(1) and this section, for any taxpayer who makes an election under section 162(h), a legislative day is any day on which the taxpayer is a state legislator and—

(1) The legislature is in session;

(2) The legislature is not in session for a period that is not longer than 4 consecutive days, without extension for Saturdays, Sundays, or holidays;

(3) The taxpayer's attendance at a meeting of a committee of the legislature is formally recorded; or

(4) The taxpayer's attendance at any session of the legislature that only a limited number of members are expected to attend (such as a *pro forma* session), on any day not described in paragraph (b)(1) or (b)(2) of this section, is formally recorded.

(c) *Fifty mile rule.* Section 162(h) and this section do not apply to any taxpayer who is a state legislator and whose place of residence within the legislative district represented by the taxpayer is 50 or fewer miles from the capitol building of the state. For purposes of this paragraph (c), the distance between the taxpayer's place of residence within the legislative district represented by the taxpayer and the capitol building of the state is the shortest of the more commonly traveled routes between the two points.

(d) *Definitions and special rules.* The following definitions apply for purposes of section 162(h) and this section.

(1) *State legislator.* A taxpayer becomes a state legislator on the day the taxpayer is sworn into office and ceases to be a state legislator on the day following the day on which the taxpayer's term in office ends.

(2) *Living expenses.* Living expenses include lodging, meals, and incidental expenses. *Incidental expenses* has the same meaning as in 41 CFR 300–3.1.

(3) *In session*—(i) *In general.* For purposes of this section, the legislature of which a taxpayer is a member is in session on any day if, at any time during that day, the members of the legislature are expected to attend and participate as an assembled body of the legislature.

(ii) *Examples.* The following examples illustrate the rules of this paragraph (d)(3):

Example 1. B is a member of the legislature of State X. On Day 1, the State X legislature is convened and the members of the legislature are expected to attend and participate. On Day 1, the State X legislature is in session within the meaning of paragraph (d)(3)(i) of this section. B does not attend the session of the State X legislature on Day 1. However, Day 1 is a legislative day for B for purposes of section 162(h)(2)(A) and paragraph (b)(1) of this section.

Example 2. C, D, and E are members of the legislature of State X. On Day 2, the State X legislature is convened for a limited session in which not all members of the legislature are expected to attend and participate. Thus, on Day 2 the legislature is not in session within the meaning of paragraph (d)(3)(i) of this section, and Day 2 is not a legislative day under paragraph (b)(1) of this section. In addition, Day 2 is not a day described in paragraph (b)(2) of this section. C and D are the only members who are called to, and do, attend the limited session on Day 2, and their attendance at the session is formally recorded. E is not called and does not attend. Therefore, Day 2 is a legislative day as to C and D under section 162(h)(2)(B) and paragraph (b)(4) of this section. Day 2 is not a legislative day as to E.

(4) *Committee of the legislature.* A committee of the legislature is any group that includes one or more legislators and that is charged with conducting business of the legislature. Committees of the legislature include, but are not limited to, committees to which the legislature refers bills for consideration, committees that the legislature has authorized to conduct inquiries into matters of public concern, and committees charged with the internal administration of the legislature. For purposes of this section, groups that are not considered committees of the legislature include, but are not limited to, groups that promote particular issues, raise campaign funds, or are caucuses of members of a political party.

(5) *Federal per diem.* The Federal per diem for any city and day is the maximum amount allowable to employees of the executive branch of the Federal government for living expenses while away from home in pursuit of a trade or business in that city on that day. See 5 U.S.C. 5702 and the regulations under that section.

(e) *Election*—(1) *Time for making election.* A taxpayer's election under section 162(h) must be made for each taxable year for which the election is to be in effect and must be made no later than the due date (including extensions) of the taxpayer's Federal income tax return for the taxable year.

(2) *Manner of making election.* A taxpayer makes an election under section 162(h) by attaching a statement to the taxpayer's income tax return for the taxable year for which the election is made. The statement must include—

(i) The taxpayer's name, address, and taxpayer identification number;

(ii) A statement that the taxpayer is making an election under section 162(h); and

(iii) Information establishing that the taxpayer is a state legislator entitled to make the election, for example, a statement identifying the taxpayer's state and legislative district and representing that the taxpayer's place of residence in the legislative district is not 50 or fewer miles from the state capitol building.

(3) *Revocation of election.* An election under section 162(h) may be revoked only with the consent of the Commissioner. An application for consent to revoke an election must be signed by the taxpayer and filed with the submission processing center with which the election was filed, and must include—

(i) The taxpayer's name, address, and taxpayer identification number;

(ii) A statement that the taxpayer is revoking an election under section 162(h) for a specified year; and

(iii) A statement explaining why the taxpayer seeks to revoke the election.

(f) *Effect of election on otherwise deductible expenses for travel away from home*—(1) *Legislative days*—(i) *Living expenses.* For any legislative day for which an election under section 162(h) and this section is in effect, the amount of an electing taxpayer's living expenses while away from home is the greater of the amount of the living expenses—

(A) Specified in paragraph (a)(2) of this section in connection with the trade or business of being a legislator; or

(B) Otherwise allowable under section 162(a)(2) in the pursuit of any trade or business of the taxpayer.

(ii) *Other expenses.* For any legislative day for which an election under section 162(h) and this section is in effect, the amount of an electing taxpayer's expenses (other than living expenses) for travel away from home is the sum of the substantiated expenses, such as expenses for travel fares, telephone calls, and local transportation, that are otherwise deductible under section 162(a)(2) in the pursuit of any trade or business of the taxpayer.

(2) *Non-legislative days.* For any day that is not a legislative day, the amount of an electing taxpayer's expenses (including amounts for living expenses) for travel away from home is the sum of the substantiated expenses that are otherwise deductible under section 162(a)(2) in the pursuit of any trade or business of the taxpayer.

(g) *Cross references.* See § 1.62–1T(e)(4) for rules regarding allocation of unreimbursed expenses of state legislators and section 274(n) for limitations on the amount allowable as a deduction for expenses for or allocable to meals.

(h) *Effective/applicability date.* This section applies to expenses paid or incurred, or deemed expended under section 162(h), in taxable years beginning after *April 8, 2010*.

[T.D. 9481, 75 FR 17856, Apr. 8, 2010]

§ 1.162–25 Deductions with respect to noncash fringe benefits.

(a) [Reserved]

(b) *Employee.* If an employer provides the use of a vehicle (as defined in § 1.61–21(e)(2)) to an employee as a noncash fringe benefit and includes the entire value of the benefit in the employee's gross income without taking into account any exclusion for a working condition fringe allowable under section 132 and the regulations thereunder, the employee may deduct that value multiplied by the percentage of the total use of the vehicle that is in connection with the employer's trade or business (business value). For taxable years beginning before January 1, 1990, the employee may deduct the business value from gross income in determining adjusted gross income. For taxable years beginning on or after January 1, 1990, the employee may deduct the business value only as a miscellaneous itemized deduction in determining taxable income, subject to the 2-percent floor provided in section 67. If the employer determines the value of the noncash fringe benefit under a special accounting rule that allows the employer to treat the value of benefits provided during the last two months of the calendar year or any shorter period as paid during the subsequent calendar year, then the employee must determine the deduction allowable under this paragraph (b) without regard to any use of the benefit during those last two months or any shorter period. The employee may not use a cents-per-mile valuation method to determine the deduction allowable under this paragraph (b).

[T.D. 8451, 57 FR 57669, Dec. 7, 1992; 57 FR 60568, Dec. 21, 1992]

§ 1.162–25T Deductions with respect to noncash fringe benefits (temporary).

(a) *Employer.* If an employer includes the value of a noncash fringe benefit in an employee's gross income, the employer may not deduct this amount as compensation for services, but rather may deduct only the costs incurred by the employer in providing the benefit to the employee. The employer may be allowed a cost recovery deduction under section 168 or a deduction under section 179 for an expense not chargeable to capital account, or, if the noncash fringe benefit is property leased by the employer, a deduction for the ordinary and necessary business expense of leasing the property.

(b) [Reserved]

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

(1) On January 1, 1986, X Company owns and provides the use of an automobile with a fair market value of $20,000 to E, an employee, for the entire calendar year. Both X and E compute taxable income on the basis of the calendar year. Seventy percent of the use of the automobile by E is in connection with X's trade or business. If X uses the special rule provided in § 1.61–21(d) for valuing the availability of the automobile and takes into account the amount excludable as a working condition fringe, X would include $1,680 ($5,600, the Annual Lease Value, less 70 percent of $5,600) in E's gross income for 1986. X may not deduct the amount included in E's income as compensation for services. X may, however, determine a cost recovery deduction under section 168, subject to the limitations under section 280F, for taxable year 1986.

(2) The facts are the same as in *Example (1)* of paragraph (c)(1) of this section, except that X includes $5,600 in E's gross income, the value of the noncash fringe benefit without taking into account the amount excludable as a working condition fringe. X may not deduct that amount as compensation for services, but may determine a cost recovery deduction under section 168, subject to the limitations under section 280F. For purposes of determining adjusted gross income, E may deduct $3,920 ($5,600 multiplied by the percent of business use).

[T.D. 8061, 50 FR 46013, Nov. 6, 1985, as amended by T.D. 8063, 50 FR 52312, Dec. 23, 1985; T.D. 8276, 54 FR 51026, Dec. 12, 1989; T.D. 8451, 57 FR 57669, Dec. 7, 1992; T.D. 9849, 84 FR 9233, Mar. 14, 2019]

§ 1.162–27 Certain employee remuneration in excess of $1,000,000 not deductible for taxable years beginning on or after January 1, 1994, and for taxable years beginning prior to January 1, 2018.

(a) *Scope.* This section provides rules for the application of the $1 million deduction limitation under section 162(m)(1) for taxable years beginning on or after January 1, 1994, and beginning prior to January 1, 2018, and, as provided in paragraph (j) of this section, for taxable years beginning after December 31, 2017. For rules concerning the applicability of section 162(m)(1) to taxable years beginning after December 31, 2017, see § 1.162–33. Paragraph (b) of this section provides the general rule limiting deductions under section 162(m)(1). Paragraph (c) of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides an exception from the deduction limitation for compensation payable on a commission basis. Paragraph (e) of this section provides an exception for qualified performance-based compensation. Paragraphs (f) and (g) of this section provide special rules for corporations that become publicly held corporations and payments that are subject to section 280G, respectively. Paragraph (h) of this section provides transition rules, including the rules for contracts that are grandfathered and not subject to section 162(m)(1). Paragraph (j) of this section contains the effective date provisions, which also specify when these rules apply to the deduction for compensation otherwise deductible in a taxable year beginning after December 31, 2017. For rules concerning the deductibility of compensation for services that are not covered by section 162(m)(1) and this section, see section 162(a)(1) and § 1.162–7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1). For rules concerning the deduction limitation under section 162(m)(6) applicable to certain health insurance providers, see § 1.162–31.

(b) *Limitation on deduction.* Section 162(m) precludes a deduction under chapter 1 of the Internal Revenue Code by any publicly held corporation for compensation paid to any covered employee to the extent that the compensation for the taxable year exceeds $1,000,000.

(c) *Definitions*—(1) *Publicly held corporation*—(i) *General rule.* A *publicly held corporation* means any corporation issuing any class of common equity securities required to be registered under section 12 of the Exchange Act. A corporation is not considered publicly held if the registration of its equity securities is voluntary. For purposes of this section, whether a corporation is publicly held is determined based solely on whether, as of the last day of its taxable year, the corporation is subject to the reporting obligations of section 12 of the Exchange Act.

(ii) *Affiliated groups.* A publicly held corporation includes an affiliated group of corporations, as defined in section 1504 (determined without regard to section 1504(b)). For purposes of this section, however, an affiliated group of corporations does not include any subsidiary that is itself a publicly held corporation. Such a publicly held subsidiary, and its subsidiaries (if any), are separately subject to this section. If a covered employee is paid compensation in a taxable year by more than one member of an affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the group. Any amount disallowed as a deduction by this section must be prorated among the payor corporations in proportion to the amount of compensation paid to the covered employee by each such corporation in the taxable year.

(2) *Covered employee*—(i) *General rule.* A *covered employee* means any individual who, on the last day of the taxable year, is—

(A) The chief executive officer of the corporation or is acting in such capacity; or

(B) Among the four highest compensated officers (other than the chief executive officer).

(ii) *Application of rules of the Securities and Exchange Commission.* Whether an individual is the chief executive officer described in paragraph (c)(2)(i)(A) of this section or an officer described in paragraph (c)(2)(i)(B) of this section is determined pursuant to the executive compensation disclosure rules under the Exchange Act.

(3) *Compensation*—(i) *In general.* For purposes of the deduction limitation described in paragraph (b) of this section, *compensation* means the aggregate amount allowable as a deduction under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to section 162(m)) for remuneration for services performed by a covered employee, whether or not the services were performed during the taxable year.

(ii) *Exceptions. Compensation* does not include—

(A) Remuneration covered in section 3121(a)(5)(A) through section 3121(a)(5)(D) (concerning remuneration that is not treated as *wages* for purposes of the Federal Insurance Contributions Act); and

(B) Remuneration consisting of any benefit provided to or on behalf of an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude it from gross income. In addition, compensation does not include salary reduction contributions described in section 3121(v)(1).

(4) *Compensation Committee.* The *compensation committee* means the committee of directors (including any subcommittee of directors) of the publicly held corporation that has the authority to establish and administer performance goals described in paragraph (e)(2) of this section, and to certify that performance goals are attained, as described in paragraph (e)(5) of this section. A committee of directors is not treated as failing to have the authority to establish performance goals merely because the goals are ratified by the board of directors of the publicly held corporation or, if applicable, any other committee of the board of directors. See paragraph (e)(3) of this section for rules concerning the composition of the compensation committee.

(5) *Exchange Act.* The *Exchange Act* means the Securities Exchange Act of 1934.

(6) *Examples.* This paragraph (c) may be illustrated by the following examples:

Example 1. Corporation X is a publicly held corporation with a July 1 to June 30 fiscal year. For Corporation X's taxable year ending on June 30, 1995, Corporation X pays compensation of $2,000,000 to A, an employee. However, A's compensation is not required to be reported to shareholders under the executive compensation disclosure rules of the Exchange Act because A is neither the chief executive officer nor one of the four highest compensated officers employed on the last day of the taxable year. A's compensation is not subject to the deduction limitation of paragraph (b) of this section.

Example 2. C, a covered employee, performs services and receives compensation from Corporations X, Y, and Z, members of an affiliated group of corporations. Corporation X, the parent corporation, is a publicly held corporation. The total compensation paid to C from all affiliated group members is $3,000,000 for the taxable year, of which Corporation X pays $1,500,000; Corporation Y pays $900,000; and Corporation Z pays $600,000. Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m), $2,000,000 of the aggregate compensation paid is nondeductible. Corporations X, Y, and Z each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation X has a nondeductible compensation expense of $1,000,000 ($1,500,000 × $2,000,000/$3,000,000). Corporation Y has a nondeductible compensation expense of $600,000 ($900,000 × $2,000,000/$3,000,000). Corporation Z has a nondeductible compensation expense of $400,000 ($600,000 × $2,000,000/$3,000,000).

Example 3. Corporation W, a calendar year taxpayer, has total assets equal to or exceeding $5 million and a class of equity security held of record by 500 or more persons on December 31, 1994. However, under the Exchange Act, Corporation W is not required to file a registration statement with respect to that security until April 30, 1995. Thus, Corporation W is not a publicly held corporation on December 31, 1994, but is a publicly held corporation on December 31, 1995.

Example 4. The facts are the same as in *Example 3,* except that on December 15, 1996, Corporation W files with the Securities and Exchange Commission to disclose that Corporation W is no longer required to be registered under section 12 of the Exchange Act and to terminate its registration of securities under that provision. Because Corporation W is no longer subject to Exchange Act reporting obligations as of December 31, 1996, Corporation W is not a publicly held corporation for taxable year 1996, even though the registration of Corporation W's securities does not terminate until 90 days after Corporation W files with the Securities and Exchange Commission.

(d) *Exception for compensation paid on a commission basis.* The deduction limit in paragraph (b) of this section shall not apply to any compensation paid on a commission basis. For this purpose, compensation is paid on a commission basis if the facts and circumstances show that it is paid solely on account of income generated directly by the individual performance of the individual to whom the compensation is paid. Compensation does not fail to be attributable directly to the individual merely because support services, such as secretarial or research services, are utilized in generating the income. However, if compensation is paid on account of broader performance standards, such as income produced by a business unit of the corporation, the compensation does not qualify for the exception provided under this paragraph (d).

(e) *Exception for qualified performance-based compensation*—

(1) *In general.* The deduction limit in paragraph (b) of this section does not apply to qualified performance-based compensation. Qualified performance-based compensation is compensation that meets all of the requirements of paragraphs (e)(2) through (e)(5) of this section.

(2) *Performance goal requirement*—(i) *Preestablished goal.* Qualified performance-based compensation must be paid solely on account of the attainment of one or more preestablished, objective performance goals. A performance goal is considered preestablished if it is established in writing by the compensation committee not later than 90 days after the commencement of the period of service to which the performance goal relates, provided that the outcome is substantially uncertain at the time the compensation committee actually establishes the goal. However, in no event will a performance goal be considered to be preestablished if it is established after 25 percent of the period of service (as scheduled in good faith at the time the goal is established) has elapsed. A performance goal is objective if a third party having knowledge of the relevant facts could determine whether the goal is met. Performance goals can be based on one or more business criteria that apply to the individual, a business unit, or the corporation as a whole. Such business criteria could include, for example, stock price, market share, sales, earnings per share, return on equity, or costs. A performance goal need not, however, be based upon an increase or positive result under a business criterion and could include, for example, maintaining the status quo or limiting economic losses (measured, in each case, by reference to a specific business criterion). A performance goal does not include the mere continued employment of the covered employee. Thus, a vesting provision based solely on continued employment would not constitute a performance goal. See paragraph (e)(2)(vi) of this section for rules on compensation that is based on an increase in the price of stock.

(ii) *Objective compensation formula.* A preestablished performance goal must state, in terms of an objective formula or standard, the method for computing the amount of compensation payable to the employee if the goal is attained. A formula or standard is objective if a third party having knowledge of the relevant performance results could calculate the amount to be paid to the employee. In addition, a formula or standard must specify the individual employees or class of employees to which it applies.

(iii) *Discretion.* (A) The terms of an objective formula or standard must preclude discretion to increase the amount of compensation payable that would otherwise be due upon attainment of the goal. A performance goal is not discretionary for purposes of this paragraph (e)(2)(iii) merely because the compensation committee reduces or eliminates the compensation or other economic benefit that was due upon attainment of the goal. However, the exercise of negative discretion with respect to one employee is not permitted to result in an increase in the amount payable to another employee. Thus, for example, in the case of a bonus pool, if the amount payable to each employee is stated in terms of a percentage of the pool, the sum of these individual percentages of the pool is not permitted to exceed 100 percent. If the terms of an objective formula or standard fail to preclude discretion to increase the amount of compensation merely because the amount of compensation to be paid upon attainment of the performance goal is based, in whole or in part, on a percentage of salary or base pay and the dollar amount of the salary or base pay is not fixed at the time the performance goal is established, then the objective formula or standard will not be considered discretionary for purposes of this paragraph (e)(2)(iii) if the maximum dollar amount to be paid is fixed at that time.

(B) If compensation is payable upon or after the attainment of a performance goal, and a change is made to accelerate the payment of compensation to an earlier date after the attainment of the goal, the change will be treated as an increase in the amount of compensation, unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If compensation is payable upon or after the attainment of a performance goal, and a change is made to defer the payment of compensation to a later date, any amount paid in excess of the amount that was originally owed to the employee will not be treated as an increase in the amount of compensation if the additional amount is based either on a reasonable rate of interest or on one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of a specific investment (including any decrease as well as any increase in the value of an investment). If compensation is payable in the form of property, a change in the timing of the transfer of that property after the attainment of the goal will not be treated as an increase in the amount of compensation for purposes of this paragraph (e)(2)(iii). Thus, for example, if the terms of a stock grant provide for stock to be transferred after the attainment of a performance goal and the transfer of the stock also is subject to a vesting schedule, a change in the vesting schedule that either accelerates or defers the transfer of stock will not be treated as an increase in the amount of compensation payable under the performance goal.

(C) Compensation attributable to a stock option, stock appreciation right, or other stock-based compensation does not fail to satisfy the requirements of this paragraph (e)(2) to the extent that a change in the grant or award is made to reflect a change in corporate capitalization, such as a stock split or dividend, or a corporate transaction, such as any merger of a corporation into another corporation, any consolidation of two or more corporations into another corporation, any separation of a corporation (including a spinoff or other distribution of stock or property by a corporation), any reorganization of a corporation (whether or not such reorganization comes within the definition of such term in section 368), or any partial or complete liquidation by a corporation.

(iv) *Grant-by-grant determination.* The determination of whether compensation satisfies the requirements of this paragraph (e)(2) generally shall be made on a grant-by-grant basis. Thus, for example, whether compensation attributable to a stock option grant satisfies the requirements of this paragraph (e)(2) generally is determined on the basis of the particular grant made and without regard to the terms of any other option grant, or other grant of compensation, to the same or another employee. As a further example, except as provided in paragraph (e)(2)(vi), whether a grant of restricted stock or other stock-based compensation satisfies the requirements of this paragraph (e)(2) is determined without regard to whether dividends, dividend equivalents, or other similar distributions with respect to stock, on such stock-based compensation are payable prior to the attainment of the performance goal. Dividends, dividend equivalents, or other similar distributions with respect to stock that are treated as separate grants under this paragraph (e)(2)(iv) are not performance-based compensation unless they separately satisfy the requirements of this paragraph (e)(2).

(v) *Compensation contingent upon attainment of performance goal.* Compensation does not satisfy the requirements of this paragraph (e)(2) if the facts and circumstances indicate that the employee would receive all or part of the compensation regardless of whether the performance goal is attained. Thus, if the payment of compensation under a grant or award is only nominally or partially contingent on attaining a performance goal, none of the compensation payable under the grant or award will be considered performance-based. For example, if an employee is entitled to a bonus under either of two arrangements, where payment under a nonperformance-based arrangement is contingent upon the failure to attain the performance goals under an otherwise performance-based arrangement, then neither arrangement provides for compensation that satisfies the requirements of this paragraph (e)(2). Compensation does not fail to be qualified performance-based compensation merely because the plan allows the compensation to be payable upon death, disability, or change of ownership or control, although compensation actually paid on account of those events prior to the attainment of the performance goal would not satisfy the requirements of this paragraph (e)(2). As an exception to the general rule set forth in the first sentence of paragraph (e)(2)(iv) of this section, the facts-and-circumstances determination referred to in the first sentence of this paragraph (e)(2)(v) is made taking into account all plans, arrangements, and agreements that provide for compensation to the employee.

(vi) *Application of requirements to stock options and stock appreciation rights*—(A) *In general.* Compensation attributable to a stock option or a stock appreciation right is deemed to satisfy the requirements of this paragraph (e)(2) if the grant or award is made by the compensation committee; the plan under which the option or right is granted states the maximum number of shares with respect to which options or rights may be granted during a specified period to any individual employee; and, under the terms of the option or right, the amount of compensation the employee may receive is based solely on an increase in the value of the stock after the date of the grant or award. A plan may satisfy the requirement to provide a maximum number of shares with respect to which stock options and stock appreciation rights may be granted to any individual employee during a specified period if the plan specifies an aggregate maximum number of shares with respect to which stock options, stock appreciation rights, restricted stock, restricted stock units and other equity-based awards that may be granted to any individual employee during a specified period under a plan approved by shareholders in accordance with §1.162–27(e)(4). If the amount of compensation the employee may receive under the grant or award is not based solely on an increase in the value of the stock after the date of grant or award (for example, in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation under this paragraph (e)(2)(vi)(A). Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent that may be payable, provided that payment of the dividend equivalent is not made contingent on the exercise of the option. The rule that the compensation attributable to a stock option or stock appreciation right must be based solely on an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exercisability of the grant or award is contingent on, the attainment of a performance goal that satisfies the requirements of this paragraph (e)(2).

(B) *Cancellation and repricing.* Compensation attributable to a stock option or stock appreciation right does not satisfy the requirements of this paragraph (e)(2) to the extent that the number of options granted exceeds the maximum number of shares for which options may be granted to the employee as specified in the plan. If an option is canceled, the canceled option continues to be counted against the maximum number of shares for which options may be granted to the employee under the plan. If, after grant, the exercise price of an option is reduced, the transaction is treated as a cancellation of the option and a grant of a new option. In such case, both the option that is deemed to be canceled and the option that is deemed to be granted reduce the maximum number of shares for which options may be granted to the employee under the plan. This paragraph (e)(2)(vi)(B) also applies in the case of a stock appreciation right where, after the award is made, the base amount on which stock appreciation is calculated is reduced to reflect a reduction in the fair market value of stock.

(vii) *Examples.* This paragraph (e)(2) may be illustrated by the following examples:

Example 1. No later than 90 days after the start of a fiscal year, but while the outcome is substantially uncertain, Corporation S establishes a bonus plan under which A, the chief executive officer, will receive a cash bonus of $500,000, if year-end corporate sales are increased by at least 5 percent. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to A if, in its judgment, other subjective factors warrant a reduction. The bonus will meet the requirements of this paragraph (e)(2).

Example 2. The facts are the same as in *Example 1*, except that the bonus is based on a percentage of Corporation S's total sales for the fiscal year. Because Corporation S is virtually certain to have some sales for the fiscal year, the outcome of the performance goal is not substantially uncertain, and therefore the bonus does not meet the requirements of this paragraph (e)(2).

Example 3. The facts are the same as in *Example 1*, except that the bonus is based on a percentage of Corporation S's total profits for the fiscal year. Although some sales are virtually certain for virtually all public companies, it is substantially uncertain whether a company will have profits for a specified future period even if the company has a history of profitability. Therefore, the bonus will meet the requirements of this paragraph (e)(2).

Example 4. B is the general counsel of Corporation R, which is engaged in patent litigation with Corporation S. Representatives of Corporation S have informally indicated to Corporation R a willingness to settle the litigation for $50,000,000. Subsequently, the compensation committee of Corporation R agrees to pay B a bonus if B obtains a formal settlement for at least $50,000,000. The bonus to B does not meet the requirement of this paragraph (e)(2) because the performance goal was not established at a time when the outcome was substantially uncertain.

Example 5. Corporation S, a public utility, adopts a bonus plan for selected salaried employees that will pay a bonus at the end of a 3-year period of $750,000 each if, at the end of the 3 years, the price of S stock has increased by 10 percent. The plan also provides that the 10-percent goal will automatically adjust upward or downward by the percentage change in a published utilities index. Thus, for example, if the published utilities index shows a net increase of 5 percent over a 3-year period, then the salaried employees would receive a bonus only if Corporation S stock has increased by 15 percent. Conversely, if the published utilities index shows a net decrease of 5 percent over a 3-year period, then the salaried employees would receive a bonus if Corporation S stock has increased by 5 percent. Because these automatic adjustments in the performance goal are preestablished, the bonus meets the requirement of this paragraph (e)(2), notwithstanding the potential changes in the performance goal.

Example 6. The facts are the same as in *Example 5*, except that the bonus plan provides that, at the end of the 3-year period, a bonus of $750,000 will be paid to each salaried employee if either the price of Corporation S stock has increased by 10 percent or the earnings per share on Corporation S stock have increased by 5 percent. If both the earnings-per-share goal and the stock-price goal are preestablished, the compensation committee's discretion to choose to pay a bonus under either of the two goals does not cause any bonus paid under the plan to fail to meet the requirement of this paragraph (e)(2) because each goal independently meets the requirements of this paragraph (e)(2). The choice to pay under either of the two goals is tantamount to the discretion to choose not to pay under one of the goals, as provided in paragraph (e)(2)(iii) of this section.

Example 7. Corporation U establishes a bonus plan under which a specified class of employees will participate in a bonus pool if certain preestablished performance goals are attained. The amount of the bonus pool is determined under an objective formula. Under the terms of the bonus plan, the compensation committee retains the discretion to determine the fraction of the bonus pool that each employee may receive. The bonus plan does not satisfy the requirements of this paragraph (e)(2). Although the aggregate amount of the bonus plan is determined under an objective formula, a third party could not determine the amount that any individual could receive under the plan.

Example 8. The facts are the same as in *Example 7*, except that the bonus plan provides that a specified share of the bonus pool is payable to each employee, and the total of these shares does not exceed 100% of the pool. The bonus plan satisfies the requirements of this paragraph (e)(2). In addition, the bonus plan will satisfy the requirements of this paragraph (e)(2) even if the compensation committee retains the discretion to reduce the compensation payable to any individual employee, provided that a reduction in the amount of one employee's bonus does not result in an increase in the amount of any other employee's bonus.

Example 9. Corporation V establishes a stock option plan for salaried employees. The terms of the stock option plan specify that no individual salaried employee shall receive options for more than 100,000 shares over any 3-year period. The compensation committee grants options for 50,000 shares to each of several salaried employees. The exercise price of each option is equal to or greater than the fair market value of a share of V stock at the time of each grant. Compensation attributable to the exercise of the options satisfies the requirements of paragraph (e)(2)(vi) of this section. If, however, the terms of the options provide that the exercise price is less than fair market value of a share of V stock at the date of grant, no compensation attributable to the exercise of those options satisfies the requirements of this paragraph (e)(2) unless issuance or exercise of the options was contingent upon the attainment of a preestablished performance goal that satisfies this paragraph (e)(2). If, however, the terms of the plan also provide that Corporation V could grant options to purchase no more than 900,000 shares over any 3-year period, but did not provide a limitation on the number of shares that any individual employee could purchase, then no compensation attributable to the exercise of those options satisfies the requirements of paragraph (e)(2)(vi) of this section.

Example 10. The facts are the same as in *Example 9*, except that, within the same 3-year grant period, the fair market value of Corporation V stock is significantly less than the exercise price of the options. The compensation committee reprices those options to that lower current fair market value of Corporation V stock. The repricing of the options for 50,000 shares held by each salaried employee is treated as the grant of new options for an additional 50,000 shares to each employee. Thus, each of the salaried employees is treated as having received grants for 100,000 shares. Consequently, if any additional options are granted to those employees during the 3-year period, compensation attributable to the exercise of those additional options would not satisfy the requirements of this paragraph (e)(2). The results would be the same if the compensation committee canceled the outstanding options and issued new options to the same employees that were exercisable at the fair market value of Corporation V stock on the date of reissue.

Example 11. Corporation W maintains a plan under which each participating employee may receive incentive stock options, nonqualified stock options, stock appreciation rights, or grants of restricted Corporation W stock. The plan specifies that each participating employee may receive options, stock appreciation rights, restricted stock, or any combination of each, for no more than 20,000 shares over the life of the plan. The plan provides that stock options may be granted with an exercise price of less than, equal to, or greater than fair market value on the date of grant. Options granted with an exercise price equal to, or greater than, fair market value on the date of grant do not fail to meet the requirements of this paragraph (e)(2) merely because the compensation committee has the discretion to determine the types of awards (*i.e.*, options, rights, or restricted stock) to be granted to each employee or the discretion to issue options or make other compensation awards under the plan that would not meet the requirements of this paragraph (e)(2). Whether an option granted under the plan satisfies the requirements of this paragraph (e)(2) is determined on the basis of the specific terms of the option and without regard to other options or awards under the plan.

Example 12. Corporation X maintains a plan under which stock appreciation rights may be awarded to key employees. The plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price plus a percentage "gross up" intended to offset the tax liability of the employee. In addition, the plan permits the compensation committee to make awards under which the amount of compensation payable to the employee is equal to the increase in the stock price, based on the highest price, which is defined as the highest price paid for Corporation X stock (or offered in a tender offer or other arms-length offer) during the 90 days preceding exercise. Compensation attributable to awards under the plan satisfies the requirements of paragraph (e)(2)(vi) of this section, provided that the terms of the plan specify the maximum number of shares for which awards may be made.

Example 13. Corporation W adopts a plan under which a bonus will be paid to the CEO only if there is a 10% increase in earnings per share during the performance period. The plan provides that earnings per share will be calculated without regard to any change in accounting standards that may be required by the Financial Accounting Standards Board after the goal is established. After the goal is established, such a change in accounting standards occurs. Corporation W's reported earnings, for purposes of determining earnings per share under the plan, are adjusted pursuant to this plan provision to factor out this change in standards. This adjustment will not be considered an exercise of impermissible discretion because it is made pursuant to the plan provision.

Example 14. Corporation X adopts a performance-based incentive pay plan with a four-year performance period. Bonuses under the plan are scheduled to be paid in the first year after the end of the performance period (year 5). However, in the second year of the performance period, the compensation committee determines that any bonuses payable in year 5 will instead, for bona fide business reasons, be paid in year 10. The compensation committee also determines that any compensation that would have been payable in year 5 will be adjusted to reflect the delay in payment. The adjustment will be based on the greater of the future rate of return of a specified mutual fund that invests in blue chip stocks or of a specified venture capital investment over the five-year deferral period. Each of these investments, considered by itself, is a predetermined actual investment because it is based on the future rate of return of an actual investment. However, the adjustment in this case is not based on predetermined actual investments within the meaning of paragraph (e)(2)(iii)(B) of this section because the amount payable by Corporation X in year 10 will be based on the greater of the two investment returns and, thus, will not be based on the actual rate of return on either specific investment.

Example 15. The facts are the same as in *Example 14*, except that the increase will be based on Moody's Average Corporate Bond Yield over the five-year deferral period. Because this index reflects a reasonable rate of interest, the increase in the compensation payable that is based on the index's rate of return is not considered an impermissible increase in the amount of compensation payable under the formula.

Example 16. The facts are the same as in *Example 14*, except that the increase will be based on the rate of return for the Standard & Poor's 500 Index. This index does not measure interest rates and thus does not represent a reasonable rate of interest. In addition, this index does not represent an actual investment. Therefore, any additional compensation payable based on the rate of return of this index will result in an impermissible increase in the amount payable under the formula. If, in contrast, the increase were based on the rate of return of an existing mutual fund that is invested in a manner that seeks to approximate the Standard & Poor's 500 Index, the increase would be based on a predetermined actual investment within the meaning of paragraph (e)(2)(iii)(B) of this section and thus would not result in an impermissible increase in the amount payable under the formula.

(3) *Outside directors*—(i) *General rule.* The performance goal under which compensation is paid must be established by a compensation committee comprised solely of two or more outside directors. A director is an outside director if the director—

(A) Is not a current employee of the publicly held corporation;

(B) Is not a former employee of the publicly held corporation who receives compensation for prior services (other than benefits under a tax-qualified retirement plan) during the taxable year;

(C) Has not been an officer of the publicly held corporation; and

(D) Does not receive remuneration from the publicly held corporation, either directly or indirectly, in any capacity other than as a director. For this purpose, remuneration includes any payment in exchange for goods or services.

(ii) *Remuneration received.* For purposes of this paragraph (e)(3), remuneration is received, directly or indirectly, by a director in each of the following circumstances:

(A) If remuneration is paid, directly or indirectly, to the director personally or to an entity in which the director has a beneficial ownership interest of greater than 50 percent. For this purpose, remuneration is considered paid when actually paid (and throughout the remainder of that taxable year of the corporation) and, if earlier, throughout the period when a contract or agreement to pay remuneration is outstanding.

(B) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity in which the director has a beneficial ownership interest of at least 5 percent but not more than 50 percent. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(C) If remuneration, other than de minimis remuneration, was paid by the publicly held corporation in its preceding taxable year to an entity by which the director is employed or self-employed other than as a director. For this purpose, remuneration is considered paid when actually paid or, if earlier, when the publicly held corporation becomes liable to pay it.

(iii) *De minimis remuneration*—(A) *In general.* For purposes of paragraphs (e)(3)(ii)(B) and (C) of this section, remuneration that was paid by the publicly held corporation in its preceding taxable year to an entity is de minimis if payments to the entity did not exceed 5 percent of the gross revenue of the entity for its taxable year ending with or within that preceding taxable year of the publicly held corporation.

(B) *Remuneration for personal services and substantial owners.* Notwithstanding paragraph (e)(3)(iii)(A) of this section, remuneration in excess of $60,000 is not de minimis if the remuneration is paid to an entity described in paragraph (e)(3)(ii)(B) of this section, or is paid for personal services to an entity described in paragraph (e)(3)(ii)(C) of this section.

(iv) *Remuneration for personal services.* For purposes of paragraph (e)(3)(iii)(B) of this section, remuneration from a publicly held corporation is for personal services if—

(A) The remuneration is paid to an entity for personal or professional services, consisting of legal, accounting, investment banking, and management consulting services (and other similar services that may be specified by the Commissioner in revenue rulings, notices, or other guidance published in the Internal Revenue Bulletin), performed for the publicly held corporation, and the remuneration is not for services that are incidental to the purchase of goods or to the purchase of services that are not personal services; and

(B) The director performs significant services (whether or not as an employee) for the corporation, division, or similar organization (within the entity) that actually provides the services described in paragraph (e)(3)(iv)(A) of this section to the publicly held corporation, or more than 50 percent of the entity's gross revenues (for the entity's preceding taxable year) are derived from that corporation, subsidiary, or similar organization.

(v) *Entity defined.* For purposes of this paragraph (e)(3), entity means an organization that is a sole proprietorship, trust, estate, partnership, or corporation. The term also includes an affiliated group of corporations as defined in section 1504 (determined without regard to section 1504(b)) and a group of organizations that would be an affiliated group but for the fact that one or more of the organizations are not incorporated. However, the aggregation rules referred to in the preceding sentence do not apply for purposes of determining whether a director has a beneficial ownership interest of at least 5 percent or greater than 50 percent.

(vi) *Employees and former officers.* Whether a director is an employee or a former officer is determined on the basis of the facts at the time that the individual is serving as a director on the compensation committee. Thus, a director is not precluded from being an outside director solely because the director is a former officer of a corporation that previously was an affiliated corporation of the publicly held corporation. For example, a director of a parent corporation of an affiliated group is not precluded from being an outside director solely because that director is a former officer of an affiliated subsidiary that was spun off or liquidated. However, an outside director would no longer be an outside director if a corporation in which the director was previously an officer became an affiliated corporation of the publicly held corporation.

(vii) *Officer*. Solely for purposes of this paragraph (e)(3), *officer* means an administrative executive who is or was in regular and continued service. The term implies continuity of service and excludes those employed for a special and single transaction. An individual who merely has (or had) the title of officer but not the authority of an officer is not considered an officer. The determination of whether an individual is or was an officer is based on all of the facts and circumstances in the particular case, including without limitation the source of the individual's authority, the term for which the individual is elected or appointed, and the nature and extent of the individual's duties.

(viii) *Members of affiliated groups*. For purposes of this paragraph (e)(3), the outside directors of the publicly held member of an affiliated group are treated as the outside directors of all members of the affiliated group.

(ix) *Examples*. This paragraph (e)(3) may be illustrated by the following examples:

Example 1. Corporations X and Y are members of an affiliated group of corporations as defined in section 1504, until July 1, 1994, when Y is sold to another group. Prior to the sale, A served as an officer of Corporation Y. After July 1, 1994, A is not treated as a former officer of Corporation X by reason of having been an officer of Y.

Example 2. Corporation Z, a calendar-year taxpayer, uses the services of a law firm by which B is employed, but in which B has a less-than-5-percent ownership interest. The law firm reports income on a July 1 to June 30 basis. Corporation Z appoints B to serve on its compensation committee for calendar year 1998 after determining that, in calendar year 1997, it did not become liable to the law firm for remuneration exceeding the lesser of $60,000 or five percent of the law firm's gross revenue (calculated for the year ending June 30, 1997). On October 1, 1998, Corporation Z becomes liable to pay remuneration of $50,000 to the law firm on June 30, 1999. For the year ending June 30, 1998, the law firm's gross revenue was less than $1 million. Thus, in calendar year 1999, B is not an outside director. However, B may satisfy the requirements for an outside director in calendar year 2000, if, in calendar year 1999, Corporation Z does not become liable to the law firm for additional remuneration. This is because the remuneration actually paid on June 30, 1999 was considered paid on October 1, 1998 under paragraph (e)(3)(ii)(C) of this section.

Example 3. Corporation Z, a publicly held corporation, purchases goods from Corporation A. D, an executive and less- than-5-percent owner of Corporation A, sits on the board of directors of Corporation Z and on its compensation committee. For 1997, Corporation Z obtains representations to the effect that D is not eligible for any commission for D's sales to Corporation Z and that, for purposes of determining D's compensation for 1997, Corporation A's sales to Corporation Z are not otherwise treated differently than sales to other customers of Corporation A (including its affiliates, if any) or are irrelevant. In addition, Corporation Z has no reason to believe that these representations are inaccurate or that it is otherwise paying remuneration indirectly to D personally. Thus, in 1997, no remuneration is considered paid by Corporation Z indirectly to D personally under paragraph (e)(3)(ii)(A) of this section.

Example 4. (i) Corporation W, a publicly held corporation, purchases goods from Corporation T. C, an executive and less- than-5-percent owner of Corporation T, sits on the board of directors of Corporation W and on its compensation committee. Corporation T develops a new product and agrees on January 1, 1998 to pay C a bonus of $500,000 if Corporation W contracts to purchase the product. Even if Corporation W purchases the new product, sales to Corporation W will represent less than 5 percent of Corporation T's gross revenues. In 1999, Corporation W contracts to purchase the new product and, in 2000, C receives the $500,000 bonus from Corporation T. In 1998, 1999, and 2000, Corporation W does not obtain any representations relating to indirect remuneration to C personally (such as the representations described in *Example 3*).

(ii) Thus, in 1998, 1999, and 2000, remuneration is considered paid by Corporation W indirectly to C personally under paragraph (e)(3)(ii)(A) of this section. Accordingly, in 1998, 1999, and 2000, C is not an outside director of Corporation W. The result would have been the same if Corporation W had obtained appropriate representations but nevertheless had reason to believe that it was paying remuneration indirectly to C personally.

Example 5. Corporation R, a publicly held corporation, purchases utility service from Corporation Q, a public utility. The chief executive officer, and less-than-5-percent owner, of Corporation Q is a director of Corporation R. Corporation R pays Corporation Q more than $60,000 per year for the utility service, but less than 5 percent of Corporation Q's gross revenues. Because utility services are not personal services, the fees paid are not subject to the $60,000 de minimis rule for remuneration for personal services within the meaning of paragraph (e)(3)(iii)(B) of this section. Thus, the chief executive officer qualifies as an outside director of Corporation R, unless disqualified on some other basis.

Example 6. Corporation A, a publicly held corporation, purchases management consulting services from Division S of Conglomerate P. The chief financial officer of Division S is a director of Corporation A. Corporation A pays more than $60,000 per year for the management consulting services, but less than 5 percent of Conglomerate P's gross revenues. Because management consulting services are personal services within the meaning of paragraph (e)(3)(iv)(A) of this section, and the chief financial officer performs significant services for Division S, the fees paid are subject to the $60,000 de minimis rule as remuneration for personal services. Thus, the chief financial officer does not qualify as an outside director of Corporation A.

Example 7. The facts are the same as in *Example 6,* except that the chief executive officer, and less-than-5-percent owner, of the parent company of Conglomerate P is a director of Corporation A and does not perform significant services for Division S. If the gross revenues of Division S do not constitute more than 50 percent of the gross revenues of Conglomerate P for P's preceding taxable year, the chief executive officer will qualify as an outside director of Corporation A, unless disqualified on some other basis.

(4) *Shareholder approval requirement*—(i) *General rule.* The material terms of the performance goal under which the compensation is to be paid must be disclosed to and subsequently approved by the shareholders of the publicly held corporation before the compensation is paid. The requirements of this paragraph (e)(4) are not satisfied if the compensation would be paid regardless of whether the material terms are approved by shareholders. The material terms include the employees eligible to receive compensation; a description of the business criteria on which the performance goal is based; and either the maximum amount of compensation that could be paid to any employee or the formula used to calculate the amount of compensation to be paid to the employee if the performance goal is attained (except that, in the case of a formula based, in whole or in part, on a percentage of salary or base pay, the maximum dollar amount of compensation that could be paid to the employee must be disclosed).

(ii) *Eligible employees.* Disclosure of the employees eligible to receive compensation need not be so specific as to identify the particular individuals by name. A general description of the class of eligible employees by title or class is sufficient, such as the chief executive officer and vice presidents, or all salaried employees, all executive officers, or all key employees.

(iii) *Description of business criteria*—(A) *In general.* Disclosure of the business criteria on which the performance goal is based need not include the specific targets that must be satisfied under the performance goal. For example, if a bonus plan provides that a bonus will be paid if earnings per share increase by 10 percent, the 10-percent figure is a target that need not be disclosed to shareholders. However, in that case, disclosure must be made that the bonus plan is based on an earnings-per-share business criterion. In the case of a plan under which employees may be granted stock options or stock appreciation rights, no specific description of the business criteria is required if the grants or awards are based on a stock price that is no less than current fair market value.

(B) *Disclosure of confidential information.* The requirements of this paragraph (e)(4) may be satisfied even though information that otherwise would be a material term of a performance goal is not disclosed to shareholders, provided that the compensation committee determines that the information is confidential commercial or business information, the disclosure of which would have an adverse effect on the publicly held corporation. Whether disclosure would adversely affect the corporation is determined on the basis of the facts and circumstances. If the compensation committee makes such a determination, the disclosure to shareholders must state the compensation committee's belief that the information is confidential commercial or business information, the disclosure of which would adversely affect the company. In addition, the ability not to disclose confidential information does not eliminate the requirement that disclosure be made of the maximum amount of compensation that is payable to an individual under a performance goal.

Confidential information does not include the identity of an executive or the class of executives to which a performance goal applies or the amount of compensation that is payable if the goal is satisfied.

(iv) *Description of compensation.* Disclosure as to the compensation payable under a performance goal must be specific enough so that shareholders can determine the maximum amount of compensation that could be paid to any individual employee during a specified period. If the terms of the performance goal do not provide for a maximum dollar amount, the disclosure must include the formula under which the compensation would be calculated. Thus, if compensation attributable to the exercise of stock options is equal to the difference between the exercise price and the current value of the stock, then disclosure of the maximum number of shares for which grants may be made to any individual employee during a specified period and the exercise price of those options (for example, fair market value on date of grant) would satisfy the requirements of this paragraph (e)(4)(iv). In that case, shareholders could calculate the maximum amount of compensation that would be attributable to the exercise of options on the basis of their assumptions as to the future stock price.

(v) *Disclosure requirements of the Securities and Exchange Commission.* To the extent not otherwise specifically provided in this paragraph (e)(4), whether the material terms of a performance goal are adequately disclosed to shareholders is determined under the same standards as apply under the Exchange Act.

(vi) *Frequency of disclosure.* Once the material terms of a performance goal are disclosed to and approved by shareholders, no additional disclosure or approval is required unless the compensation committee changes the material terms of the performance goal. If, however, the compensation committee has authority to change the targets under a performance goal after shareholder approval of the goal, material terms of the performance goal must be disclosed to and reapproved by shareholders no later than the first shareholder meeting that occurs in the fifth year following the year in which shareholders previously approved the performance goal.

(vii) *Shareholder vote.* For purposes of this paragraph (e)(4), the material terms of a performance goal are approved by shareholders if, in a separate vote, a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under applicable state law) are cast in favor of approval.

(viii) *Members of affiliated group.* For purposes of this paragraph (e)(4), the shareholders of the publicly held member of the affiliated group are treated as the shareholders of all members of the affiliated group.

(ix) *Examples.* This paragraph (e)(4) may be illustrated by the following examples:

Example 1. Corporation X adopts a plan that will pay a specified class of its executives an annual cash bonus based on the overall increase in corporate sales during the year. Under the terms of the plan, the cash bonus of each executive equals $100,000 multiplied by the number of percentage points by which sales increase in the current year when compared to the prior year. Corporation X discloses to its shareholders prior to the vote both the class of executives eligible to receive awards and the annual formula of $100,000 multiplied by the percentage increase in sales. This disclosure meets the requirements of this paragraph (e)(4). Because the compensation committee does not have the authority to establish a different target under the plan, Corporation X need not redisclose to its shareholders and obtain their reapproval of the material terms of the plan until those material terms are changed.

Example 2. The facts are the same as in *Example 1* except that Corporation X discloses only that bonuses will be paid on the basis of the annual increase in sales. This disclosure does not meet the requirements of this paragraph (e)(4) because it does not include the formula for calculating the compensation or a maximum amount of compensation to be paid if the performance goal is satisfied.

Example 3. Corporation Y adopts an incentive compensation plan in 1995 that will pay a specified class of its executives a bonus every 3 years based on the following 3 factors: increases in earnings per share, reduction in costs for specified divisions, and increases in sales by specified divisions. The bonus is payable in cash or in Corporation Y stock, at the option of the executive. Under the terms of the plan, prior to the beginning of each 3-year period, the compensation committee determines the specific targets under each of the three factors (*i.e.*, the amount of the increase in earnings per share, the reduction in costs, and the amount of sales) that must be met in order for the executives to receive a bonus. Under the terms of the plan, the compensation committee retains the discretion to determine whether a bonus will be paid under any one of the goals. The terms of the plan also specify that no executive may receive a bonus in excess of $1,500,000 for any 3-year period. To satisfy the requirements of this paragraph (e)(4), Corporation Y obtains shareholder approval of the plan at its 1995 annual shareholder meeting. In the proxy statement issued to shareholders, Corporation Y need not disclose to shareholders the specific targets that are set by the compensation committee. However, Corporation Y must disclose that bonuses are paid on the basis of earnings per share, reductions in costs, and increases in sales of specified divisions. Corporation Y also must disclose the maximum amount of compensation that any executive may receive under the plan is $1,500,000 per 3-year period. Unless changes in the material terms of the plan are made earlier, Corporation Y need not disclose the material terms of the plan to the shareholders and obtain their reapproval until the first shareholders' meeting held in 2000.

Example 4. The same facts as in *Example 3,* except that prior to the beginning of the second 3-year period, the compensation committee determines that different targets will be set under the plan for that period with regard to all three of the performance criteria (*i.e.*, earnings per share, reductions in costs, and increases in sales). In addition, the compensation committee raises the maximum dollar amount that can be paid under the plan for a 3-year period to $2,000,000. The increase in the maximum dollar amount of compensation under the plan is a changed material term. Thus, to satisfy the requirements of this paragraph (e)(4), Corporation Y must disclose to and obtain approval by the shareholders of the plan as amended.

Example 5. In 1998, Corporation Z establishes a plan under which a specified group of executives will receive a cash bonus not to exceed $750,000 each if a new product that has been in development is completed and ready for sale to customers by January 1, 2000. Although the completion of the new product is a material term of the performance goal under this paragraph (e)(4), the compensation committee determines that the disclosure to shareholders of the performance goal would adversely affect Corporation Z because its competitors would be made aware of the existence and timing of its new product. In this case, the requirements of this paragraph (e)(4) are satisfied if all other material terms, including the maximum amount of compensation, are disclosed and the disclosure affirmatively states that the terms of the performance goal are not being disclosed because the compensation committee has determined that those terms include confidential information, the disclosure of which would adversely affect Corporation Z.

(5) *Compensation committee certification.* The compensation committee must certify in writing prior to payment of the compensation that the performance goals and any other material terms were in fact satisfied. For this purpose, approved minutes of the compensation committee meeting in which the certification is made are treated as a written certification. Certification by the compensation committee is not required for compensation that is attributable solely to the increase in the value of the stock of the publicly held corporation.

(f) *Companies that become publicly held, spinoffs, and similar transactions*—(1) *In general.* In the case of a corporation that was not a publicly held corporation and then becomes a publicly held corporation, the deduction limit of paragraph (b) of this section does not apply to any remuneration paid pursuant to a compensation plan or agreement that existed during the period in which the corporation was not publicly held. However, in the case of such a corporation that becomes publicly held in connection with an initial public offering, this relief applies only to the extent that the prospectus accompanying the initial public offering disclosed information concerning those plans or agreements that satisfied all applicable securities laws then in effect. In accordance with paragraph (c)(1)(ii) of this section, a corporation that is a member of an affiliated group that includes a publicly held corporation is considered publicly held and, therefore, cannot rely on this paragraph (f)(1).

(2) *Reliance period.* Paragraph (f)(1) of this section may be relied upon until the earliest of—

(i) The expiration of the plan or agreement;

(ii) The material modification of the plan or agreement, within the meaning of paragraph (h)(1)(iii) of this section;

(iii) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(iv) The first meeting of shareholders at which directors are to be elected that occurs after the close of the third calendar year following the calendar year in which the initial public offering occurs or, in the case of a privately held corporation that becomes publicly held without an initial public offering, the first calendar year following the calendar year in which the corporation becomes publicly held.

(3) *Stock-based compensation.* Paragraph (f)(1) of this section will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (f)(1) of this section if the grant occurs on or before the earliest of the events specified in paragraph (f)(2) of this section. This paragraph does not apply to any form of stock-based compensation other than the forms listed in the immediately preceding sentence. Thus, for example, compensation payable under a restricted stock unit arrangement or a phantom stock arrangement must be paid, rather than merely granted, on or before the occurrence of the earliest of the events specified in paragraph (f)(2) of this section in order for paragraph (f)(1) of this section to apply.

(4) *Subsidiaries that become separate publicly held corporations*—(i) *In general.* If a subsidiary that is a member of the affiliated group described in paragraph (c)(1)(ii) of this section becomes a separate publicly held corporation (whether by spinoff or otherwise), any remuneration paid to covered employees of the new publicly held corporation will satisfy the exception for performance-based compensation described in paragraph (e) of this section if the conditions in either paragraph (f)(4)(ii) or (f)(4)(iii) of this section are satisfied.

(ii) *Prior establishment and approval.* Remuneration satisfies the requirements of this paragraph (f)(4)(ii) if the remuneration satisfies the requirements for performance-based compensation set forth in paragraphs (e)(2), (e)(3), and (e)(4) of this section (by application of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) before the corporation becomes a separate publicly held corporation, and the certification required by paragraph (e)(5) of this section is made by the compensation committee of the new publicly held corporation (but if the performance goals are attained before the corporation becomes a separate publicly held corporation, the certification may be made by the compensation committee referred to in paragraph (e)(3)(viii) of this section before it becomes a separate publicly held corporation). Thus, this paragraph (f)(4)(ii) requires that the outside directors and shareholders (within the meaning of paragraphs (e)(3)(viii) and (e)(4)(viii) of this section) of the corporation before it becomes a separate publicly held corporation establish and approve, respectively, the performance-based compensation for the covered employees of the new publicly held corporation in accordance with paragraphs (e)(3) and (e)(4) of this section.

(iii) *Transition period.* Remuneration satisfies the requirements of this paragraph (f)(4)(iii) if the remuneration satisfies all of the requirements of paragraphs (e)(2), (e)(3), and (e)(5) of this section. The outside directors (within the meaning of paragraph (e)(3)(viii) of this section) of the corporation before it becomes a separate publicly held corporation, or the outside directors of the new publicly held corporation, may establish and administer the performance goals for the covered employees of the new publicly held corporation for purposes of satisfying the requirements of paragraphs (e)(2) and (e)(3) of this section. The certification required by paragraph (e)(5) of this section must be made by the compensation committee of the new publicly held corporation. However, a taxpayer may rely on this paragraph (f)(4)(iii) to satisfy the requirements of paragraph (e) of this section only for compensation paid, or stock options, stock appreciation rights, or restricted property granted, prior to the first regularly scheduled meeting of the shareholders of the new publicly held corporation that occurs more than 12 months after the date the corporation becomes a separate publicly held corporation. Compensation paid, or stock options, stock appreciation rights, or restricted property granted, on or after the date of that meeting of shareholders must satisfy all requirements of paragraph (e) of this section, including the shareholder approval requirement of paragraph (e)(4) of this section, in order to satisfy the requirements for performance-based compensation.

(5) *Example*. The following example illustrates the application of paragraph (f)(4)(ii) of this section:

Example. Corporation P, which is publicly held, decides to spin off Corporation S, a wholly owned subsidiary of Corporation P. After the spinoff, Corporation S will be a separate publicly held corporation. Before the spinoff, the compensation committee of Corporation P, pursuant to paragraph (e)(3)(viii) of this section, establishes a bonus plan for the executives of Corporation S that provides for bonuses payable after the spinoff and that satisfies the requirements of paragraph (e)(2) of this section. If, pursuant to paragraph (e)(4)(viii) of this section, the shareholders of Corporation P approve the plan prior to the spinoff, that approval will satisfy the requirements of paragraph (e)(4) of this section with respect to compensation paid pursuant to the bonus plan after the spinoff. However, the compensation committee of Corporation S will be required to certify that the goals are satisfied prior to the payment of the bonuses in order for the bonuses to be considered performance-based compensation.

(g) *Coordination with disallowed excess parachute payments*. The $1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) that would have been included in the compensation of the covered employee for the taxable year but for being disallowed by reason of section 280G. For example, assume that during a taxable year a corporation pays $1,500,000 to a covered employee and no portion satisfies the exception in paragraph (d) of this section for commissions or paragraph (e) of this section for qualified performance-based compensation. Of the $1,500,000, $600,000 is an excess parachute payment, as defined in section 280G(b)(1) and is disallowed by reason of that section. Because the excess parachute payment reduces the limitation of paragraph (b) of this section, the corporation can deduct $400,000, and $500,000 of the otherwise deductible amount is nondeductible by reason of section 162(m).

(h) *Transition rules*—(1) *Compensation payable under a written binding contract which was in effect on February 17, 1993*—(i) *General rule*. The deduction limit of paragraph (b) of this section does not apply to any compensation payable under a written binding contract that was in effect on February 17, 1993. The preceding sentence does not apply unless, under applicable state law, the corporation is obligated to pay the compensation if the employee performs services. However, the deduction limit of paragraph (b) of this section does apply to a contract that is renewed after February 17, 1993. A written binding contract that is terminable or cancelable by the corporation after February 17, 1993, without the employee's consent is treated as a new contract as of the date that any such termination or cancellation, if made, would be effective. Thus, for example, if the terms of a contract provide that it will be automatically renewed as of a certain date unless either the corporation or the employee gives notice of termination of the contract at least 30 days before that date, the contract is treated as a new contract as of the date that termination would be effective if that notice were given. Similarly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date. Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as a new contract as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee.

(ii) *Compensation payable under a plan or arrangement*. If a compensation plan or arrangement meets the requirements of paragraph (h)(1)(i) of this section, the compensation paid to an employee pursuant to the plan or arrangement will not be subject to the deduction limit of paragraph (b) of this section even though the employee was not eligible to participate in the plan as of

February 17, 1993. However, the preceding sentence does not apply unless the employee was employed on February 17, 1993, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

(iii) *Material modifications.* (A) Paragraph (h)(1)(i) of this section will not apply to any written binding contract that is materially modified. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a binding written contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract prior to a material modification are not affected, but amounts received subsequent to the material modification are not treated as paid under a binding, written contract described in paragraph (h)(1)(i) of this section.

(B) A modification of the contract that accelerates the payment of compensation will be treated as a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid in excess of the amount that was originally payable to the employee under the contract will not be treated as a material modification if the additional amount is based on either a reasonable rate of interest or one or more predetermined actual investments (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the actual rate of return of the specific investment (including any decrease as well as any increase in the value of the investment).

(C) The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a binding, written contract where the facts and circumstances show that the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, a supplemental payment of compensation that satisfies the requirements of qualified performance-based compensation in paragraph (e) of this section will not be treated as a material modification.

(iv) Examples. The following examples illustrate the exception of this paragraph (h)(1):

Example 1. Corporation X executed a 3-year compensation arrangement with C on February 15, 1993, that constitutes a written binding contract under applicable state law. The terms of the arrangement provide for automatic extension after the 3-year term for additional 1-year periods, unless the corporation exercises its option to terminate the arrangement within 30 days of the end of the 3-year term or, thereafter, within 30 days before each anniversary date. Termination of the compensation arrangement does not require the termination of C's employment relationship with Corporation X. Unless terminated, the arrangement is treated as renewed on February 15, 1996, and the deduction limit of paragraph (b) of this section applies to payments under the arrangement after that date.

Example 2. Corporation Y executed a 5-year employment agreement with B on January 1, 1992, providing for a salary of $900,000 per year. Assume that this agreement constitutes a written binding contract under applicable state law. In 1992 and 1993, B receives the salary of $900,000 per year. In 1994, Corporation Y increases B's salary with a payment of $20,000. The $20,000 supplemental payment does not constitute a material modification of the written binding contract because the $20,000 payment is less than or equal to a reasonable cost-of-living increase from 1993. However, the $20,000 supplemental payment is subject to the limitation in paragraph (b) of this section. On January 1, 1995, Corporation Y increases B's salary to $1,200,000. The $280,000 supplemental payment is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid under the written binding contract and it is greater than a reasonable, annual cost-of-living increase. Because the written binding contract is materially modified as of January 1, 1995, all compensation paid to B in 1995 and thereafter is subject to the deduction limitation of section 162(m).

Example 3. Assume the same facts as in *Example 2,* except that instead of an increase in salary, B receives a restricted stock grant subject to B's continued employment for the balance of the contract. The restricted stock grant is not a material modification of the binding written contract because any additional compensation paid to B under the grant is not paid on the basis of substantially the same elements and conditions as B's salary because it is based both on the stock price and B's continued service. However, compensation attributable to the restricted stock grant is subject to the deduction limitation of section 162(m).

(2) *Special transition rule for outside directors.* A director who is a disinterested director is treated as satisfying the requirements of an outside director under paragraph (e)(3) of this section until the first meeting of shareholders at which directors are to be elected that occurs on or after January 1, 1996. For purposes of this paragraph (h)(2) and paragraph (h)(3) of this section, a director is a disinterested director if the director is disinterested within the meaning of Rule 16b–3(c)(2)(i), 17 CFR 240.16b–3(c)(2)(i), under the Exchange Act (including the provisions of Rule 16b–3(d)(3), as in effect on April 30, 1991).

(3) *Special transition rule for previously-approved plans—(i) In general.* Any compensation paid under a plan or agreement approved by shareholders before December 20, 1993, is treated as satisfying the requirements of paragraphs (e)(3) and (e)(4) of this section, provided that the directors administering the plan or agreement are disinterested directors and the plan was approved by shareholders in a manner consistent with Rule 16b–3(b), 17 CFR 240.16b–3(b), under the Exchange Act or Rule 16b–3(a), 17 CFR 240.16b–3(a) (as contained in 17 CFR part 240 revised April 1, 1990). In addition, for purposes of satisfying the requirements of paragraph (e)(2)(vi) of this section, a plan or agreement is treated as stating a maximum number of shares with respect to which an option or right may be granted to any employee if the plan or agreement that was approved by the shareholders provided for an aggregate limit, consistent with Rule 16b–3(b), 17 CFR 250.16b–3(b), on the shares of employer stock with respect to which awards may be made under the plan or agreement.

(ii) *Reliance period.* The transition rule provided in this paragraph (h)(3) shall continue and may be relied upon until the earliest of—

(A) The expiration or material modification of the plan or agreement;

(B) The issuance of all employer stock and other compensation that has been allocated under the plan; or

(C) The first meeting of shareholders at which directors are to be elected that occurs after December 31, 1996.

(iii) *Stock-based compensation.* This paragraph (h)(3) will apply to any compensation received pursuant to the exercise of a stock option or stock appreciation right, or the substantial vesting of restricted property, granted under a plan or agreement described in paragraph (h)(3)(i) of this section if the grant occurs on or before the earliest of the events specified in paragraph (h)(3)(ii) of this section.

(iv) *Example.* The following example illustrates the application of this paragraph (h)(3):

Example. Corporation Z adopted a stock option plan in 1991. Pursuant to Rule 16b–3 under the Exchange Act, the stock option plan has been administered by disinterested directors and was approved by Corporation Z shareholders. Under the terms of the plan, shareholder approval is not required again until 2001. In addition, the terms of the stock option plan include an aggregate limit on the number of shares available under the plan. Option grants under the Corporation Z plan are made with an exercise price equal to or greater than the fair market value of Corporation Z stock. Compensation attributable to the exercise of options that are granted under the plan before the earliest of the dates specified in paragraph (h)(3)(ii) of this section will be treated as satisfying the requirements of paragraph (e) of this section for qualified performance-based compensation, regardless of when the options are exercised.

(i) [Reserved]

(j) *Effective date*—(1) *In general.* Section 162(m) and this section apply to the deduction for compensation that is otherwise deductible by the corporation in taxable years beginning on or after January 1, 1994, and beginning prior to January 1, 2018. Section 162(m) and this section also apply to compensation that is a grandfathered amount (as defined in §1.162–33(g)) at the time it is paid to the covered employee or otherwise deductible. For examples of the application of the rules of this section to grandfathered amounts paid during or otherwise deductible for taxable years beginning after December 31, 2017, see §1.162–33(g).

(2) *Delayed effective date for certain provisions*—(i) *Date on which remuneration is considered paid.* Notwithstanding paragraph (j)(1) of this section, the rules in the second sentence of each of paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section for determining the date or dates on which remuneration is considered paid to a director are effective for taxable years beginning on or after January 1, 1995. Prior to those taxable years, taxpayers must follow the rules in paragraphs (e)(3)(ii)(A), (e)(3)(ii)(B), and (e)(3)(ii)(C) of this section or another reasonable, good faith interpretation of section 162(m) with respect to the date or dates on which remuneration is considered paid to a director.

(ii) *Separate treatment of publicly held subsidiaries.* Notwithstanding paragraph (j)(1) of this section, the rule in paragraph (c)(1)(ii) of this section that treats publicly held subsidiaries as separately subject to section 162(m) is effective as of the first regularly scheduled meeting of the shareholders of the publicly held subsidiary that occurs more than 12 months after December 2, 1994. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for this purpose, except that the grant must occur before the shareholder meeting specified in this paragraph (j)(2)(ii). Taxpayers may choose to rely on the rule referred to in the first sentence of this paragraph (j)(2)(ii) for the period prior to the effective date of the rule.

(iii) *Subsidiaries that become separate publicly held corporations.* Notwithstanding paragraph (j)(1) of this section, if a subsidiary of a publicly held corporation becomes a separate publicly held corporation as described in paragraph (f)(4)(i) of this section, then, for the duration of the reliance period described in paragraph (f)(2) of this section, the rules of paragraph (f)(1) of this section are treated as applying (and the rules of paragraph (f)(4) of this section do not apply) to remuneration paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, provided that the treatment of that remuneration as performance-based is in accordance with a reasonable, good faith interpretation of section 162(m). However, if remuneration is paid to covered employees of that new publicly held corporation pursuant to a plan or agreement that existed prior to December 2, 1994, but that remuneration is not performance-based under a reasonable, good faith interpretation of section 162(m), the rules of paragraph (f)(1) of this section will be treated as applying only until the first regularly scheduled meeting of shareholders that occurs more than 12 months after December 2, 1994. The rules of paragraph (f)(4) of this section will apply as of that first regularly scheduled meeting. The rule for stock-based compensation set forth in paragraph (f)(3) of this section will apply for purposes of this paragraph (j)(2)(iii), except that the grant must occur before the shareholder meeting specified in the preceding sentence if the remuneration is not performance-based under a reasonable, good faith interpretation of section 162(m). Taxpayers may choose to rely on the rules of paragraph (f)(4) of this section for the period prior to the applicable effective date referred to in the first or second sentence of this paragraph (j)(2)(iii).

(iv) *Bonus pools.* Notwithstanding paragraph (j)(1) of this section, the rules in paragraph (e)(2)(iii)(A) that limit the sum of individual percentages of a bonus pool to 100 percent will not apply to remuneration paid before January 1, 2001, based on performance in any performance period that began prior to December 20, 1995.

(v) *Compensation based on a percentage of salary or base pay.* Notwithstanding paragraph (j)(1) of this section, the requirement in paragraph (e)(4)(i) of this section that, in the case of certain formulas based on a percentage of salary or base pay, a corporation disclose to shareholders the maximum dollar amount of compensation that could be paid to the employee, will apply only to plans approved by shareholders after April 30, 1995.

(vi) The modifications to paragraphs (e)(2)(vi)(A), (e)(2)(vii) *Example 9,* and (e)(4)(iv) of this section concerning the maximum number of shares with respect to which a stock option or stock appreciation right that may be granted and the amount of compensation that may be paid to any individual employee apply to compensation attributable to stock options and stock appreciation rights that are granted on or after June 24, 2011. The last two sentences of §1.162–27(f)(3) apply to remuneration that is otherwise deductible resulting from a stock option, stock appreciation right, restricted stock (or other property), restricted stock unit, or any other form of equity-based remuneration that is granted on or after April 1, 2015.

[T.D. 8650, 60 FR 65537, Dec. 20, 1995, as amended at 61 FR 4350, Feb. 6, 1996; T.D. 9716, 80 FR 16972, Mar. 31, 2015; T.D. 9932, 85 FR 86492, Dec. 30, 2020]

§ 1.162–28 Allocation of costs to lobbying activities.

(a) *Introduction*—(1) *In general.* Section 162(e)(1) denies a deduction for certain amounts paid or incurred in connection with activities described in section 162(e)(1) (A) and (D) (*lobbying activities*). To determine the nondeductible amount, a taxpayer must allocate costs to lobbying activities. This section describes costs that must be allocated to lobbying activities and prescribes rules permitting a taxpayer to use a reasonable method to allocate those costs. This section does not apply to taxpayers subject to section 162(e)(5)(A). In addition, this section does not apply for purposes of sections 4911 and 4945 and the regulations thereunder.

(2) *Recordkeeping.* For recordkeeping requirements, see section 6001 and the regulations thereunder.

(b) *Reasonable method of allocating costs*—(1) *In general.* A taxpayer must use a reasonable method to allocate the costs described in paragraph (c) of this section to lobbying activities. A method is not reasonable unless it is applied consistently and is consistent with the special rules in paragraph (g) of this section. Except as provided in paragraph (b)(2) of this section, reasonable methods of allocating costs to lobbying activities include (but are not limited to)—

(i) The ratio method described in paragraph (d) of this section;

(ii) The gross-up method described in paragraph (e) of this section; and

(iii) A method that applies the principles of section 263A and the regulations thereunder (see paragraph (f) of this section).

(2) *Taxpayers not permitted to use certain methods.* A taxpayer (other than one subject to section 6033(e)) that does not pay or incur reasonable labor costs for persons engaged in lobbying activities may not use the gross-up method. For example, a partnership or sole proprietorship in which the lobbying activities are performed by the owners who do not receive a salary or guaranteed payment for services does not pay or incur reasonable labor costs for persons engaged in those activities and may not use the gross-up method.

(c) *Costs allocable to lobbying activities*—(1) *In general.* Costs properly allocable to lobbying activities include labor costs and general and administrative costs.

(2) *Labor costs.* For each taxable year, labor costs include costs attributable to full-time, part-time, and contract employees. Labor costs include all elements of compensation, such as basic compensation, overtime pay, vacation pay, holiday pay, sick leave pay, payroll taxes, pension costs, employee benefits, and payments to a supplemental unemployment benefit plan.

(3) *General and administrative costs.* For each taxable year, general and administrative costs include depreciation, rent, utilities, insurance, maintenance costs, security costs, and other administrative department costs (for example, payroll, personnel, and accounting).

(d) *Ratio method*—(1) *In general.* Under the ratio method described in this paragraph (d), a taxpayer allocates to lobbying activities the sum of its third-party costs (as defined in paragraph (d)(5) of this section) allocable to lobbying activities and the costs determined by using the following formula:

$$\frac{\text{Lobbying labor hours}}{\text{Total labor hours}} \times \text{Total costs of operations.}$$

(2) *Lobbying labor hours.* Lobbying labor hours are the hours that a taxpayer's personnel spend on lobbying activities during the taxable year. A taxpayer may use any reasonable method to determine the number of labor hours spent on lobbying activities and may use the de minimis rule of paragraph (g)(1) of this section. A taxpayer may treat as zero the lobbying labor hours of personnel engaged in secretarial, clerical, support, and other administrative activities (as opposed to activities involving significant judgment with respect to lobbying activities). Thus, for example, the hours spent on lobbying activities by para-professionals and analysts may not be treated as zero.

(3) *Total labor hours.* Total labor hours means the total number of hours that a taxpayer's personnel spend on a taxpayer's trade or business during the taxable year. A taxpayer may make reasonable assumptions concerning total hours spent by personnel on the taxpayer's trade or business. For example, it may be reasonable, based on all the facts and circumstances, to assume that all full-time personnel spend 1,800 hours per year on a taxpayer's trade or business. If, under paragraph (d)(2) of this section, a taxpayer treats as zero the lobbying labor hours of personnel engaged in secretarial, clerical, support, and other administrative activities, the taxpayer must also treat as zero the total labor hours of all personnel engaged in those activities.

(4) *Total costs of operations.* A taxpayer's total costs of operations means the total costs of the taxpayer's trade or business for a taxable year, excluding third-party costs (as defined in paragraph (d)(5) of this section).

(5) *Third-party costs.* Third-party costs are amounts paid or incurred in whole or in part for lobbying activities conducted by third parties (such as amounts paid to taxpayers subject to section 162(e)(5)(A) or dues or other similar amounts that are not deductible in whole or in part under section 162(e)(3)) and amounts paid or incurred for travel (including meals and lodging while away from home) and entertainment relating in whole or in part to lobbying activities.

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

Example. (i) In 1996, three full-time employees, A, B, and C, of Taxpayer W engage in both lobbying activities and nonlobbying activities. A spends 300 hours, B spends 1,700 hours, and C spends 1,000 hours on lobbying activities, for a total of 3,000 hours spent on lobbying activities for W. W reasonably assumes that each of its three employees spends 2,000 hours a year on W's business.

(ii) W's total costs of operations are $300,000. W has no third-party costs.

(iii) Under the ratio method, X allocates $150,000 to its lobbying activities for 1996, as follows:

$$\frac{\text{Lobbying labor hours}}{\text{Total labor hours}} \times \text{Total costs of operations} + \text{Allocable third-party costs} = \text{Costs allocable to lobbying activities}$$

$$\left[\frac{300 + 1{,}700 + 1{,}000}{6{,}000} \times \$300{,}000\right] + [0] = \$150{,}000.$$

(e) *Gross-up method*—(1) *In general.* Under the gross-up method described in this paragraph (e)(1), the taxpayer allocates to lobbying activities the sum of its third-party costs (as defined in paragraph (d)(5) of this section) allocable to lobbying activities and 175 percent of its basic lobbying labor costs (as defined in paragraph (e)(3) of this section) of all personnel.

(2) *Alternative gross-up method.* Under the alternative gross-up method described in this paragraph (e)(2), the taxpayer allocates to lobbying activities the sum of its third-party costs (as

defined in paragraph (d)(5) of this section) allocable to lobbying activities and 225 percent of its basic lobbying labor costs (as defined in paragraph (e)(3)), excluding the costs of personnel who engage in secretarial, clerical, support, and other administrative activities (as opposed to activities involving significant judgment with respect to lobbying activities).

(3) *Basic lobbying labor costs.* For purposes of this paragraph (e), basic lobbying labor costs are the basic costs of lobbying labor hours (as defined in paragraph (d)(2) of this section) determined for the appropriate personnel. For purposes of this paragraph (e), basic costs of lobbying labor hours are wages or other similar costs of labor, including, for example, guaranteed payments for services. Basic costs do not include pension, profit-sharing, employee benefits, and supplemental unemployment benefit plan costs, or other similar costs.

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

Example. (i) In 1996, three employees, A, B, and C, of Taxpayer X engage in both lobbying activities and nonlobbying activities. A spends 300 hours, B spends 1,700 hours, and C spends 1,000 hours on lobbying activities.

(ii) X has no third-party costs.

(iii) For purposes of the gross-up method, X determines that its basic labor costs are $20 per hour for A, $30 per hour for B, and $25 per hour for C. Thus, its basic lobbying labor costs are ($20 × 300) + ($30 × 1,700) + ($25 × 1,000), or ($6,000 + $51,000 + $25,000), for total basic lobbying labor costs for 1996 of $82,000.

(iv) Under the gross-up method, X allocates $143,500 to its lobbying activities for 1996, as follows:

$$175\% \times \begin{array}{l}\text{Basic lobbying labor}\\ \text{costs of all personnel}\end{array} + \begin{array}{l}\text{Allocable third-}\\ \text{party costs}\end{array} = \begin{array}{l}\text{Costs allocable to}\\ \text{lobbying activities}\end{array}$$

$$[175\% \times \$82{,}000] \qquad + [0] \qquad = \$143{,}500.$$

(f) *Section 263A cost allocation methods*—(1) *In general.* A taxpayer may allocate its costs to lobbying activities under the principles set forth in section 263A and the regulations thereunder, except to the extent inconsistent with paragraph (g) of this section. For this purpose, lobbying activities are considered a service department or function. Therefore, a taxpayer may allocate costs to lobbying activities by applying the methods provided in §§ 1.263A–1 through 1.263A–3. See § 1.263A–1(e)(4), which describes service costs generally; § 1.263A–1(f), which sets forth cost allocation methods available under section 263A; and § 1.263A–1(g)(4), which provides methods of allocating service costs.

(2) *Example.* The provisions of this paragraph (f) are illustrated by the following example.

Example. (i) Three full-time employees, A, B, and C, work in the Washington office of Taxpayer Y, a manufacturing concern. They each engage in lobbying activities and nonlobbying activities. In 1996, A spends 75 hours, B spends 1,750 hours, and C spends 2,000 hours on lobbying activities. A's hours are not spent on direct contact lobbying as defined in paragraph (g)(2) of this section. All three work 2,000 hours during 1996. The Washington office also employs one secretary, D, who works exclusively for A, B, and C.

(ii) In addition, three departments in the corporate headquarters in Chicago benefit the Washington office: Public affairs, human resources, and insurance.

(iii) Y is subject to section 263A and uses the step-allocation method to allocate its service costs. Prior to the amendments to section 162(e), the Washington office was treated as an overall management function for purposes of section 263A. As such, its costs were fully deductible and no further allocations were made under Y's step allocation. Following the amendments to section 162(e), Y adopts its 263A step-allocation methodology to allocate costs to lobbying activities. Y adds a lobbying department to its step-allocation program, which results in an allocation of costs to the lobbying department from both the Washington office and the Chicago office.

(iv) Y develops a labor ratio to allocate its Washington office costs between the newly defined lobbying department and the overall management department. To determine the hours allocable to lobbying activities, Y uses the de minimis rule of paragraph (g)(1) of this section. Under this rule, A's hours spent on lobbying activities are treated as zero because less than 5 percent of A's time is spent on lobbying (75/2,000 = 3.75%). In addition, because D works exclusively for personnel engaged in lobbying activities, D's hours are not used to develop the allocation ratio. Y assumes that D's allocation of time follows the average time of all the personnel engaged in lobbying activities. Thus, Y's labor ratio is determined as follows:

Employee	Departments		
	Lobbying hours	Overall management hours	Total hours
A	0	2,000	2,000
B	1,750	250	2,000
C	2,000	0	2,000
Totals	3,750	2,250	6,000

$$\text{Lobbying Department Ratio} = \frac{3{,}750}{6{,}000} = 62.5\%$$

$$\text{Overall Management Department Ratio} = \frac{2{,}250}{6{,}000} = 37.5\%$$

(v) In 1996, the Washington office has the following costs:

Account	Amount
Professional Salaries and Benefits	$660,000
Clerical Salaries and Benefits	50,000
Rent Expense	100,000
Depreciation on Furniture and Equip	40,000
Utilities	15,000
Outside Payroll Service	5,000
Miscellaneous	10,000
Third-Party Lobbying (Law Firm)	90,000
Total Washington Costs	$970,000

(vi) In addition, $233,800 of costs from the public affairs department, $30,000 of costs from the insurance department, and $5,000 of costs from the human resources department are allocable to the Washington office from departments in Chicago. Therefore, the Washington office costs are allocated to the Lobbying and Overall Management departments as follows:

Total Washington department costs from above	$970,000
Plus Costs Allocated From Other Departments	268,800
Less third-party costs directly allocable to lobbying	(90,000)
Total Washington office costs	1,148,800

	Lobbying department	Overall management department
Department Allocation Ratios	62.5%	37.5%
× Washington Office Costs	$1,148,800	$1,148,800
= Costs Allocated to Departments	$718,000	$430,800

(vii) Y's step-allocation for its Lobbying Department is determined as follows:

Y's step-allocation	Lobbying department
Washington costs allocated to lobbying department	$718,000
Plus third-party costs	90,000
Total costs of lobbying activities	808,000

(g) *Special rules.* The following rules apply to any reasonable method of allocating costs to lobbying activities.

(1) *De minimis rule for labor hours.* Subject to the exception provided in paragraph (g)(2) of this section, a taxpayer may treat time spent by an individual on lobbying activities as zero if less than five percent of the person's time is spent on lobbying activities. Reasonable methods must be used to determine if less than five percent of a person's time is spent on lobbying activities.

(2) *Direct contact lobbying labor hours.* Notwithstanding paragraph (g)(1) of this section, a taxpayer must treat all hours spent by a person on direct contact lobbying (as well as the hours that person spends in connection with direct contact lobbying, including time spent traveling that is allocable to the direct contact lobbying) as labor hours allocable to lobbying activities. An activity is direct contact lobbying if it is a meeting, telephone conversation, letter, or other similar means of communication with a legislator (other than a local legislator) or covered executive branch official (as defined in section 162(e)(6)) and otherwise qualifies as a lobbying activity. A person who engages in research, preparation, and other background activities related to

direct contact lobbying but who does not make direct contact with a legislator or covered executive branch official is not engaged in direct contact lobbying.

(3) *Taxpayer defined*. For purposes of this section, a taxpayer includes a tax-exempt organization subject to section 6033(e).

(h) *Effective date*. This section is effective for amounts paid or incurred on or after July 21, 1995. Taxpayers must adopt a reasonable interpretation of sections 162(e)(1)(A) and (D) for amounts paid or incurred before this date.

[T.D. 8602, 60 FR 37573, July 21, 1995]

§ 1.162–29 Influencing legislation.

(a) *Scope*. This section provides rules for determining whether an activity is influencing legislation for purposes of section 162(e)(1)(A). This section does not apply for purposes of sections 4911 and 4945 and the regulations thereunder.

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

(1) *Influencing legislation*. Influencing legislation means—

(i) Any attempt to influence any legislation through a lobbying communication; and

(ii) All activities, such as research, preparation, planning, and coordination, including deciding whether to make a lobbying communication, engaged in for a purpose of making or supporting a lobbying communication, even if not yet made. See paragraph (c) of this section for rules for determining the purposes for engaging in an activity.

(2) *Attempt to influence legislation*. An attempt to influence any legislation through a lobbying communication is making the lobbying communication.

(3) *Lobbying communication*. A lobbying communication is any communication (other than any communication compelled by subpoena, or otherwise compelled by Federal or State law) with any member or employee of a legislative body or any other government official or employee who may participate in the formulation of the legislation that—

(i) Refers to specific legislation and reflects a view on that legislation; or

(ii) Clarifies, amplifies, modifies, or provides support for views reflected in a prior lobbying communication.

(4) *Legislation*. Legislation includes any action with respect to Acts, bills, resolutions, or other similar items by a legislative body. Legislation includes a proposed treaty required to be submitted by the President to the Senate for its advice and consent from the time the President's representative begins to negotiate its position with the prospective parties to the proposed treaty.

(5) *Specific legislation*. Specific legislation includes a specific legislative proposal that has not been introduced in a legislative body.

(6) *Legislative bodies*. Legislative bodies are Congress, state legislatures, and other similar governing bodies, excluding local councils (and similar governing bodies), and executive, judicial, or administrative bodies. For this purpose, administrative bodies include school boards, housing authorities, sewer and water districts, zoning boards, and other similar Federal, State, or local special purpose bodies, whether elective or appointive.

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

Example 1. Taxpayer P's employee, A, is assigned to approach members of Congress to gain their support for a pending bill. A drafts and P prints a position letter on the bill. P distributes the letter to members of Congress. Additionally, A personally contacts several members of Congress or their staffs to seek support for P's position on the bill. The letter and the personal contacts are lobbying communications. Therefore, P is influencing legislation.

Example 2. Taxpayer R is invited to provide testimony at a congressional oversight hearing concerning the implementation of The Financial Institutions Reform, Recovery, and Enforcement Act of 1989. Specifically, the hearing concerns a proposed regulation increasing the threshold value of commercial and residential real estate transactions for which an appraisal by a state licensed or certified appraiser is required. In its testimony, R states that it is in favor of the proposed regulation. Because R does not refer to any specific legislation or reflect a view on any such legislation, R has not made a lobbying communication. Therefore, R is not influencing legislation.

Example 3. State X enacts a statute that requires the licensing of all day-care providers.

Agency B in State X is charged with writing rules to implement the statute. After the enactment of the statute, Taxpayer S sends a letter to Agency B providing detailed proposed rules that S recommends Agency B adopt to implement the statute on licensing of day-care providers. Because the letter to Agency B neither refers to nor reflects a view on any specific legislation, it is not a lobbying communication. Therefore, S is not influencing legislation.

Example 4. Taxpayer T proposes to a State Park Authority that it purchase a particular tract of land for a new park. Even if T's proposal would necessarily require the State Park Authority eventually to seek appropriations to acquire the land and develop the new park, T has not made a lobbying communication because there has been no reference to, nor any view reflected on, any specific legislation. Therefore, T's proposal is not influencing legislation.

Example 5. (i) Taxpayer U prepares a paper that asserts that lack of new capital is hurting State X's economy. The paper indicates that State X residents either should invest more in local businesses or increase their savings so that funds will be available to others interested in making investments. U forwards a summary of the unpublished paper to legislators in State X with a cover letter that states in part:

You must take action to improve the availability of new capital in the state.

(ii) Because neither the summary nor the cover letter refers to any specific legislative proposal and no other facts or circumstances indicate that they refer to an existing legislative proposal, forwarding the summary to legislators in State X is not a lobbying communication. Therefore, U is not influencing legislation.

(iii) Q, a member of the legislature of State X, calls U to request a copy of the unpublished paper from which the summary was prepared. U forwards the paper with a cover letter that simply refers to the enclosed materials. Because U's letter to Q and the unpublished paper do not refer to any specific legislation or reflect a view on any such legislation, the letter is not a lobbying communication. Therefore, U is not influencing legislation.

Example 6. (i) Taxpayer V prepares a paper that asserts that lack of new capital is hurting the national economy. The paper indicates that lowering the capital gains rate would increase the availability of capital and increase tax receipts from the capital gains tax. V forwards the paper to its representatives in Congress with a cover letter that says, in part:

I urge you to support a reduction in the capital gains tax rate.

(ii) V's communication is a lobbying communication because it refers to and reflects a view on a specific legislative proposal (*i.e.*, lowering the capital gains rate). Therefore, V is influencing legislation.

Example 7. Taxpayer W, based in State A, notes in a letter to a legislator of State A that State X has passed a bill that accomplishes a stated purpose and then says that State A should pass such a bill. No such bill has been introduced into the State A legislature. The communication is a lobbying communication because it refers to and reflects a view on a specific legislative proposal. Therefore, W is influencing legislation.

Example 8. (i) Taxpayer Y represents citrus fruit growers. Y writes a letter to a United States senator discussing how pesticide O has benefited citrus fruit growers and disputing problems linked to its use. The letter discusses a bill pending in Congress and states in part:

This bill would prohibit the use of pesticide O. If citrus growers are unable to use this pesticide, their crop yields will be severely reduced, leading to higher prices for consumers and lower profits, even bankruptcy, for growers.

(ii) Y's views on the bill are reflected in this statement. Thus, the communication is a lobbying communication, and Y is influencing legislation.

Example 9. (i) B, the president of Taxpayer Z, an insurance company, meets with Q, who chairs the X state legislature's committee with jurisdiction over laws regulating insurance companies, to discuss the possibility of legislation to address current problems with surplus-line companies. B recommends that legislation be introduced that would create minimum capital and surplus requirements for surplus-line companies and create clearer guidelines concerning the risks that surplus-line companies can insure. B's discussion with Q is a lobbying communication because B refers to and reflects a view on a specific legislative proposal. Therefore, Z is influencing legislation.

(ii) Q is not convinced that the market for surplus-line companies is substantial enough to warrant such legislation and requests that B provide information on the amount and types of risks covered by surplus-line companies. After the meeting, B has employees of Z prepare estimates of the percentage of property and casualty insurance risks handled by surplus-line companies. B sends the estimates with a cover letter that simply refers to the enclosed materials. Although B's follow-up letter to Q does not refer to specific legislation or reflect a view on such legislation, B's letter supports the views reflected in the earlier communication. Therefore, the letter is a lobbying communication and Z is influencing legislation.

(c) *Purpose for engaging in an activity*—(1) *In general.* The purposes for engaging in an activity are determined based on all the facts and circumstances. Facts and circumstances include, but are not limited to—

(i) Whether the activity and the lobbying communication are proximate in time;

(ii) Whether the activity and the lobbying communication relate to similar subject matter;

(iii) Whether the activity is performed at the request of, under the direction of, or on behalf of a person making the lobbying communication;

(iv) Whether the results of the activity are also used for a nonlobbying purpose; and

(v) Whether, at the time the taxpayer engages in the activity, there is specific legislation to which the activity relates.

(2) *Multiple purposes.* If a taxpayer engages in an activity both for the purpose of making or supporting a lobbying communication and for some nonlobbying purpose, the taxpayer must treat the activity as engaged in partially for a lobbying purpose and partially for a nonlobbying purpose. This division of the activity must result in a reasonable allocation of costs to influencing legislation. See §1.162–28 (allocation rules for certain expenditures to which section 162(e)(1) applies). A taxpayer's treatment of these multiple-purpose activities will, in general, not result in a reasonable allocation if it allocates to influencing legislation—

(i) Only the incremental amount of costs that would not have been incurred but for the lobbying purpose; or

(ii) An amount based solely on the number of purposes for engaging in that activity without regard to the relative importance of those purposes.

(3) *Activities treated as having no purpose to influence legislation.* A taxpayer that engages in any of the following activities is treated as having done so without a purpose of making or supporting a lobbying communication—

(i) Before evidencing a purpose to influence any specific legislation referred to in paragraph (c)(3)(i)(A) or (B) of this section (or similar legislation)—

(A) Determining the existence or procedural status of specific legislation, or the time, place, and subject of any hearing to be held by a legislative body with respect to specific legislation; or

(B) Preparing routine, brief summaries of the provisions of specific legislation;

(ii) Performing an activity for purposes of complying with the requirements of any law (for example, satisfying state or federal securities law filing requirements);

(iii) Reading any publications available to the general public or viewing or listening to other mass media communications; and

(iv) Merely attending a widely attended speech.

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

Example 1. (i) *Facts.* In 1997, Agency F issues proposed regulations relating to the business of Taxpayer W. There is no specific legislation during 1997 that is similar to the regulatory proposal. W undertakes a study of the impact of the proposed regulations on its business. W incorporates the results of that study in comments sent to Agency F in 1997. In 1998, legislation is introduced in Congress that is similar to the regulatory proposal. Also in 1998, W writes a letter to Senator P stating that it opposes the proposed legislation. W encloses with the letter a copy of the comments it sent to Agency F.

(ii) *Analysis.* W's letter to Senator P refers to and reflects a view on specific legislation and therefore is a lobbying communication. Although W's study of the impact of the proposed regulations is proximate in time and similar in subject matter to its lobbying communication, W performed the study and incorporated the results in comments sent to Agency F when no legislation with a similar subject matter was pending (a nonlobbying use). On these facts, W engaged in the study solely for a nonlobbying purpose.

Example 2. (i) *Facts.* The governor of State Q proposes a budget that includes a proposed sales tax on electricity. Using its records of electricity consumption, Taxpayer Y estimates the additional costs that the budget proposal would impose upon its business. In the same year, Y writes to members of the state legislature and explains that it opposes the proposed sales tax. In its letter, Y includes its estimate of the costs that the sales tax would impose on its business. Y does not demonstrate any other use of its estimates.

(ii) *Analysis.* The letter is a lobbying communication (because it refers to and reflects a view on specific legislation, the governor's proposed budget). Y's estimate of additional costs under the proposal supports the lobbying communication, is proximate in time and similar in subject matter to a specific legislative proposal then in existence, and is not used for a nonlobbying purpose. Based on these facts, Y estimated its additional costs under the budget proposal solely to support the lobbying communication.

Example 3. (i) *Facts.* A senator in the State Q legislature announces her intention to introduce legislation to require health insurers to cover a particular medical procedure in all policies sold in the state. Taxpayer Y has different policies for two groups of employees, one of which covers the procedure and one of which does not. After the bill is introduced, Y's legislative affairs staff asks Y's human resources staff to estimate the additional cost to cover the procedure for both groups of employees. Y's human resources staff prepares a study estimating Y's increased costs and forwards it to the legislative affairs staff. Y's legislative staff then writes to members of the state legislature and explains that it opposes the proposed change in insurance coverage based on the study. Y's legislative affairs staff thereafter forwards the study, prepared for its use in opposing the statutory proposal, to its labor relations staff for use in negotiations with employees scheduled to begin later in the year.

(ii) *Analysis.* The letter to legislators is a lobbying communication (because it refers to and reflects a view on specific legislation). The activity of estimating Y's additional costs under the proposed legislation relates to the same subject as the lobbying communication, occurs close in time to the lobbying communication, is conducted at the request of a person making a lobbying communication, and relates to specific legislation then in existence. Although Y used the study in its labor negotiations, mere use for that purpose does not establish that Y estimated its additional costs under the proposed legislation in part for a nonlobbying purpose. Thus, based on all the facts and circumstances, Y estimated the additional costs it would incur under the proposal solely to make or support the lobbying communication.

Example 4. (i) *Facts.* After several years of developmental work under various contracts, in 1996, Taxpayer A contracts with the Department of Defense (DOD) to produce a prototype of a new generation military aircraft. A is aware that DOD will be able to fund the contract only if Congress appropriates an amount for that purpose in the upcoming appropriations process. In 1997, A conducts simulation tests of the aircraft and revises the specifications of the aircraft's expected performance capabilities, as required under the contract. A submits the results of the tests and the revised specifications to DOD. In 1998, Congress considers legislation to appropriate funds for the contract. In that connection, A summarizes the results of the simulation tests and of the aircraft's expected performance capabilities, and submits the summary to interested members of Congress with a cover letter that encourages them to support appropriations of funds for the contract.

(ii) *Analysis.* The letter is a lobbying communication (because it refers to specific legislation (*i.e.*, appropriations) and requests passage). The described activities in 1996, 1997, and 1998 relate to the same subject as the lobbying communication. The summary was prepared specifically for, and close in time to, that communication. Based on these facts, the summary was prepared solely for a lobbying purpose. In contrast, A conducted the tests and revised the specifications to comply with its production contract with DOD. A conducted the tests and revised the specifications solely for a nonlobbying purpose.

Example 5. (i) *Facts.* C, president of Taxpayer W, travels to the state capital to attend a two-day conference on new manufacturing processes. C plans to spend a third day in the capital meeting with state legislators to explain why W opposes a pending bill unrelated to the subject of the conference. At the meetings with the legislators, C makes lobbying communications by referring to and reflecting a view on the pending bill.

(ii) *Analysis.* C's traveling expenses (transportation and meals and lodging) are partially for the purpose of making or supporting the lobbying communications and partially for a nonlobbying purpose. As a result, under paragraph (c)(2) of this section, W must reasonably allocate C's traveling expenses between these two purposes. Allocating to influencing legislation only C's incremental transportation expenses (*i.e.*, the taxi fare to meet with the state legislators) does not result in a reasonable allocation of traveling expenses.

Example 6. (i) *Facts.* On February 1, 1997, a bill is introduced in Congress that would affect Company E. Employees in E's legislative affairs department, as is customary, prepare a brief summary of the bill and periodically confirm the procedural status of the bill through conversations with employees and members of Congress. On March 31, 1997, the head of E's legislative affairs department meets with E's President to request that B, a chemist, temporarily help the legislative affairs department analyze the bill. The President agrees, and suggests that B also be assigned to draft a position letter in opposition to the bill. Employees of the legislative affairs department continue to confirm periodically the procedural status of the bill. On October 31, 1997, B's position letter in opposition to the bill is delivered to members of Congress.

(ii) *Analysis.* B's letter is a lobbying communication because it refers to and reflects a view on specific legislation. Under paragraph (c)(3)(i) of this section, the assignment of B to assist the legislative affairs department in analyzing the bill and in drafting a position letter in opposition to the bill evidences a purpose to influence legislation. Neither the activity of periodically confirming the procedural status of the bill nor the activity of preparing the routine, brief summary of the bill before March 31 constitutes influencing legislation. In contrast, periodically confirming the procedural status of the bill on or after March 31 relates to the same subject as, and is close in time to, the lobbying communication and is used for no nonlobbying purpose. Consequently, after March 31, E determined the procedural status of the bill for the purpose of supporting the lobbying communication by B.

(d) *Lobbying communication made by another.* If a taxpayer engages in activities for a purpose of supporting a lobbying communication to be made by another person (or by a group of persons), the taxpayer's activities are treated under paragraph (b) of this section as influencing legislation. For example, if a taxpayer or an employee of the taxpayer (as a volunteer or otherwise) engages in an activity to assist a trade association in preparing its lobbying communication, the taxpayer's activities are influencing legislation even if the lobbying communication is made by the trade association and not the taxpayer. If, however, the taxpayer's employee, acting outside the employee's scope of employment, volunteers to engage in those activities, then the taxpayer is not influencing legislation.

(e) *No lobbying communication.* Paragraph (e) of this section applies if a taxpayer engages in an activity for a purpose of making or supporting a lobbying communication, but no lobbying communication that the activity supports has yet been made.

(1) *Before the filing date.* Under this paragraph (e)(1), if on the filing date of the return for any taxable year the taxpayer no longer expects, under any reasonably foreseeable circumstances, that a lobbying communication will be made that is supported by the activity, then the taxpayer will be treated as if it did not engage in the activity for a purpose of making or supporting a lobbying communication. Thus, the taxpayer need not treat any amount allocated to that activity for that year under §1.162–28 as an amount to which section 162(e)(1)(A) applies. The filing date for purposes of paragraph (e) of this section is the earlier of the time the taxpayer files its timely return for the year or the due date of the timely return.

(2) *After the filing date*—(i) *In general.* If, at any time after the filing date, the taxpayer no longer expects, under any reasonably foreseeable circumstances, that a lobbying communication will be made that is supported by the activity, then any amount previously allocated under §1.162–28 to the activity and disallowed under section 162(e)(1)(A) is treated as an amount that is not subject to section 162(e)(1)(A) and that is paid or incurred only at the time the taxpayer no longer expects that a lobbying communication will be made.

(ii) *Special rule for certain tax-exempt organizations.* For a tax-exempt organization subject to section 6033(e), the amounts described in paragraph (e)(2)(i) of this section are treated as reducing (but not below zero) its expenditures to which section 162(e)(1) applies beginning with that year and continuing for subsequent years to the extent not treated in prior years as reducing those expenditures.

(f) *Anti-avoidance rule.* If a taxpayer, alone or with others, structures its activities with a principal purpose of achieving results that are unreasonable in light of the purposes of section 162(e)(1)(A) and section 6033(e), the Commissioner can recast the taxpayer's activities for federal tax purposes as appropriate to achieve tax results that are consistent with the intent of section 162(e)(1)(A), section 6033(e) (if applicable), and this section, and the pertinent facts and circumstances.

(g) *Taxpayer defined.* For purposes of this section, a taxpayer includes a tax-exempt organization subject to section 6033(e).

(h) *Effective date.* This section is effective for amounts paid or incurred on or after July 21, 1995. Taxpayers must adopt a reasonable interpretation of section 162(e)(1)(A) for amounts paid or incurred before this date.

[T.D. 8602, 60 FR 37575, July 21, 1995]

§ 1.162–31 The $500,000 deduction limitation for remuneration provided by certain health insurance providers.

(a) *Scope*. This section sets forth rules regarding the deduction limitation under section 162(m)(6), which provides that a covered health insurance provider's deduction for applicable individual remuneration (AIR) and deferred deduction remuneration (DDR) attributable to services performed by an applicable individual in a disqualified taxable year is limited to $500,000. Paragraph (b) of this section sets forth definitions of the terms used in this section. Paragraph (c) of this section explains the general limitation on deductions under section 162(m)(6). Paragraph (d) of this section sets forth the methods that must be used to attribute AIR and DDR to services performed in one or more taxable years of a covered health insurance provider. Paragraph (e) of this section sets forth rules on how the deduction limit applies to AIR and DDR that is otherwise deductible under chapter 1 of the Internal Revenue Code (Code) but for the deduction limitation under section 162(m)(6) (referred to in this section as remuneration that is otherwise deductible). Paragraph (f) of this section sets forth additional rules for persons participating in certain corporate transactions. Paragraph (g) of this section explains the interaction of section 162(m)(6) with sections 162(m)(1) and 280G. Paragraph (h) of this section sets forth rules for determining the amounts of remuneration that are not subject to the deduction limitation under section 162(m)(6) due to the statutory effective date (referred to in this section as grandfathered amounts). Paragraph (i) of this section sets forth transition rules for DDR that is attributable to services performed in taxable years beginning after December 31, 2009 and before January 1, 2013. Paragraph (j) of this section sets forth the effective and applicability dates of the rules in this section.

(b) *Definitions*—(1) *Health insurance issuer*. For purposes of this section, a *health insurance issuer* is a health insurance issuer as defined in section 9832(b)(2).

(2) *Aggregated group*. For purposes of this section, an *aggregated group* is a health insurance issuer and each other person that is treated as a single employer with the health insurance issuer at any time during the taxable year of the health insurance issuer under sections 414(b) (controlled groups of corporations), 414(c) (partnerships, proprietorships, etc. under common control), 414(m) (affiliated service groups), or 414(o), except that the rules in section 1563(a)(2) and (3) (with respect to corporations) and § 1.414(c)–2(c) and (d) (with respect to trades or businesses under common control) for brother-sister groups and combined groups are disregarded.

(3) *Parent entity*—(i) *In general*. For purposes of this section, a *parent entity* is either—

(A) The common parent of a parent-subsidiary controlled group of corporations (within the meaning of section 414(b)) or a parent-subsidiary group of trades or businesses under common control (within the meaning of section 414(c)) that includes a health insurance issuer, or

(B) the health insurance issuer in an aggregated group that is an affiliated service group (within the meaning of section 414(m)) or a group described in section 414(o).

(ii) *Certain aggregated groups with multiple health insurance issuers*—(A) *In general*. If two or more health insurance issuers are members of an aggregated group that is an affiliated service group (within the meaning of section 414(m)) or group described in section 414(o), the parent entity is the health insurance issuer in the aggregated group that is designated in writing by the other members of the aggregated group to act as the parent entity.

(B) *Successor parent entities*. If a health insurance issuer that is the parent entity of an aggregated group pursuant to paragraph (b)(3)(ii)(A) of this section (a predecessor parent entity) ceases to be a member of the aggregated group (for example, as a result of a corporate transaction) and, after the predecessor parent entity ceases to be a member of the aggregated group, two or more health insurance issuers are members of the aggregated group, the new parent entity (the successor parent entity) is another member of the aggregated group designated in writing by the remaining members of the aggregated group. The successor parent entity must be a health insurance issuer in the aggregated group that has the same taxable year as the predecessor parent entity; provided, however, that if no health insurance issuer in the aggregated group has the same taxable year as the predecessor parent entity, the members of the aggregated group may designate in writing any other health insurance issuer in the aggregated group to be the parent entity.

(C) *Failure to designate a parent entity.* If the members of an aggregated group that includes two or more health insurance issuers and that is an affiliated service group (within the meaning of section 414(m)) or a group described in section 414(o) fail to designate in writing a health insurance issuer to act as the parent entity of the aggregated group, the parent entity of the aggregated group for all taxable years is deemed to be an entity with a taxable year that is the calendar year (without regard to whether the aggregated group includes or has ever included an entity with a calendar year taxable year) for all purposes under this section for which a parent entity's taxable year is relevant.

(4) *Covered health insurance provider*—(i) *In general.* For purposes of this section and except as otherwise provided in this paragraph (b)(4), a *covered health insurance provider* is—

(A) A health insurance issuer for any of its taxable years beginning after December 31, 2012 in which at least 25 percent of the gross premiums it receives from providing health insurance coverage (as defined in section 9832(b)(1)) are from providing minimum essential coverage (as defined in section 5000A(f)),

(B) a health insurance issuer for any of its taxable years beginning after December 31, 2009 and before January 1, 2013 in which it receives premiums from providing health insurance coverage (as defined in section 9832(b)(1)),

(C) the parent entity of an aggregated group of which one or more health insurance issuers described in paragraphs (b)(4)(i)(A) or (B) of this section are members for the taxable year of the parent entity with which, or in which, ends the taxable year of any such health insurance issuer; however, if the parent entity of an aggregated group is a health insurance issuer described in paragraphs (b)(4)(i)(A) or (B) of this section, that health insurance issuer is a covered health insurance provider for any taxable year that it is otherwise a covered health insurance provider, without regard to whether the taxable year of any other health insurance issuer described in paragraphs (b)(4)(i)(A) or (B) of this section ends with or within its taxable year, and

(D) each other member of an aggregated group of which one or more health insurance issuers described in paragraphs (b)(4)(i)(A) or (B) of this section are members for the taxable year of the other member ending with, or within, the parent entity's taxable year.

(ii) *Parent entities with short taxable years.* If for any reason a parent entity has a taxable year that is less than 12 months (for example, because the taxable year of a predecessor parent entity ends when it ceases to be a member of an aggregated group), then, for purposes of determining whether the parent entity and each other member of the aggregated group is a covered health insurance provider with respect to the parent entity's short taxable year (that is, for purposes of determining whether the taxable year of a health insurance issuer described in paragraph (b)(4)(i)(A) or (B) of this section ends with or within the short taxable year of the parent entity and for purposes of determining whether another member of the aggregated group has a taxable year ending with or within the short taxable year of the parent entity), the taxable year of the parent entity is treated as the 12-month period ending on the last day of the short taxable year. Accordingly, a parent entity is a covered health insurance provider for its short taxable year if it is a health insurance issuer described in paragraph (b)(4)(i)(A) or (B) of this section or if the taxable year of a health insurance issuer described in paragraph (b)(4)(i)(A) or (B) of this section in an aggregated group with the parent entity ends with or within the 12-month period ending on the last day of the parent entity's short taxable year. Similarly, each other member of the parent entity's aggregated group is a covered health insurance provider for its taxable year ending with or within the 12-month period ending on the last day of the parent entity's short taxable year.

(iii) *Predecessor and successor parent entities.* If the parent entity of an aggregated group changes, the members of the aggregated group may be covered health insurance providers based on their relationship to either or both parent entities with respect to the taxable years of the parent entities in which the change occurs.

(iv) *Self-insured plans.* For purposes of this section, a person is not a covered health insurance provider solely because it maintains a self-insured medical reimbursement plan. For this purpose, a self-insured medical reimbursement plan is a separate written plan for the benefit of employees (including former employees) that provides for reimbursement of medical expenses referred to in section 105(b) and does not provide for reimbursement under an individual or group policy of accident or health insurance issued by a licensed insurance company or under an arrangement in the nature of a prepaid health care plan that is regulated under federal or state law in a manner similar to the regulation of insurance companies, and may include a plan maintained by an employee organization described in section 501(c)(9).

(v) *De minimis exception*—(A) *In general.* A health insurance issuer and any member of its aggregated group that would otherwise be a covered health insurance provider under paragraph (b)(4)(i), (ii), or (iii) of this section for a taxable year beginning after December 31, 2012 is not a covered health insurance provider under this section for that taxable year if the premiums received by the health insurance issuer and any other health insurance issuers in its aggregated group from providing health insurance coverage (as defined in section 9832(b)(1)) that constitutes minimum essential coverage (as defined in section 5000A(f)) are less than two percent of the gross revenues of the health insurance issuer and all other members of its aggregated group for that taxable year. A health insurance issuer and any member of its aggregated group that would otherwise be a covered health insurance provider under paragraph (b)(4)(i), (ii), or (iii) of this section for a taxable year beginning after December 31, 2009 and before January 1, 2013 is not a covered health insurance provider for purposes of this section for that taxable year if the premiums received by the health insurance issuer and any other health insurance issuers in its aggregated group from providing health insurance coverage (as defined in section 9832(b)(1)) are less than two percent of the gross revenues of the health insurance issuer and all other members of its aggregated group for that taxable year. In determining whether premiums constitute less than two percent of gross revenues, the amount of gross revenues must be determined in accordance with generally accepted accounting principles. For the definition of the term *premiums,* see paragraph (b)(5) of this section. A person that would be a covered health insurance provider for a taxable year in an aggregated group with a predecessor parent entity and that would also be a covered health insurance provider for that taxable year in an aggregated group with a successor parent entity is not a covered health insurance provider under the *de minimis* exception only if the aggregated groups of which the person is a member meet the requirements of the *de minimis* exception based on both the taxable year of the predecessor parent entity and the taxable year of the successor parent entity.

(B) *One-year de minimis exception transition period.* If a health insurance issuer or a member of an aggregated group is not a covered health insurance provider for a taxable year solely by reason of the *de minimis* exception described in paragraph (b)(4)(v)(A) of this section, but fails to meet the requirements of the *de minimis* exception described in paragraph (b)(4)(v)(A) of this section for the immediately following taxable year, that health insurance issuer or member of an aggregated group will not be a covered health insurance provider for that immediately following taxable year.

(vi) *Examples.* The following examples illustrate the principles of this paragraph (b)(4). For purposes of these examples, each corporation has a taxable year that is the calendar year, unless the example provides otherwise.

Example 1. (i) Corporations Y and Z are members of an aggregated group under paragraph (b)(2) of this section. Y is a health insurance issuer that is a covered health insurance provider pursuant to paragraph (b)(4)(i)(A) of this section and receives premiums from providing health insurance coverage that is minimum essential coverage during its 2015 taxable year in an amount that is less than two percent of the combined gross revenues of Y and Z for their 2015 taxable years. Z is not a health insurance issuer.

(ii) Y and Z are not covered health insurance providers under paragraph (b)(4) of this section for their 2015 taxable years because they meet the requirements of the *de minimis* exception under paragraph (b)(4)(v)(A) of this section.

Example 2. (i) Corporations V, W, and X are members of an aggregated group under paragraph (b)(2) of this section. V is a health insurance issuer that is a covered health insurance provider pursuant to paragraph (b)(4)(i)(A) of this section, but neither W nor X is a health insurance issuer. W is the parent entity of the aggregated group. V's taxable year ends on December 31, W's taxable year ends on June 30, and X's taxable year ends on September 30. For its taxable year ending December 31, 2016, V receives $3x of premiums from providing minimum essential coverage and has no other revenue. For its taxable year ending June 30, 2017, W has $100x in gross revenue. For its taxable year ending September 30, 2016, X has $60x in gross revenue.

(ii) But for the *de minimis* exception, V (the health insurance issuer) would be a covered health insurance provider for its taxable year ending December 31, 2016; W (the parent entity) would be a covered health insurance provider for its taxable year ending June 30, 2017 (its taxable year with which, or within which, ends the taxable year of the health insurance issuer); and X (the other member of the aggregated group) would be a covered health insurance provider for its taxable year ending on September 30, 2016 (its taxable year ending with, or within, the taxable year of the parent entity). However, the premiums received by V (the health insurance issuer) from providing minimum essential coverage during the taxable year that it would otherwise be a covered health insurance provider under paragraph (b)(4)(i)(A) of this section are less than two percent of the combined gross revenues of V, W, and X for the related taxable years that they would otherwise be covered health insurance providers under paragraph (b)(4)(i) of this section ($3x is less than $3.26x (two percent of $163x)). Therefore, the *de minimis* exception of paragraph (b)(4)(v)(A) of this section applies, and V, W, and X are not covered health insurance providers for these taxable years.

Example 3. (i) The facts are the same as *Example 2,* except that V receives $4x of premiums for providing minimum essential coverage for its taxable year ending December 31, 2016. In addition, the members of the VWX aggregated group were not covered health insurance providers for their taxable years ending December 31, 2015, June 30, 2016, and September 30, 2015, respectively (their immediately preceding taxable years) solely by reason of the *de minimis* exception of paragraph (b)(4)(v)(A) of this section.

(ii) Although the premiums received by the members of the aggregated group from providing minimum essential coverage are more than two percent of the gross revenues of the aggregated group for the taxable years during which the members would otherwise be treated as covered health insurance providers under paragraph (b)(4)(i) of this section ($4x is greater than $3.28x (two percent of $164x)), they were not covered health insurance providers for their immediately preceding taxable years solely because of the *de minimis* exception of paragraph (b)(4)(v)(A) of this section. Therefore, V, W, and X are not covered health insurance providers for their taxable years ending on December 31, 2016, June 30, 2017, and September 30, 2016, respectively, because of the one-year transition period under paragraph (b)(4)(v)(B) of this section. However, the members of the VWX aggregated group will be covered health insurance providers for their subsequent taxable years if they would otherwise be covered health insurance providers for those taxable years under paragraph (b)(4) of this section.

Example 4. (i) Corporations W, X, Y, and Z are members of a controlled group described in section 414(b)) that is an aggregated group under paragraph (b)(2) of this section. W and X are health insurance issuers. Y and Z are not health insurance issuers. W is the parent entity of the aggregated group. W's and Y's taxable years end on December 31; X's taxable year ends on March 31; and Z's taxable year ends on June 30. As a result of a corporate transaction, W is no longer a member of the WXYZ aggregated group as of September 30, 2016, and W's taxable year ends on that date. Following the corporate transaction, X becomes the parent entity of the XYZ aggregated group.

(ii) Because W's taxable year is treated as the 12-month period ending on September 30, 2016, W is the parent entity for X's taxable year ending March 31, 2016, Z's taxable year ending June 30, 2016, and Y's taxable year ending December 31, 2015. Because X's taxable year begins on April 1, 2016 and ends on March 31, 2017, for purposes of paragraph (b)(4) of this section, X is the parent entity for Z's taxable year ending June 30, 2016, Y's taxable year ending December 31, 2016, and W's taxable year ending September 30, 2016.

Example 5. (i) The facts are the same as *Example 4*. In addition, W receives $4x of premiums for providing minimum essential coverage and no other revenue for its taxable year beginning January 1, 2016 and ending September 30, 2016. X receives $2x of premiums for providing minimum essential coverage and has no other revenue for its taxable year ending March 31, 2016. X receives $1x of premiums for providing minimum essential coverage and no other revenue for its taxable year ending March 31, 2017. For its taxable year ending December 31, 2015, Y has $100x in gross revenue. For its taxable year ending December 31, 2016, Y has $200x in gross revenue. For its taxable year ending June 30, 2016, Z has $120x in gross revenue (none of which constitute premiums for providing health insurance coverage that constitutes minimum essential coverage (as defined in section 5000A(f)). W, X, Y, and Z did not qualify for the *de minimis* exception in any prior taxable years.

(ii) For its taxable year ending June 30, 2016, Z does not meet the requirements for the *de minimis* exception described in paragraph (b)(4)(v)(A). Even though Z meets the requirements for the *de minimis* exception with respect to the taxable year of parent entity X ending March 31, 2017 ($5x is less than two percent of $325x), Z does not meet the requirements for the *de minimis* exception based on the premiums and gross revenues of the taxable years of its aggregated group members ending with or within the deemed 12-month taxable year of parent entity W ending September 30, 2016 ($6x is more than two percent of $226x). Therefore, Z is a covered health insurance provider for its June 30, 2016 taxable year.

(iii) For its taxable year ending December 31, 2015, Y does not meet the requirements for the *de minimis* exception described in paragraph (b)(4)(v)(A) ($6x is more than two percent of $226x). For its taxable year ending December 31, 2016, Y meets the requirements for the *de minimis* exception described in paragraph (b)(4)(v)(A) ($5x is less than two percent of $325x). Therefore, Y is a covered health insurance provider for its December 31, 2015 taxable year, but is not a covered health insurance provider for its December 31, 2016 taxable year.

(iv) For its taxable year ending September 30, 2016, W does not meet the requirements for the *de minimis* exception described in paragraph (b)(4)(v)(A). Even though W meets the requirements for the *de minimis* exception with respect to X's taxable year ending March 31, 2017 ($5x is less than two percent of $325x), W does not meet the requirements for the *de minimis* exception with respect its taxable year ending September 30, 2016 ($6x is more than two percent of $226x). Therefore, W is a covered health insurance provider for its September 30, 2016 taxable year.

(v) For its taxable year ending March 31, 2016, X does not meet the requirements for the *de minimis* exception ($6x is more than two percent of $226x). For its taxable year ending March, 31 2017, X meets the requirements for the *de minimis* exception ($5x is less than two percent of $325x). Therefore, X is a covered health insurance provider for its March 31, 2016 taxable year, but is not a covered health insurance provider for its March 31, 2017 taxable year.

(5) *Premiums*—(i) For purposes of this section, the term *premiums* means premiums written (including premiums written for assumption reinsurance, but reduced by assumption reinsurance ceded (as described in paragraph (b)(5)(ii) of this section), excluding indemnity reinsurance written (as described in paragraph (b)(5)(iii) of this section) and direct service payments (as described in paragraph (b)(5)(iv) of this section), but without reduction for ceding commissions or medical loss ratio rebates, determined in a manner consistent with the requirements for reporting under the Supplemental Health Care Exhibit published by the National Association of Insurance Commissioners or the MLR Annual Reporting Form filed with the Center for Medicare & Medicaid Services' Center for Consumer Information and Insurance Oversight of the U.S. Department of Health and Human Services (or any successor or replacement exhibits or forms).

(ii) *Assumption reinsurance.* For purposes of this paragraph (b)(5), the term *assumption reinsurance* means reinsurance for which there is a novation and the reinsurer takes over the entire risk of loss pursuant to a new contract.

(iii) *Indemnity reinsurance.* For purposes of this paragraph (b)(5), the term *indemnity reinsurance* means reinsurance provided pursuant to an agreement between a health insurance issuer and a reinsuring company under which the reinsuring company agrees to indemnify the health insurance issuer for all or part of the risk of loss under policies specified in the agreement, and the health insurance issuer retains its liability to provide health insurance coverage (as defined in section 9832(b)(1)) to, and its contractual relationship with, the insured.

(iv) *Direct service payments.* For purposes of this paragraph (b)(5), the term *direct service payment* means a capitated, prepaid, periodic, or other payment made by a health insurance issuer or another entity that receives premiums from providing health insurance coverage (as defined in section 9832(b)(1)) to another organization as compensation for providing, managing, or arranging for the provision of healthcare services by physicians, hospitals, or other healthcare providers, regardless of whether the organization that receives the compensation is subject to healthcare provider, health insurance, health plan licensing, financial solvency, or other similar regulatory requirements under state insurance law.

(6) *Disqualified taxable year.* For purposes of this section, the term *disqualified taxable year* means, with respect to any person, any taxable year for which the person is a covered health insurance provider.

(7) *Applicable individual*—(i) *In general.* For purposes of this section, except as provided in paragraph (b)(7)(ii) of this section, the term *applicable individual* means, with respect to any covered health insurance provider for any disqualified taxable year, any individual (or any other person described in guidance of general applicability published in the Internal Revenue Bulletin)—

(A) who is an officer, director, or employee in that taxable year, or

(B) who provides services for or on behalf of the covered health insurance provider during that taxable year.

(ii) *Independent contractors*—Remuneration for services performed by an independent contractor for a covered health insurance provider is subject to the deduction limitation under section 162(m)(6). However, an independent contractor is not an applicable individual with respect to a covered health insurance provider for a disqualified taxable year if each of the following requirements is satisfied:

(A) The independent contractor is actively engaged in the trade or business of providing services to recipients, other than as an employee or as a member of the board of directors of a corporation (or similar position with respect to an entity that is not a corporation);

(B) The independent contractor provides significant services (as defined in §1.409A–1(f)(2)(iii)) to two or more persons to which the independent contractor is not related and that are not related to one another (as defined in §1.409A–1(f)(2)(ii)); and

(C) The independent contractor is not related to the covered health insurance provider or any member of its aggregated group, applying the definition of related person contained in §1.409A–1(f)(2)(ii), subject to the modification that for purposes of applying the references to sections 267(b) and 707(b)(1), the language ''20 percent'' is not used instead of ''50 percent'' each place ''50 percent'' appears in sections 267(b) and 707(b)(1).

(8) *Service provider.* For purposes of this section, the term *service provider* means, with respect to a covered health insurance provider for any period, an individual who is an officer, director, or employee, or who provides services for, or on behalf of, the covered health insurance provider or any member of its aggregated group.

(9) *Remuneration*—(i) *In general.* For purposes of this section, except as provided in paragraph (b)(9)(ii) of this section, the term *remuneration* has the same meaning as the term *applicable employee remuneration*, as defined in section 162(m)(4), but without regard to the exceptions under section 162(m)(4)(B) (remuneration payable on a commission basis), section 162(m)(4)(C) (performance-based compensation), and section 162(m)(4)(D) (existing binding contracts), and the regulations under those sections.

(ii) *Exceptions.* For purposes of this section, remuneration does not include—

(A) A payment made to, or for the benefit of, an applicable individual from or to a trust described in section 401(a) within the meaning of section 3121(a)(5)(A),

(B) A payment made under an annuity plan described in section 403(a) within the meaning of section 3121(a)(5)(B),

(C) A payment made under a simplified employee pension plan described in section 408(k)(1) within the meaning of section 3121(a)(5)(C),

(D) A payment made under an annuity contract described in section 403(b) within the meaning of section 3121(a)(5)(D),

(E) Salary reduction contributions described in section 3121(v)(1), and

(F) Remuneration consisting of any benefit provided to, or on behalf of, an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude the value of the benefit from gross income.

(10) *Applicable Individual Remuneration or AIR.* For purposes of this section, the term *applicable individual remuneration* or *AIR* means, with respect to any applicable individual for any disqualified taxable year, the aggregate amount allowable as a deduction under this chapter for that taxable year (determined without regard to section 162(m)) for remuneration for services performed by that applicable individual (whether or not in that taxable year). AIR does not include any DDR with respect to services performed during any taxable year. AIR for a disqualified taxable year may include remuneration for services performed in a taxable year before the taxable year in which the deduction for the remuneration is allowable. For example, a discretionary bonus granted and paid to an applicable individual in a disqualified taxable year in recognition of services performed in prior taxable years is AIR for the disqualified taxable year in which the bonus is granted and paid. In addition, a grant of restricted stock in a disqualified taxable year with respect to which an applicable individual makes an election under section 83(b) is AIR for the disqualified taxable year of the covered health insurance provider in which the grant of the restricted stock is made. See paragraph (b)(9)(ii) of this section for certain remuneration that is not treated as AIR for purposes of this section.

(11) *Deferred Deduction Remuneration or DDR.* For purposes of this section, the term *deferred deduction remuneration* or *DDR* means remuneration that would be AIR for services performed in a disqualified taxable year but for the fact that the deduction (determined without regard to section 162(m)(6)) for the remuneration is allowable in a subsequent taxable year. Whether remuneration is DDR is determined without regard to when the remuneration is paid, except to the extent that the timing of the payment affects the taxable year in which the remuneration is otherwise deductible. For example, payments that are otherwise deductible by a covered health insurance provider in an initial taxable year, but are paid to an applicable individual by the 15th day of the third month of the immediately subsequent taxable year of the covered health insurance provider (as described in §1.404(b)–1T, Q&A–2(b)(1)), are AIR for the initial taxable year (and not DDR) because the deduction for the payments is allowable in the initial taxable year, and not a subsequent taxable year. Except as otherwise provided in paragraph (i) of this section (regarding transition rules for certain DDR attributable to services performed in taxable years beginning before January 1, 2013), DDR that is attributable to services performed in a disqualified taxable year of a covered health insurance provider is subject to the section 162(m)(6) deduction limitation even if the taxable year in which the remuneration is otherwise deductible is not a disqualified taxable year. Similarly, DDR is subject to the section 162(m)(6) deduction limitation regardless of whether an applicable individual is a service provider of the covered health insurance provider in the taxable year in which the DDR is otherwise deductible. However, remuneration that is attributable to services performed in a taxable year that is not a disqualified taxable year is not DDR even if the remuneration is otherwise deductible in a disqualified taxable year. See also paragraph (b)(9)(ii) of this section for certain remuneration that is not treated as DDR for purposes of this section.

(12) *Substantial risk of forfeiture.* For purposes of this section, the term *substantial risk of forfeiture* has the same meaning as provided in §1.409A–1(d).

(13) *In-service payment*. An *in-service payment* is any amount that is paid with respect to an applicable individual from an account balance plan described in §1.409A–1(c)(2)(i)(A) or (B) or a nonaccount balance plan described in §1.409A–1(c)(2)(i)(C) in a taxable year of a covered health insurance provider during which at any time the applicable individual is a service provider (including amounts that became otherwise deductible, but were not paid, in a previous taxable year of a covered health insurance provider). Amounts that are paid in the last year that an applicable individual is a service provider (for example, amounts paid at separation from service) are in-service payments if the applicable individual is a service provider at any time during the taxable year of the covered health insurance provider in which the payment is made.

(14) *Payment year*. For purposes of this section, the term *payment year* means the taxable year of a covered health insurance provider for which remuneration becomes otherwise deductible.

(15) *Measurement date*. For purposes of this section, the term *measurement date* means the last day of the taxable year of a covered health insurance provider.

(c) *Deduction Limitation*—(1) *AIR*. For any disqualified taxable year beginning after December 31, 2012, no deduction is allowed under this chapter for AIR that is attributable to services performed by an applicable individual in that taxable year to the extent that the amount of that remuneration exceeds $500,000.

(2) *DDR*. For any taxable year beginning after December 31, 2012, no deduction is allowed under this chapter for DDR that is attributable to services performed by an applicable individual in any disqualified taxable year beginning after December 31, 2009, to the extent that the amount of such remuneration exceeds $500,000 reduced (but not below zero) by the sum of:

(i) The AIR for that applicable individual for that disqualified taxable year; and

(ii) The portion of the DDR for those services that was subject to the deduction limitation under section 162(m)(6)(A)(ii) and this paragraph (c)(2) in a preceding taxable year, or would have been subject to the deduction limitation under section 162(m)(6)(A)(ii) and this paragraph (c)(2) in a preceding taxable year if section 162(m)(6) was effective for taxable years beginning after December 31, 2009 and before January 1, 2013.

(d) *Services to which remuneration is attributable*—(1) *Attribution to a taxable year*—(i) *In general*. The deduction limitation under section 162(m)(6) applies to AIR and DDR attributable to services performed by an applicable individual in a disqualified taxable year of a covered health insurance provider. When an amount of AIR or DDR becomes otherwise deductible (and not before that time), that remuneration must be attributed to services performed by an applicable individual in a taxable year of the covered health insurance provider in accordance with the rules of this paragraph (d). After the remuneration has been attributed to services performed by an applicable individual in a taxable year of a covered health insurance provider, the rules of paragraph (e) of this section are then applied to determine whether the deduction with respect to the remuneration is limited by section 162(m)(6).

(ii) *Overview*. Paragraphs (d)(1)(iii) through (v) of this section, and paragraph (d)(2) of this section, set forth rules of general applicability for attributing remuneration to services performed by an applicable individual in a taxable year of a covered health insurance provider. Paragraph (d)(3) sets forth two methods for attributing remuneration provided under an account balance plan—the account balance ratio method (described in paragraph (d)(3)(ii) of this section) and the principal additions method (described in paragraph (d)(3)(iii) of this section). Paragraph (d)(4) of this section sets forth two methods for attributing remuneration provided under a nonaccount balance plan—the present value ratio method (described in paragraph (d)(4)(ii) of this section) and the formula benefit ratio method (described in paragraph (d)(4)(iii) of this section). Paragraph (d)(5) of this section sets forth rules for attributing remuneration resulting from equity-based remuneration (such as stock options, stock appreciation rights, restricted stock, and restricted stock units). Paragraph (d)(6) of this section sets forth rules for attributing remuneration that is involuntary separation pay. Paragraph (d)(7) of this section sets forth rules for attributing remuneration that is received under a reimbursement arrangement, and paragraph (d)(8) of this section sets forth rules for attributing remuneration that results from a split-dollar life insurance arrangement.

(iii) *No attribution to taxable years during which no services are performed or before a legally binding right arises*—(A) *In general*. For purposes of this section, remuneration is not attributable—

(*1*) To a taxable year of a covered health insurance provider ending before the later of the date the applicable individual begins providing services to the covered health insurance provider (or any member of its aggregated group) and the date the applicable individual obtains a legally binding right to the remuneration, or

(*2*) To any other taxable year of a covered health insurance provider during which the applicable individual is not a service provider.

(B) *Attribution of remuneration before the commencement of services or a legally binding right arises*. To the extent that remuneration would otherwise be attributable in accordance with paragraphs (d)(2) through (11) of this section to a taxable year ending before the later of the date an applicable individual begins providing services to a covered health insurance provider (or any member of its aggregated group) and the date the applicable individual obtains a legally binding right to the remuneration, the remuneration is attributed to services performed in the taxable year in which the later of these dates occurs. For example, if an applicable individual obtains a contractual right to remuneration in a taxable year of a covered health insurance provider and the remuneration would otherwise be attributable to that taxable year pursuant to paragraph (d)(2) of this section, but the applicable individual does not begin providing services to the covered health insurance provider until the next taxable year, the remuneration is attributable to the taxable year in which the applicable individual begins providing services.

(iv) *Attribution to 12-month periods*. To the extent that a covered health insurance provider is required to attribute remuneration on a daily *pro rata* basis under this paragraph (d), it may treat any 12-month period as having 365 days (and so may ignore the extra day in leap years).

(v) *Remuneration subject to nonlapse restriction or similar formula*. For purposes of this section, if stock or other property is subject to a nonlapse restriction (as defined in § 1.83–3(h)), or if the remuneration payable to an applicable individual is determined under a formula that, if applied to stock or other property, would be a nonlapse restriction, the amount of the remuneration and the attribution of that remuneration to taxable years must be determined based upon application of the nonlapse restriction or formula. For example, if the earnings or losses on an account under an account balance plan are determined based upon the performance of company stock, the valuation of which is based on a formula that if applied to the stock would be a nonlapse restriction, then that formula must be used consistently for purposes of determining the amount of the remuneration credited to that account balance in taxable years and the attribution of that remuneration to taxable years.

(2) *Legally binding right*. Unless attributable to services performed in a different taxable year pursuant to paragraphs (d)(3) through (11) of this section, remuneration is attributable to services performed in the taxable year of a covered health insurance provider in which an applicable individual obtains a legally binding right to the remuneration. An applicable individual does not have a legally binding right to remuneration if the remuneration may be reduced unilaterally or eliminated by a covered health insurance provider or other person after the services creating the right to the remuneration have been performed. However, if the facts and circumstances indicate that the discretion to reduce or eliminate the remuneration is available or exercisable only upon a condition, or the

discretion to reduce or eliminate the remuneration lacks substantive significance, an applicable individual will be considered to have a legally binding right to the remuneration. For this purpose, remuneration is not considered to be subject to unilateral reduction or elimination merely because it may be reduced or eliminated by operation of the objective terms of a plan, such as the application of a nondiscretionary, objective provision creating a substantial risk of forfeiture.

(3) *Account balance plans*—(i) *In general*. When remuneration for services performed by an applicable individual for a covered health insurance provider becomes otherwise deductible (for example, because the amount was paid or made available during that taxable year) from a plan described in §1.409A–1(c)(2)(i)(A) or (B) (an *account balance plan*), that remuneration must be attributed to services performed by the applicable individual in a taxable year of the covered health insurance provider in accordance with an attribution method described in either paragraph (d)(3)(ii) or (d)(3)(iii) of this section. However, except as provided in paragraphs (d)(3)(ii)(D) and (f)(3) of this section, the covered health insurance provider and all members of its aggregated group must apply the same attribution method under this paragraph (d)(3) consistently for all taxable years beginning after September 23, 2014 for all amounts that become otherwise deductible under all account balance plans.

(ii) *Account balance ratio method*—(A) *In general*. Under this method, remuneration for services performed by an applicable individual for a covered health insurance provider that becomes otherwise deductible under an account balance plan must be attributed to services performed by the applicable individual in each taxable year of the covered health insurance provider ending with or before the payment year during which the applicable individual was a service provider and for which the account balance of the applicable individual increased (determined in accordance with paragraph (d)(3)(ii)(B) and (C) of this section). The amount attributed to each such taxable year is equal to the amount of remuneration that becomes otherwise deductible multiplied by a fraction, the numerator of which is the increase in the applicable individual's account balance under the plan for the taxable year, and the denominator of which is the sum of all such increases for all taxable years during which the applicable individual was a service provider. Thus, remuneration that becomes otherwise deductible under a plan is attributed to a taxable year of the covered health insurance provider in proportion to the increase in the applicable individual's account balance for that taxable year.

(B) *Increase in the account balance*. For purposes of this paragraph (d)(3)(ii), an increase in an account balance under an account balance plan occurs for a taxable year if the account balance as of the measurement date in that taxable year is greater than the account balance as of the measurement date in every earlier taxable year. In that case, the amount of the increase for that taxable year is equal to the excess of the applicable individual's account balance as of the measurement date for that taxable year over the greatest of the applicable individual's account balances under the plan as of the measurement date in every earlier taxable year. If the applicable individual's account balance as of the measurement date in a taxable year is less than or equal to the applicable individual's account balance as of the measurement date in any earlier taxable year, there is no increase in the account balance for that later taxable year.

(C) *Certain account balance adjustments*. For purposes of determining the account balance on a measurement date under paragraph (d)(3)(ii)(B) of this section, the account balance is adjusted as provided in this paragraph (d)(3)(ii)(C).

(*1*) *In-service payments*. If an in-service payment is made from the account of an applicable individual under an account balance plan in any taxable year of a covered health insurance provider, then the rules of this paragraph (d)(3)(ii)(C)(*1*) apply.

(*i*) Solely for purposes of determining the increase in the applicable individual's account balance as of the measurement date in the payment year (and not for purposes of attributing any amount that becomes otherwise deductible in any later taxable year), the account balance as of the measurement date for that taxable year is increased by the amount of all in-service payments made from the plan during that taxable year.

(*ii*) For purposes of attributing any amount that becomes otherwise deductible under the plan in any taxable year after the payment year of the in-service payment—

(*A*) the account balance as of the measurement date in each taxable year that ends before the taxable year to which the in-service payment is attributed pursuant to this paragraph (d)(3)(ii) is reduced by the sum of the amount of the in-service payment that is attributed to that taxable year and the amount of the in-service payment that is attributed to each taxable year that ends before that taxable year, if any, and

(B) to the extent that the in-service payment includes an amount that was deductible by the covered health insurance provider in a previous taxable year and, therefore, was previously attributable to services performed by the applicable individual in one or more taxable years of the covered health insurance provider (for example, because the amount was made available in a previous taxable year but was not paid at that time), the account balance as of the measurement date for each taxable year that ends before the taxable year to which the in-service payment is attributed pursuant to this paragraph (d)(3)(ii) is reduced by the sum of the amount of the in-service payment previously attributable to that taxable year and the amount of the in-service payment previously attributable to each taxable year that ends before that taxable year, if any.

(*2*) *Certain increases after ceasing to be a service provider.* Any addition (other than income or earnings) to an account balance plan made in a taxable year that begins after an applicable individual ceases to be a service provider (and that ends before the applicable individual becomes a service provider again, if applicable) is added to the account balance of the applicable individual as of the measurement date of the first preceding taxable year in which the applicable individual was a service provider.

(*3*) *Account balance adjustments for grandfathered amounts.* If a covered health insurance provider uses the principal additions method for determining grandfathered amounts for an applicable individual under paragraph (h) of this section, then, for purposes of determining the increase in the applicable individual's account balance, the account balance as of any measurement date is reduced by the amount of any grandfathered amounts otherwise included in the account balance.

(D) *Transition rule for amounts attributed before the applicability date of the final regulations.* Amounts that become otherwise deductible in taxable years beginning before September 23, 2014 may be attributed to services performed in taxable years of a covered health insurance provider under the rules set forth in the proposed regulations. If a covered health insurance provider attributes an amount paid to an applicable individual pursuant to a method permitted under the proposed regulations and then chooses to use the account balance ratio method to attribute amounts that subsequently become otherwise deductible with respect to that applicable individual, then, for purposes of applying the account balance ratio method to attribute any amount that becomes otherwise deductible under the plan after the taxable year in which the last payment was made that was attributed pursuant to the proposed regulations, the account balance as of the measurement date for each taxable year that ends before the taxable year in which the last payment that was attributed pursuant to the proposed regulations is reduced by the sum of the amount previously attributed to that taxable year under the proposed regulations and the amount previously attributable to each taxable year that ends prior to that taxable year under the proposed regulations, if any.

(iii) *Principal additions method*—(A) *In general.* Under this method, remuneration that becomes otherwise deductible under an account balance plan during a payment year must be attributed to services performed by the applicable individual in the taxable year of the covered health insurance provider during which the applicable individual was a service provider and in which the principal addition to which the amount relates is credited under the plan (determined in accordance with paragraph (d)(3)(iii)(B) and (C) of this section). An amount relates to a principal addition if the amount is a payment of the principal addition or earnings on the principal addition, based on a separate accounting of these amounts. The principal additions method described in this paragraph may be used to attribute amounts that become otherwise deductible under an account balance plan only if the covered health insurance provider separately accounts for each principal addition to the plan (and any earnings thereon) and traces each amount that becomes otherwise deductible under the plan to a principal addition made in a taxable year of the covered health insurance provider.

(B) *Principal addition*—(*1*) For purposes of this paragraph (d)(3)(iii), the excess (if any) of the sum of the account balance of an applicable individual in an account balance plan as of the last day of a taxable year and any payments made during the taxable year over the account balance as of the last day of the immediately preceding taxable year, that is not due to earnings or losses (as described in paragraph (d)(3)(iii)(C) of this section), is treated as a principal addition that is credited to the plan in that taxable year if the applicable individual was a service provider during that taxable year. If the applicable individual was not a service provider during that taxable year, the excess described in the preceding sentence is treated as a principal addition that is credited to the plan in accordance with paragraph (d)(3)(iii)(B)(*2*) of this section.

(*2*) *Principal additions after termination of employment*. Any principal addition to an account balance plan made in a taxable year that begins after an applicable individual ceases to be a service provider (and that ends before the applicable individual becomes a service provider again, if applicable) is treated as a principal addition that is credited in the first preceding taxable year in which the applicable individual was a service provider.

(C) *Earnings*. Whether remuneration constitutes earnings on a principal addition is determined under the principles defining income attributable to an amount taken into account under §31.3121(v)(2)–1(d)(2). Therefore, for an account balance plan, earnings on an amount deferred generally include an amount credited on behalf of an applicable individual under the terms of the arrangement that reflects a rate of return that does not exceed either the rate of return on a predetermined actual investment (as defined in §31.3121(v)(2)–1(d)(2)(i)(B)), or, if the income does not reflect the rate of return on a predetermined actual investment, a rate of return that reflects a reasonable rate of interest (as defined in §31.3121(v)(2)–1(d)(2)(i)(C)). For purposes of this paragraph (d)(3)(iii), the use of a rate of return that is not based on a predetermined actual investment or a reasonable rate of interest generally will result in the treatment of some or all of the remuneration as a principal addition that is attributable to services performed by an applicable individual in a taxable year of a covered health insurance provider in accordance with this paragraph (d)(3)(iii) of this section.

(4) *Nonaccount balance plans*—(i) *In general*. When remuneration for services performed by an applicable individual for a covered health insurance provider becomes otherwise deductible under a plan described in §1.409A–1(c)(2)(i)(C) (a nonaccount balance plan), that remuneration must be attributed to services performed by the applicable individual in a taxable year of the covered health insurance provider in accordance with the attribution method described in either paragraph (d)(4)(ii) or (d)(4)(iii) of this section. However, except as provided in paragraphs (d)(4)(ii)(D) and (d)(4)(iii)(D) and (f)(3) of this section, the covered health insurance provider and all members of its aggregated group must apply the same attribution method under this paragraph (d)(4) consistently for all taxable years beginning after September 23, 2014 for all amounts that become deductible under all nonaccount balance plans.

(ii) *Present value ratio attribution method*—(A) *In general.* Under this method, remuneration for services performed by an applicable individual for a covered health insurance provider that becomes otherwise deductible under a nonaccount balance plan must be attributed to services performed by the applicable individual in each taxable year of the covered health insurance provider ending with or before the payment year during which the applicable individual was a service provider for which the present value of the future payment(s) to be made to or on behalf of the applicable individual under the plan increased (determined in accordance with paragraph (d)(3)(ii)(B) and (C) of this section). The amount attributed to each such taxable year is equal to the amount of remuneration that becomes otherwise deductible under the plan multiplied by a fraction, the numerator of which is the increase in the present value of the future payment(s) to which the applicable individual has a legally binding right under the plan for the taxable year, and the denominator of which is the sum of all such increases for all taxable years during which the applicable individual was a service provider. Thus, remuneration that becomes otherwise deductible under a plan is attributed to a taxable year of the covered health insurance provider in proportion to the increase in the present value of the future payment(s) under the plan for that taxable year.

(B) *Increase in present value of future payments.* For purposes of this paragraph (d)(4)(ii), for a taxable year of a covered health insurance provider, an increase in the present value of the future payment(s) to which an applicable individual has a legally binding right under a nonaccount balance plan occurs if the present value of the future payment(s) as of the measurement date in the taxable year is greater than the present value of the future payment(s) as of the measurement date in every earlier taxable year. In that case, the amount of the increase for that taxable year is equal to the excess of the present value of the future payment(s) to which the applicable individual has a legally binding right under the plan as of the measurement date for that taxable year over the greatest present value of the future payment(s) to which the applicable individual had a legally binding right under the plan as of the measurement date in every earlier taxable year. If the present value of the future payment(s) as of a measurement date in a taxable year is less than or equal to the present value of the future payment(s) as of the measurement date in any earlier taxable year, then there is no increase in the present value of the future payment(s) to which the applicable individual has a legally binding right under the plan for that later taxable year. For purposes of determining the increase (or decrease) in the present value of a future payment(s) under a nonaccount balance plan, the rules of §31.3121(v)(2)–1(c)(2) apply (including the requirement that reasonable actuarial assumptions and methods be used).

(C) *Certain present value adjustments.* For purposes of determining the present value of the future payment(s) to which an applicable individual has a legally binding right to receive as of a measurement date under paragraph (d)(4)(ii)(B) of this section, the present value is adjusted as provided in this paragraph (d)(3)(iii)(C).

(*1*) *In-service payments.* If an in-service payment is made to or on behalf of an applicable individual under a nonaccount balance plan in any taxable year of a covered health insurance provider, then the rules of this paragraph (d)(3)(iii)(C)(*1*) apply.

(*i*) Solely for purposes of determining the increase in the present value of the future payment(s) under the plan for the payment year (and not for purposes of attributing any amount that becomes otherwise deductible in any later taxable year), the present value of the future payment(s) under the plan as of the measurement date in the payment year is increased by the amount of any reduction in the present value of the future payment(s) resulting from the in-service payment made from the plan during that taxable year.

(*ii*) For purposes of attributing any amount that becomes otherwise deductible under the plan in any taxable year after the payment year of the in-service payment, the present value of the future payment(s) as of the measurement date for each taxable year that ends before the payment year is reduced by the present value of the future payment to which the applicable individual had a legally binding right to be paid on the date of the in-service payment (determined as of the measurement date based upon all of the applicable factors under the plan as of the measurement date, such as compensation and years of service on that date).

(*2*) *Increases in the present value of future payments after ceasing to be a service provider*. Any increase in the present value of the future payment(s) under a plan in a taxable year that begins after an applicable individual ceases to be a service provider (and that ends before the applicable individual becomes a service provider again, if applicable) that is not due merely to the passage of time or a change in the reasonable actuarial assumptions used to determine the present value of the future payment(s) is added to the present value of the future payment(s) for the applicable individual as of the measurement date of the most recent preceding taxable year in which the applicable individual was a service provider.

(D) *Transition rule for amounts attributed before the effective date of the final regulations*. Amounts that become otherwise deductible in taxable years beginning before September 23, 2014 may be attributed under the rules set forth in the proposed regulations. If a covered health insurance provider attributes an amount paid to an applicable individual pursuant to the proposed regulations and then chooses to use the present value ratio method to attribute amounts that subsequently become otherwise deductible with respect to that applicable individual, then, for purposes of applying the present value ratio method to attribute any amount that becomes otherwise deductible under the plan in any taxable year after the taxable year in which the last payment was made that was attributed pursuant to the proposed regulations, the present value of the future payment(s) as of the measurement date for each taxable year that ends before the taxable year in which the last payment that was attributed pursuant to the proposed regulations is reduced by the present value of each future payment to which the applicable individual had a legally binding right to be paid that was attributed pursuant to the proposed regulations (determined as of the measurement date based upon all of the applicable factors under the plan as of the measurement date, such as compensation and years of service on that date), with no adjustment for an amount that became otherwise deductible, but was not paid.

(iii) *Formula benefit ratio method*—(A) *In general*. Under this method, remuneration that becomes otherwise deductible under a nonaccount balance plan on a date (referred to for these purposes as the *date of payment*) must be attributed to services performed by the applicable individual in each taxable year of the covered health insurance provider ending with or before the payment year during which the applicable individual was a service provider and for which the formula benefit of the applicable individual under the plan increased (determined in accordance with paragraph (d)(3)(iii)(B), (C) and (D) of this section). The amount attributed to each such taxable year is equal to the amount of remuneration that becomes otherwise deductible under the plan on the date of payment multiplied by a fraction, the numerator of which is the increase in the applicable individual's formula benefit under the plan for the taxable year and the denominator of which is the sum of all such increases for all taxable years during which the applicable individual was a service provider (which will generally be the amount that becomes otherwise deductible under the plan on the date of payment). Thus, remuneration that becomes otherwise deductible under a plan is attributed to a taxable year of the covered health insurance provider in proportion to the increase in the applicable individual's formula benefit under the plan in that taxable year.

(B) *Formula benefit*. For purposes of this paragraph (d)(4)(iii), an applicable individual's formula benefit as of any date is the benefit (or portion thereof) to which the applicable individual has a legally binding right under a nonaccount balance plan as of that date determined based upon all of the applicable factors under the plan (for example, compensation and years of service as of that date), disregarding any substantial risk of forfeiture and assuming that the applicable individual meets any applicable eligibility requirements for the benefit as of that date. For this purpose, the formula benefit is expressed in the form that it has become otherwise deductible. For example, if an applicable individual's benefit under a plan is paid in the form of a single lump sum, then the applicable individual's formula benefit under the plan is expressed in the form of a single lump sum for all purposes under this paragraph (d)(4)(iii). If the amount that becomes otherwise deductible is payable in more than one form of payment (for example, 50 percent of the benefit is paid in the form of a lump sum and 50 percent is paid in the form of a life annuity), then each separate form of payment is treated as a separate formula benefit to which this paragraph (d)(4)(iii) is applied separately.

(C) *Increase in formula benefit.* For purposes of this paragraph (d)(4)(iii), an increase in an applicable individual's formula benefit under a nonaccount balance plan occurs for a taxable year of a covered health insurance provider if the formula benefit as of the measurement date in that taxable year is greater than the formula benefit as of the measurement date in every earlier taxable year. In that case, the amount of the increase for that taxable year is equal to excess of the formula benefit as of the measurement date in that taxable year over the greatest formula benefit as of any measurement date in any earlier taxable year. If the applicable individual's formula benefit as of a measurement date in a taxable year is less than or equal to the applicable individual's formula benefit as of the measurement date in any earlier taxable year, there is no increase in the formula benefit to which the applicable individual has a legally binding right under the plan for that later taxable year.

(D) *Certain adjustments.* For purposes of determining the increase in the formula benefit as of a date of payment under paragraph (d)(4)(iii)(C) of this section, the rules of this paragraph (d)(3)(iii)(D) apply—

(*1*) *Attribution to payment year.* Solely for purposes of attributing a payment under this paragraph (d)(4)(iii) (including an in-service payment), the date of payment is substituted for the measurement date in the payment year to determine whether an increase in the formula benefit occurs in the payment year and the amount of any such increase.

(*2*) *Amounts not paid.* If an amount becomes otherwise deductible under a nonaccount balance plan, but is not paid, the formula benefit for that amount must be determined using the form in which it will be paid, if that form is known, or any form in which it may be paid, if the actual form of payment is unknown.

(*3*) *Increases in the formula benefit after ceasing to be a service provider.* Any increase in the formula benefit with respect to an applicable individual resulting from a legally binding right arising in a taxable year that begins after the applicable individual ceases to be a service provider (and that ends before the applicable individual becomes a service provider again, if applicable) is added to the formula benefit with respect to the applicable individual as of the measurement date of the first preceding taxable year in which the applicable individual was a service provider. However, any increase in the formula benefit resulting from a legally binding right arising in a taxable year that begins before the applicable individual ceases to be a service provider is added to the formula benefit with respect to the applicable individual as of the measurement date of the taxable year in which the legally binding right arises, even if the increase is not reflected until after the applicable individual ceases to be a service provider (such as in the case of a cost of living adjustment).

(5) *Equity-based remuneration*—(i) *Stock options and stock appreciation rights*—(A) *In general.* Except as provided in paragraph (d)(5)(i)(B) of this section, remuneration resulting from the exercise of a stock option (including compensation income arising at the time of a disqualifying disposition of an incentive stock option described in

section 422 or an option under an employee stock purchase plan described in section 423) or a stock appreciation right (SAR) is attributable to services performed by an applicable individual for a covered health insurance provider on a daily *pro rata* basis over the period beginning on the date of grant (within the meaning of §1.409A–1(b)(5)(vi)(B)) of the stock option or SAR and ending on the date that the stock option or SAR is exercised, excluding any days on which the applicable individual is not a service provider.

(B) *Stock options or SARs subject to a substantial risk of forfeiture*. If a stock option or SAR is subject to a substantial risk of forfeiture, a covered health insurance provider may attribute remuneration resulting from the exercise of the stock option or SAR to services performed by an applicable individual in a taxable year on a daily *pro rata* basis over the period beginning on the date of grant (within the meaning of §1.409A–1(b)(5)(vi)(B)) of the stock option or SAR and ending on the first date that the stock option or SAR is no longer subject to a substantial risk of forfeiture, but only if the covered health insurance provider uses this attribution method consistently for all stock options or SARs exercised in taxable years of a covered health insurance provider beginning after September 23, 2014, except as provided in paragraph (f)(3) of this section.

(ii) *Restricted stock*. Remuneration resulting from restricted stock, for which an election under section 83(b) has not been made, that becomes substantially vested or transferred is attributed on a daily *pro rata* basis to services performed by an applicable individual for a covered health insurance provider over the period, excluding any days on which the applicable individual is not a service provider, beginning on the date the applicable individual obtains a legally binding right to the restricted stock and ending on the earliest of—

(A) The date the restricted stock becomes substantially vested, or

(B) The date the restricted stock is transferred by the applicable individual.

(iii) *Restricted stock units*. Remuneration resulting from a restricted stock unit (*RSU*) is attributed on a daily pro rata basis to services performed by an applicable individual for a covered health insurance provider over the period beginning on the date the applicable individual obtains a legally binding right to the RSU and ending on the date the remuneration is paid or made available, excluding any days on which the applicable individual is not a service provider.

(iv) *Partnership interests and other equity*. [Reserved]

(6) *Involuntary separation pay*. Involuntary separation pay is attributable to services performed by an applicable individual for a covered health insurance provider in the taxable year in which the involuntary separation from service occurs. Alternatively, the covered health insurance provider may attribute involuntary separation pay to services performed by an applicable individual on a daily *pro rata* basis beginning on the date that the applicable individual obtains a legally binding right to the involuntary separation pay and ending on the date of the involuntary separation from service. Involuntary separation pay to different individuals may be attributed using different methods; however, if involuntary separation payments are made to the same individual over multiple taxable years, all the payments must be attributed using the same method. For purposes of this section, the term *involuntary separation pay* means remuneration to which an applicable individual has a right to payment solely as a result of the individual's involuntary separation from service (within the meaning of §1.409A–1(n)). To the extent that involuntary separation pay is attributed to services performed in two or more taxable years of a covered health insurance provider as permitted under this paragraph, any amount of involuntary separation pay that is paid or made available must be attributed to services performed in all of those taxable years in the same proportion that the total involuntary separation pay is attributed to taxable years of the covered health insurance provider.

(7) *Reimbursements*. Remuneration that is provided in the form of a reimbursement or benefit provided in-kind (other than cash) is attributable to

services performed by an applicable individual in the taxable year of a covered health insurance provider in which the applicable individual makes a payment for which the applicable individual has a right to reimbursement or receives an in-kind benefit, except that remuneration provided in the form of a reimbursement or in-kind benefit during a taxable year of a covered health insurance provider in which an applicable individual is not a service provider is attributable to services performed in the most recent preceding taxable year of the covered health insurance provider in which the applicable individual is a service provider.

(8) *Split-dollar life insurance.* Remuneration resulting from a split-dollar life insurance arrangement (as defined in §1.61–22(b)) under which an applicable individual has a legally binding right to economic benefits described in §1.61–22(d)(2)(ii) (policy cash value to which the non-owner has current access within the meaning of §1.61–22(d)(4)(ii)) or §1.61–22(d)(2)(iii) (any other economic benefits provided to the non-owner) is attributable to services performed in the taxable year of the covered health insurance provider in which the legally binding right arises. Split-dollar life insurance arrangements under which payments are treated as split-dollar loans under §1.7872–15 generally will not give rise to DDR within the meaning of paragraph (b)(11) of this section, although they may give rise to AIR. However, in certain situations, this type of arrangement may give rise to DDR for purposes of section 162(m)(6), for example, if amounts due on a split-dollar loan are waived, cancelled, or forgiven.

(9) *Examples.* The following examples illustrate the principles of paragraphs (d)(1) through (8) of this section. For purposes of these examples, each corporation has a taxable year that is the calendar year and is a covered health insurance provider for all relevant taxable years, DDR is otherwise deductible in the taxable year in which it is paid, and amounts payable under non-account balance plans are not forfeitable upon the death of the applicable individual. For purposes of these examples, the interest rates used in these examples are assumed to be reasonable.

Example 1 (Account balance plan—account balance ratio method with earnings and a single payment). (i) B is an applicable individual of corporation Y for all relevant taxable years. On January 1, 2016, B begins participating in a nonqualified deferred compensation plan of Y that is an account balance plan. Under the terms of the plan, all amounts are fully vested at all times, and Y will pay B's entire account balance on January 1, 2019. B's account earns five percent interest per year, compounded annually. Y credits $10,000 to B under the plan annually on January 1 for three years beginning on January 1, 2016. Thus, B's account balance is $10,500 ($10,000 + ($10,000 × 5%)) on December 31, 2016; $21,525 ($10,500 + $10,000 + ($20,500 × 5%)) on December 31, 2017; and $33,101 ($21,525 + $10,000 + ($31,525 × 5%)) on December 31, 2018. On January 1, 2019, Y pays B $33,101, the entire account balance. Y attributes payments under its account balance plans using the account balance ratio method described in paragraph (d)(3)(i) of this section.

(ii) The increase in B's account balance during 2016 is $10,500 ($10,500 − zero); the increase in B's account balance for 2017 is $11,025 ($21,525 − $10,500); and the increase in B's account balance for 2018 is $11,576 ($33,101 − $21,525). The sum of all the increases is $33,101 ($10,500 + $11,025 + $11,576). Accordingly, for Y's 2016 taxable year, the attribution fraction is .3172 ($10,500/$33,101); for Y's 2017 taxable year, the attribution fraction is .3331 ($11,025/$33,101); and for Y's 2018 taxable year, the attribution fraction is .3497 ($11,576/$33,101).

(iii) With respect to the $33,301 payment made on January 1, 2019, $10,500 ($33,101 × .3172) of DDR is attributable to services performed by B in Y's 2016 taxable year; $11,026 ($33,101 × .3331) of DDR is attributable to services performed by B in Y's 2017 taxable year; and $11,575 ($33,101 × .3497) of DDR is attributable to services performed by B in Y's 2018 taxable year.

Example 2 (Account balance plan—principal additions method with earnings and a single payment. (i) The facts are the same as in *Example 1,* except that Y attributes remuneration using the principal additions method described in paragraph (d)(3)(ii) of this section.

(ii) The $10,000 principal addition made on January 1, 2016 and $1,576 of earnings thereon (interest on the 2016 $10,000 principal addition at five percent for three years compounded annually) are attributable to services performed by B in Y's 2016 taxable year; the principal addition of $10,000 on January 1, 2017 and $1,025 of earnings thereon (interest on the 2017 $10,000 principal addition at five percent for two years compounded annually) are attributable to services performed by B in Y's 2017 taxable year; and the principal addition of $10,000 to B's account on January 1, 2018 and $500 of earnings thereon (interest on the 2018 $10,000 principal addition at five percent for one year compounded annually) are attributable to services performed by B in Y's 2018 taxable year. Accordingly, with respect to the $33,301 payment made on January 1, 2019, $11,576 ($10,000 + $1,576) is attributable to services performed by B in Y's 2016 taxable year; $11,025 ($10,000 + $1,025) is attributable to services performed in Y's 2017 taxable year; and $10,500 ($10,000 + $500) is attributable to services performed by B in Y's 2018 taxable year.

Example 3 (Account balance plan—account balance ratio method with earnings and losses). (i) J is an applicable individual of corporation Z for all relevant taxable years. On January 1, 2016, J begins participating in a nonqualified deferred compensation plan of Z that is an account balance plan. Under the terms of the plan, all amounts are fully vested at all times, and Z will pay J's entire account balance on January 1, 2019. Z credits $10,000 to J under the plan on January 1, 2016 and January 1, 2018. Earnings under the terms of the plan are based on a predetermined actual investment (as defined in §31.3121(v)(2)–1(e)(2)(i)(B)), which results in J's account balance increasing by five percent in the 2016 taxable year, decreasing by five percent in the 2017 taxable year, and increasing again by five percent in the 2018 taxable year. Therefore, on December 31, 2016, J's account balance is $10,500 ($10,000 + ($10,000 × 5%)); on December 31, 2017, J's account balance is $9,975 ($10,500 − ($10,500 × 5%)); and on December 31, 2018, J's account balance is $20,974 ($9,975 + $10,000 + ($19,975 × 5%)). On January 1, 2019, Z pays J the entire account balance of $20,974.

(ii) The increase in J's account balance for 2016 is $10,500 ($10,500 − zero); the increase in J's account balance for 2017 is zero (because J's account balance decreased by $525 ($9,975 − $10,500)); the increase in J's account balance for 2018 is $10,474 ($20,974 − $10,500, which is the highest account balance in any prior taxable year). The sum of all the increases is $20,974 ($10,500 + $10,474). Thus, for Z's 2016 taxable year the attribution fraction is .5006 ($10,500/$20,974); for Z's 2017 taxable year the attribution fraction is zero because there was a decrease in the account balance for the year; and for Z's 2018 taxable year the attribution fraction is .4994 ($10,474/$20,974).

(iii) Accordingly, with respect to the $20,974 payment made on January 1, 2019, $10,499 ($20,974 × .5006) of DDR is attributable to services performed by J in Z's 2016 taxable year, and $10,474 ($20,973.75 × .4994) of DDR is attributable to services performed by J in Z's 2018 taxable year. No amount is attributable to services performed by J in Z's 2017 taxable year because there was no increase in the account balance for that taxable year.

Example 4 (Account balance plan—principal additions method with earnings and losses). (i) The facts are the same as in *Example 3,* except that Z attributes remuneration using the principal additions method described in paragraph (d)(3)(ii) of this section.

(ii) The $10,000 principal addition made on January 1, 2016 and the $474 of net earnings thereon ($500 of earnings for 2016, $525 of losses for 2017, and $499 of earnings for 2018) are attributable to services performed by J in Z's 2016 taxable year; and the $10,000 principal addition made on January 1, 2018 and the $500 of earnings thereon are attributable to services performed by J in Z's 2018 taxable year. Accordingly, with respect to the $20,974 payment made on January 1, 2019, $10,474 ($10,000 + $474) of DDR is attributable to services performed by J in Z's 2016 taxable year, and $10,500 ($10,000 + $500) of DDR is attributable to services performed by J in Z's 2018 taxable year.

Example 5 (Account balance plan—account balance ratio method with losses and an in-service payment). (i) N is an applicable individual of corporation M for all relevant taxable years. On January 1, 2016, N begins participating in a nonqualified deferred compensation plan sponsored by M that is an account balance plan. Under the plan, all amounts are fully vested at all times. The balances in N's account are $110,000 on December 31, 2016; $90,000 on December 31, 2017; $250,000 on December 31, 2018; and $240,000 on December 31, 2019. N ceases providing services to N on December 31, 2019. In accordance with the plan terms, M pays to N $10,000 on September 30, 2017, $150,000 on January 1, 2021, and $100,000 on January 1, 2022. M attributes payments under its account balance plans using the account balance ratio method described in paragraph (d)(3)(i) of this section.

(ii) For purposes of attributing the $10,000 payment made on September 30, 2017 to taxable years, the increase in N's account balance for 2016 is $110,000 ($110,000 − zero). N's account balance for 2017 is treated as $100,000 ($90,000 + $10,000 payment on September 30, 2017), but, because the account balance of $100,000 is less than the account balance in an earlier year, the increase in N's account balance for 2017 is zero. The sum of all the increases in N's account balance is $110,000 ($110,000 + $0). Thus, the attribution fraction for 2016 is 1 ($110,000/$110,000), and the attribution fraction for 2017 is zero ($0/$110,000). Accordingly, with respect to the $10,000 payment made on September 30, 2017, the entire $10,000 is attributable to services performed by N in M's 2016 taxable year, and no amount is attributable to services performed by N in M's 2017 taxable year.

(iii) After attributing the September 30, 2017 payment of $10,000 to 2016, N's account balance for 2016 is treated as being $100,000 ($110,000 − $10,000), and the increase for 2016 is likewise treated as $100,000; N's account balance for 2017 decreased; the increase in N's account balance for 2018 is $150,000 ($250,000 − $100,000); and N's account balance for 2018 decreased. The sum of all the increases is $250,000 ($100,000 + $150,000). Thus, the attribution fraction for 2016 is .40 ($100,000/$250,000); the attribution fraction for 2017 is zero ($0/$250,000); the attribution fraction for 2018 is .60 ($150,000/$250,000); and the attribution fraction for 2019 is zero ($0/$250,000).

(iv) Accordingly, with respect to the $150,000 payment made on January 1, 2021, $60,000 ($150,000 × .40) is attributable to services performed by N in M's 2016 taxable year, and $90,000 ($150,000 × .60) is attributable to services performed by N in M's 2018 taxable year. With respect to the $100,000 payment made on January 1, 2022, $40,000 ($100,000 × .40) is attributable to services performed by N in M's 2016 taxable year, and $60,000 ($100,000 × .60) is attributable to services performed by N in M's 2018 taxable year. No amount is attributable to services performed by N in M's 2017 and 2019 taxable years.

Example 6 (Account balance plan—principal additions method with multiple payments). (i) O is an applicable individual of corporation L for all relevant taxable years. On January 1, 2016, O begins participating in a nonqualified deferred compensation plan sponsored by L that is an account balance plan. Under the plan, all amounts are fully vested at all times. L credits principal additions to O's account each year, and credits earnings based on a predetermined actual investment within the meaning of §31.3121(v)(2)–1(d)(2)(i)(B). L makes principal additions of $90,000 on June 30, 2016; $140,000 on June 30, 2017; and $180,000 on June 30, 2018. The predetermined actual investment earns five percent for 2016, seven percent for 2017; eight percent for 2018; and nine percent for 2019. Thus, as of December 31, 2018, the earnings with respect to the $90,000 principal addition made on June 30, 2016 are $16,605, for a total of $106,605; and the earnings with respect to the $140,000 principal addition made on June 30, 2017 are $16,492, for a total of $156,492. As of January 1, 2020, the earnings with respect to the $180,000 principal addition made on June 30, 2018 are $24,048, for a total of $204,048. Under the terms of the plan, the principal addition (and earnings thereon) made on June 30, 2016 and June 30, 2017 are payable on December 31, 2018, and the principal addition (and earnings thereon) made on June 30, 2018 is payable on January 1, 2020. On December 31, 2018, L pays O $263,097 in accordance with the plan terms. On January 1, 2020, L pays O the remaining account balance of $204,048 in accordance with the plan terms.

(ii) The $263,097 payment made on December 31, 2018 is attributed to services performed by O in the 2016 and 2017 taxable years. Of the $263,097 payment, $106,605 is attributable to services performed by O in L's 2016 taxable year because this amount represents the $90,000 principal addition made on June 30, 2016 and earnings thereon. The remaining $156,492 is attributable to services performed by O in L's 2017 taxable year because this amount represents the $140,000 principal addition made on June 30, 2017 and earnings thereon. The $204,048 payment made on January 1, 2020 is attributable to services performed by O in L's 2018 taxable year because this amount represents the $180,000 principal addition made on June 30, 2018 and earnings thereon.

Example 7 (Account balance plan—account balance ratio method with an employer contribution after the applicable individual ceases to be a service provider). (i) A is an applicable individual of corporation Z for all relevant taxable years. On January 1, 2016, A begins participating in a nonqualified deferred compensation plan of Z that is an account balance plan. Under the terms of the plan, all amounts are fully vested at all times. The balances in A's account (including employer contributions and earnings) are $20,000 on December 31, 2016, and $60,000 on December 31, 2017. On December 31, 2017, A ceases providing services to Z. On January 1, 2019, Z makes a discretionary contribution of $30,000 to A's account balance plan. On December 31, 2019, in accordance with the plan terms, Z pays $120,000 to A, which is N's entire account balance. Z attributes payments under its account balance plans using the account balance ratio method described in paragraph (d)(3)(i) of this section.

(ii) The increase in A's account balance for 2016 is $20,000; the increase in A's account balance for 2017 is $40,000. The discretionary contribution made on January 1, 2019 of $30,000 is added to the account balance for 2017. Thus, the discretionary contribution of $30,000 on January 1, 2019, is treated as increasing A's account balance for 2017 by $30,000. The increase in A's account balance for 2016 is $20,000, and the increase in A's account balance for 2017 is $70,000 ($40,000 + $30,000). The sum of all the increases is $90,000 ($20,000 + $70,000).

(iii) Thus, the attribution fraction for 2016 is .2222 ($20,000/$90,000); and the attribution fraction for 2017 is .7778 ($70,000/$90,000). Accordingly, with respect to the $120,000 payment made on January 1, 2019, $26,664 ($120,000 × .2222) is attributable to services performed by A in Z's 2016 taxable year, and $93,336 ($120,000 × .7778) is attributable to services performed by A in Z's 2017 taxable year.

Example 8 (Account balance plan—principal additions method with a principal addition after the applicable individual ceases to be a service provider). (i) C is an applicable individual of corporation X for all relevant taxable years. On January 1, 2016, C begins participating in a nonqualified deferred compensation plan of X that is an account balance plan. Earnings under the terms of the plan are based on a predetermined actual investment (as defined in §31.3121(v)(2)–1(e)(2)(i)(B)). Under the terms of the plan, all amounts are fully vested at all times. X credits a $10,000 principal addition to C under the plan on April 1, 2016, and a $20,000 principal addition to C on April 1, 2017. C ceases providing services to X on December 31, 2017. On January 1, 2019, X credits $30,000 to C's account in recognition of C's past services. The $10,000 principal addition made on April 1, 2016 increases to $15,000 as of December 31, 2019, as a result of earnings. The $20,000 principal addition made on April 1, 2017, increases to $28,000 as of December 31, 2019 as a result of earnings. The January 1, 2019, contribution of $30,000 increases to $33,000 as of December 31, 2019, as a result of earnings. On December 31, 2019, in accordance with the plan terms, X pays C's entire account balance of $76,000. X attributes payments under its account balance plans using the principal additions method described in paragraph (d)(3)(ii) of this section.

(ii) When the $76,000 payment is made to C on December 31, 2019, the remuneration becomes attributable to service performed by C in prior taxable years. The $10,000 principal addition in 2016 plus earnings thereon of $5,000 are attributable to services performed by C in X's 2016 taxable year, and the $20,000 principal addition in 2017 (plus earnings thereon of $8,000) are attributable to services performed by C in X's 2017 taxable year. The principal addition of $30,000 plus earnings thereon of $3,000 ($33,000) are also attributable to services performed by C in X's 2017 taxable year. Thus, $16,500 of the $33,000 is attributed to services performed by C in X's 2017 taxable year.

(iii) Accordingly, with respect to the $76,000 payment by X to C on December 31, 2019, $15,000 ($10,000 + $5,000) is attributed to services performed by C in X's 2016 taxable year, and $61,000 ($20,000 + $8,000 + $33,000) is attributed to services performed by C in X's 2017 taxable year.

Example 9 (Nonaccount balance plan—present value ratio method with a single payment). (i) C is an applicable individual of corporation X for all relevant taxable years. On January 1, 2015, X grants C a vested right to a $100,000 payment on January 1, 2020. C ceases providing services on December 31, 2019. The payment of $100,000 is made on January 1, 2020. X determines the present value of the payment using an interest rate of five percent for all years.

(ii) The present value of $100,000 payable on January 1, 2020, determined using a five percent interest rate, is $82,270 as of December 31, 2015; $86,384 as of December 31, 2016; $90,703 as of December 31, 2017; $95,238 as of December 31, 2018, and $100,000 as of December 31, 2019. Accordingly, $82,270 is the amount of the increase in the present value of the future payment of $100,000 for X's 2015 taxable year ($82,270 − $0); $4,114 ($86,384 − $82,270) is the increase in the present value of the future payment for X's 2016 taxable year; $4,319 ($90,703 − $86,384) is the increase in the present value of the future payment for X's 2017 taxable year; $4,535 ($95,238 − $90,703) is the increase in the present value of the future payment for X's 2018 taxable year; and $4,762 ($100,000 − $95,238) is the increase in the present value of the future payment for X's 2019 taxable year. The sum of all the increases is $100,000 ($82,270 + $4,114 + $4,319 + $4,535 + $4,762). Thus, the attribution fraction for 2015 is .8227 ($82,270/$100,000); the attribution fraction for 2016 is .0411 ($4,114/$100,000); the attribution fraction for 2017 is .0432 ($4,319/$100,000); the attribution fraction for 2018 is .0454 ($4,535/$100,000); and the attribution fraction for 2019 is .0476 ($4,762/$100,000).

(iii) The $100,000 payment made on January 1, 2020 is multiplied by the attribution fraction for each taxable year, and the result is the amount that is attributable to service performed by C for that taxable year. Accordingly, $82,270 ($100,000 × .8227) is attributable to services performed by C in X's 2015 taxable year; $4,114 ($100,000 × .0411) is attributable to services performed by C in X's 2016 taxable year; $4,319 ($100,000 × .0432) is attributable to services performed by C in X's 2017 taxable year; $4,535 ($100,000 × .0454) is attributable to services performed by C in X's 2018 taxable year; and $4,762 ($100,000 × .0476) is attributable to services performed by C in X's 2019 taxable year.

Example 10. (Nonaccount balance plan—present value ratio method with an in-service payment). (i) The facts are the same as *Example 9,* except that X grants C a vested right to a $40,000 payment on June 30, 2018 and a vested right to a $60,000 payment on January 1, 2020.

(ii) The present value of the future payments ($40,000 payable on June 30, 2018 and $60,000 payable on January 1, 2020), determined using a five percent interest rate, is $84,758 as of December 31, 2015; $88,996 as of December 31, 2016; $93,446 as of December 31, 2017; and $57,143 as of December 31, 2018. However, for purposes of determining the increase in the present value of the future payments during 2018 (the year of the in-service payment), $57,143 must be increased by $40,000, the amount of the in-service payment, resulting in a present value of future payments as of December 31, 2018, of $97,143 solely for purposes of attributing the $40,000 in-service payment. Accordingly, $84,758 is the amount of the increase in the present value of the future payments for X's 2015 taxable year, $4,238 ($88,896 − $84,758) is the increase in the present value of the future payments for X's 2016 taxable year, $4,450 ($93,446 − $88,996) is the increase in the present value of the future payments for X's 2017 taxable year, and $3,697 ($97,143 − $93,446) is the increase in the present value of the future payments for X's 2018 taxable year. The sum of all the increases is $97,143 ($84,758 + $4,238 + $4,450 + $3,697). Thus, the attribution fraction for 2015 is .8725 ($84,758/$97,143); the attribution fraction for 2016 is .0436 ($4,238/$97,143); the attribution fraction for 2017 is .0458 ($4,450/$97,143); and the attribution fraction for 2018 is .0381 ($3,697/$97,143).

(iii) Accordingly, with respect to the $40,000 payment made on June 30, 2018, $34,900 ($40,000 × .8725) is attributable to services performed by C in X's 2015 taxable year; $1,744 ($40,000 × .0436) is attributable to services performed by C in X's 2016 taxable year; $1,832 ($40,000 × .0458) is attributable to services performed by C in X's 2017 taxable year; and $1,524 ($40,000 × .0381) is attributable to services performed by C in X's 2018 taxable year.

(iv) For purposes of attributing the $60,000 payment made on January 1, 2020, the present value of the future payments for each taxable year that ends prior to the taxable year in which the $40,000 in-service payment is paid is reduced by the present value of the future payment to which the applicable individual had a legally binding right to be paid on the date the $40,000 in-service is paid (based on the applicable factors and plan provisions as of the measurement date in each such taxable year). The present value of that future payment is $35,396 as of December 31, 2015; $37,166 as of December 31, 2016; and $39,024 as of December 31, 2017. Therefore, for purposes of attributing the $60,000 payment on January 1, 2020, the present value of future payments as of December 31, 2015, is $49,362 ($84,758 − $35,396); the present value of future payments as of December 31, 2016, is $51,830 ($88,996 − $37,166); the present value of future payments as of December 31, 2017, is $54,422 ($93,446 − $39,024). The present value of future payments as of December 31, 2018, is $57,143. Accordingly, $49,362 is the increase in the present value of the future payment of $60,000 for X's 2015 taxable year; $2,468 ($51,830 − $49,362) is the increase in the present value of the future payment for X's 2016 taxable year; $2,592 ($54,422 − $51,830) is the increase in the future value of the payment for X's 2017 taxable year; $2,721 ($57,143 − $54,422) is the increase in the future value of the payments for X's 2018 taxable year; and $2,857 ($60,000 − $57,143) is the increase in the future value of the payment for X's 2019 taxable year. The sum of all the increases is $60,000 ($49,362 + $2,468 + $2,592 + $2,721 + $2,857). Thus, the attribution fraction for 2015 is .8227 ($49,362/$60,000); the attribution fraction for 2016 is .0411 ($2,468/$60,000); the attribution fraction for 2017 is .0432 ($2,592/$60,000); the attribution fraction for 2018 is .0454 ($2,721/$60,000); and the attribution fraction for 2019 is .0476 ($2,857/$60,000).

(v) Accordingly, with respect to the $60,000 payment made on January 1, 2020, $49,362 ($60,000 × .8227) is attributable to services performed by C in X's 2015 taxable year; $2,468 ($60,000 × .0411) is attributable to services performed by C in X's 2016 taxable year; $2,592($60,000 × .0432) is attributable to services performed by C in X's 2017 taxable year; $2,721 ($60,000 × .0454) is attributable to services performed by C in X's 2018 taxable year; and $2,857 ($60,000 × .0476) is attributable to services performed by C in X's 2019 taxable year.

Example 11 (Nonaccount balance plan—formula benefit ratio method with losses and multiple payments). (i) D is an applicable individual of W for all relevant taxable years. D becomes a participant in a nonaccount balance plan sponsored by R on January 1, 2018. The plan provides W with the vested right to receive a five annual installments each equal to $20,000 times the full years of service that D completes. The first payment is to be made on the later of December 31, 2027, or on the December 31 of the first year in which D is no longer a service provider. D has a break in service in 2020 and does not accrue an additional benefit during 2020. D ceases to be a service provider on December 31, 2022, after having completed four years of service, entitling D to five annual payments equal to $80,000 per year commencing on December 31, 2027. W determines the present value of amounts to be paid under the plan using an interest rate of five percent for 2018 and 2019, and seven percent for 2021, 2022, and 2023. W uses the formula benefit ratio method described in paragraph (d)(4)(ii) of this section.

(ii) Under the plan formula, in 2018, E accrued the right to a $20,000 annual payment for five years, and E accrued an additional $20,000 in annual payments in 2019, 2021, and 2022, resulting in the right to receive an annual payment of $80,000 commencing on December 31, 2027. Thus, the attribution fraction is .25 for 2018 ($20,000/$80,000), .25 for 2019 ($20,000/$80,000), .25 for 2021 ($20,000/$80,000), and .25 for 2022 ($20,000/$80,000). The attribution fraction for 2020 is zero because no additional formula benefit accrued during that year.

(iii) The attribution fraction for each disqualified taxable year is multiplied by each payment and the result is attributed to that taxable year. Accordingly, with respect to each $80,000 payment, $20,000 ($80,000 × .25) is attributable to services performed by D in W's 2018 taxable year; $20,000 ($80,000 × .25) is attributable to services performed by D in W's 2019 taxable year; $20,000 ($80,000 × .25) is attributable to services performed by D in W's 2021 taxable year; and $20,000 ($80,000 × .25) is attributable to services performed by D in W's 2022 taxable year. No amount is attributable to services performed by D in W's 2020 taxable year.

Example 12 (Stock option). (i) E is an applicable individual of corporation V for all relevant taxable years. On January 1, 2016, V grants E an option to purchase 100 shares of V common stock at an exercise price of $50 per share (the fair market value of V common stock on the date of grant). The stock option is not subject to a substantial risk of forfeiture. On December 31, 2017, E ceases to be a service provider of V or any member of V's aggregated group. On January 1, 2019, E resumes providing services for V and again becomes both a service provider and an applicable individual of V. On December 31, 2020, when the fair market value of V common stock is $196 per share, E exercises the stock option. The remuneration resulting from the stock option exercise is $14,600 (($196 — $50) × 100).

(ii) The $14,600 is attributed *pro rata* over the 1,460 days from January 1, 2016 to December 31, 2017 and from January 1, 2019 to December 31, 2020 (365 days per year for the 2016, 2017, 2019, and 2020 taxable years), so that $10 ($14,600 divided by 1,460) is attributed to each calendar day in this period, and $3,650 (365 days × $10) of remuneration is attributed to services performed by E in each of V's 2016, 2017, 2019, and 2020 taxable years.

Example 13 (Stock option subject to a substantial risk of forfeiture). (i) The facts are the same as *Example 14,* except that the stock option is subject to a substantial risk of forfeiture that lapses on December 31, 2017, and is not transferable until that date, and V chooses to attribute remuneration resulting from the exercise of stock options that are subject to a substantial risk of forfeiture over the period beginning on the date of grant and ending on the date the substantial risk of forfeiture lapses, as permitted under paragraph (d)(5)(i)(B) of this section.

(ii) The $14,600 is attributed *pro rata* over the 730 days from January 1, 2016 to December 31, 2017 (365 days per year for the 2016 and 2017 taxable years), so that $20 ($14,600 divided by 730) is attributed to each calendar day in this period, and $7,300 (365 days × $20) is attributed to services performed by E in each of V's 2016 and 2017 taxable years.

Example 14 (Restricted stock). (i) F is an applicable individual of corporation U for all relevant taxable years. On January 1, 2017, U grants to F 1000 shares of restricted U common stock. Under the terms of the grant, the shares will be forfeited if F voluntarily terminates employment before December 31, 2019 (so that the shares are subject to a substantial risk of forfeiture through that date) and are nontransferable until the substantial risk of forfeiture lapses. F does not make an election under section 83(b) and continues in employment with U through December 31, 2019, at which time F's rights in the stock become substantially vested within the meaning of §1.83–3(b) and the fair market value of a share of the stock is $109.50. The remuneration resulting from the vesting of the restricted stock is $109,500 ($109.50 × 1000).

(ii) The $109,500 of remuneration is attributed to services performed by F over the 1,095 days between January 1, 2017 and December 31, 2019 (365 days per year for the 2017, 2018, and 2019 taxable years), so that $100 ($109,500 divided by 1,095) is attributed to each calendar day in this period, and remuneration of $36,500 (365 days × $100) is attributed to services performed by F in each of U's 2017, 2018, and 2019 taxable years.

Example 15 (RSUs). (i) G is an applicable individual of corporation T for all relevant taxable years. On January 1, 2018, T grants to G 1000 RSUs. Under the terms of the grant, T will pay G an amount on December 31, 2020 equal to the fair market value of 1000 shares of T common stock on that date, but only if G continues to provide substantial services to T (so that the RSU is subject to a substantial risk of forfeiture) through December 31, 2020. G remains employed by T through December 31, 2020, at which time the fair market value of a share of the stock is $219, and T pays G $219,000 ($219 × 1000).

(ii) The $219,000 in remuneration is attributed to services performed by G over the 1,095 days beginning on January 1, 2018 and ending on December 31, 2020 (365 days per year for the 2018, 2019, and 2020 taxable years), so that $200 ($219,000/1,095) is attributed to each calendar day in this period, and $73,000 (365 days × $200) is attributed to service performed by G in each of T's 2018, 2019, and 2020 taxable years.

Example 16 (Involuntary separation pay). (i) H is an applicable individual of corporation S. On January 1, 2015, H and S enter into an employment contract providing that S will make two payments of $150,000 each to H if H has an involuntary separation from service. Under the terms of the contract, the first payment is due on January 1 following the involuntary separation from service, and the second payment is due on January 1 of the following year. On December 31, 2016, H has an involuntary separation from service. S pays H $150,000 on January 1, 2017 and $150,000 on January 1, 2018.

(ii) Pursuant to paragraph (d)(6) of this section, involuntary separation pay may be attributed to services performed by H in the taxable year of S in which the involuntary separation from service occurs. Alternatively, involuntary separation pay may be attributed to services performed by H on a daily *pro rata* basis beginning on the date H obtains a legally binding right to the involuntary separation pay and ending on the date of the involuntary separation from service. The entire $300,000 amount, including both $150,000 payments, must be attributed using the same method. Therefore, the entire $300,000 amount (comprised of two $150,000 payments) may be attributed to services performed by H in S's 2016 taxable year, which is the taxable year in which the involuntary separation from service occurs. Alternatively, each $150,000 payment may be attributed on a daily *pro rata* basis to the period beginning on January 1, 2015 and ending December 31, 2016, so that $410.96 (($150,000 × 2)/(365 × 2)) is attributed to each day of S's 2015 and 2016 taxable years. Accordingly, $150,000 is attributed to services performed by H in each of S's 2015 and 2016 taxable years.

Example 17 (Reimbursement after termination of services). (i) I is an applicable individual of corporation R. On January 1, 2018, I enters into an agreement with R under which R will reimburse I's country club dues for two years following I's separation from service. On December 31, 2020, I ceases to be a service provider of R. I pays $50,000 in country club dues on January 1, 2021 and $50,000 on January 2, 2022. Pursuant to the agreement, R reimburses I $50,000 for the country club dues in 2021 and $50,000 in 2022.

(ii) $100,000 is attributed to services performed in R's 2020 taxable year, the taxable year in which I ceases to be a service provider.

(10) *Certain remuneration subject to a substantial risk of forfeiture.* If remuneration is attributable in accordance with paragraphs (d)(2) (legally binding right), (d)(3) (account balance plan), or (d)(4) (nonaccount balance plan) of this section to services performed in a period that includes two or more taxable years of a covered health insurance provider during which the remuneration is subject to a substantial risk of forfeiture, that remuneration must be attributed using a two-step process. First, the remuneration must be attributed to the taxable years of the covered health insurance provider in accordance with paragraph (d)(2), (3), or (4) of this section, as applicable. Second, the remuneration attributed to the period during which the remuneration is subject to a substantial risk of forfeiture (the vesting period) must be reattributed on a daily *pro rata* basis over that period beginning on the date that the applicable individual obtains a legally binding right to the remuneration and ending on the date that the substantial risk of forfeiture lapses. If a vesting period begins on a day other than the first day of a covered health insurance provider's taxable year or ends on a day other than the last day of the covered health insurance provider's taxable year, the remuneration attributable to that taxable year under the first step of the attribution process is divided between the portion of the taxable year that includes the vesting period and the portion of the taxable year that does not include the vesting period. The amount attributed to the portion of the taxable year that includes the vesting period is equal to the total amount of remuneration that would be attributable to the taxable year under the first step of the attribution process, multiplied by a fraction, the numerator of which is the number of days during the taxable year that the amount is subject to a substantial risk of forfeiture and the denominator of which is the number of days in such taxable year. The remaining amount is attributed to the portion of the taxable year that does not include the vesting period and, therefore, is not reattributed under the second step of the attribution process.

(11) *Example.* The following example illustrates the principles of paragraph (d)(10) of this section. For purposes of this example, the corporation has a taxable year that is the calendar year and is a covered health insurance provider for all relevant taxable years, DDR is otherwise deductible in the taxable year in which it is paid, and amounts payable under nonaccount balance plans are not forfeitable upon the death of the applicable individual.

Example (Account balance plan subject to a substantial risk of forfeiture using the principal additions method). (i) J is an applicable individual of corporation Q for all relevant taxable years. On January 1, 2016, J begins participating in a nonqualified deferred compensation plan that is an account balance plan. Under the terms of the plan, Q will pay J's account balance on January 1, 2021, but only if J continues to provide substantial services to Q through December 31, 2018 (so that the amount credited to J's account is subject to a substantial risk of forfeiture through that date). Q credits $10,000 to J's account annually for five years on January 1 of each year beginning on January 1, 2016. The account earns interest at a fixed rate of five percent per year, compounded annually, which solely for the purposes of this example, is assumed to be a reasonable rate of interest. Q attributes increases in account balances under the plan using the principal additions method described in paragraph (d)(3)(ii) of this section.

(ii) Earnings on a principal addition are attributed to the same disqualified taxable year of Q to which the principal addition is attributed; therefore, the amount initially attributable to Q's 2016 taxable year is $12,763 (the $10,000 principal addition in 2016 at five percent interest for five years); the amount initially attributable to Q's 2017 taxable year is $12,155 (the $10,000 principal addition in 2017 at five percent interest for four years); the amount initially attributable to Q's 2018 taxable year is $11,576 (the $10,000 principal addition in 2018 at five percent interest for three years); the amount attributable to Q's 2019 taxable year is $11,025 (the $10,000 principal addition in 2019 at five percent interest for two years); and the amount attributable to Q's 2020 taxable year is $10,500 (the $10,000 principal addition in 2020 at five percent interest for one year).

(iii) Remuneration that is attributable to two or more taxable years of Q during which it is subject to a substantial risk of forfeiture must be reattributed on a daily *pro rata* basis to the period beginning on the date that J obtains a legally binding right to the remuneration and ending on the date that the substantial risk of forfeiture lapses. Therefore, $36,494 ($12,763 + $12,155 + $11,576) is reattributed on a daily *pro rata* basis over the period beginning on January 1, 2016, and ending on December 31, 2018. Thus, $12,165 is attributed to services performed by J in each of Q's 2016, 2017, and 2018 taxable years.

(e) *Application of the deduction limitation*—(1) *Application to aggregate amounts.* The $500,000 deduction limitation is applied to the aggregate amount of AIR and DDR attributable to services performed by an applicable individual in a disqualified taxable year. The aggregate amount of AIR and DDR attributable to services performed by an applicable individual in a disqualified taxable year that exceeds the $500,000 deduction limit is not allowed as a deduction in any taxable year. Therefore, for example, if an applicable individual has more than $500,000 of AIR attributable to services performed for a covered health insurance provider in a disqualified taxable year, the amount of that AIR that exceeds $500,000 is not deductible in any taxable year, and no DDR attributable to services performed by the applicable individual in that disqualified taxable year is deductible in any taxable year. However, if an applicable individual has AIR for a disqualified taxable year that is $500,000 or less and DDR attributable to services performed in the same disqualified taxable year that, when combined with the AIR for the year, exceeds $500,000, all of the AIR is deductible in that disqualified taxable year, but the amount of DDR attributable to that taxable year that is deductible in future taxable years is limited to an amount equal to $500,000 less the amount of the AIR for that taxable year.

(2) *Order of application and calculation of deduction limitation*—(i) *In general.* The deduction limitation with respect to any applicable individual for any disqualified taxable year is applied to AIR and DDR attributable to services performed by that applicable individual in that disqualified taxable year at the time that the remuneration becomes otherwise deductible, and each time the deduction limitation is applied to an amount that is otherwise deductible, the deduction limit is reduced (but not below zero) by the amount against which it is applied. Accordingly, the deduction limitation is applied first to an applicable individual's AIR attributable to services performed in a disqualified taxable year and is reduced (but not below zero) by the amount of the AIR to which the deduction limit is applied. If the applicable individual also has an amount of DDR attributable to services performed in that disqualified taxable year that becomes otherwise deductible in a subsequent taxable year, the deduction limit, as reduced, is applied to that amount of DDR in the first taxable in which the DDR becomes otherwise deductible. The deduction limit is then further reduced (but not below zero) by the amount of the DDR to which the deduction limit is applied. If the applicable individual has an additional amount of DDR attributable to services performed in the original disqualified taxable year that becomes otherwise deductible in a subsequent taxable year, the deduction limit, as further reduced, is applied to that amount of DDR in the taxable year in which it is otherwise deductible. This process continues for future taxable years in which DDR attributable to services performed by the applicable individual in the original disqualified taxable year is otherwise deductible. No deduction is allowed in any taxable year for any AIR or DDR attributable to services performed by an applicable individual in a disqualified taxable year for

the excess of those amounts over the deduction limit (as reduced, if applicable) for that disqualified taxable year at the time the deduction limitation is applied to the remuneration.

(ii) *Application to payments*—(A) *In general*. Any payment of remuneration may include amounts that are attributable to services performed by an applicable individual in one or more taxable years of a covered health insurance provider pursuant to paragraphs (d)(2) through (11) of this section. In that case, a separate deduction limitation applies to each portion of the payment that is attributed to services performed in a different disqualified taxable year. Any portion of a payment that is attributed to a taxable year that is a disqualified taxable year is deductible only to the extent that it does not exceed the deduction limit that applies with respect to the applicable individual for that disqualified taxable year, as reduced by the amount, if any, of AIR and DDR attributable to services performed in that disqualified taxable year that was deductible in an earlier taxable year.

(3) *Examples*. The following examples illustrate the rules of paragraphs (e)(1) and (2) of this section. For purposes of these examples, each corporation has a taxable year that is the calendar year and is a covered health insurance provider for all relevant taxable years; DDR is otherwise deductible in the taxable year in which it is paid; and amounts payable under nonaccount balance plans are not forfeitable upon the death of the applicable individual.

Example 1 (Lump-sum payment of DDR attributable to a single taxable year). (i) L is an applicable individual of corporation O. During O's 2015 taxable year, O pays L $550,000 in salary, which is AIR, and grants L a right to $50,000 of DDR payable upon L's separation from service from O. L has a separation from service in 2020, at which time O pays L the $50,000 of DDR attributable to services performed by L in O's 2015 taxable year.

(ii) The $500,000 deduction limitation for 2015 is applied first to L's $550,000 of AIR for 2015. Because the $550,000 of AIR in 2015 is greater than the deduction limit, O may deduct only $500,000 of the AIR for 2015, and $50,000 of the $550,000 of AIR is not deductible for any taxable year. The deduction limit for remuneration attributable to services provided by L in O's 2015 taxable year is then reduced to zero. Because the $50,000 in DDR attributable to services performed by L in 2015 exceeds the reduced deduction limit of zero, that $50,000 is not deductible for any taxable year.

Example 2 (Installment payments of DDR attributable to a single taxable year). (i) M is an applicable individual of corporation N. During N's 2016 taxable year, N pays M $300,000 in salary, which is AIR, and grants M a right to $220,000 of DDR payable on a fixed schedule beginning upon M's separation from service. The $220,000 is attributable to services provided by M in N's 2016 taxable year. M ceases providing services on December 31, 2016. In 2020, N pays M $120,000 of DDR that is attributable to services performed in N's 2016 taxable year. In 2021, N pays M the remaining $100,000 of DDR attributable to services performed by M in N's 2016 taxable year.

(ii) The $500,000 deduction limitation for 2016 is applied first to M's $300,000 of AIR for 2016. Because the deduction limit is greater than the AIR, N may deduct the entire $300,000 of AIR paid in 2016. The $500,000 deduction limit is then reduced to $200,000 because the limitation is reduced by the amount of AIR ($500,000 − $300,000). The reduced deduction limit is then applied to M's $120,000 of DDR attributable to services performed by M in N's 2016 taxable year that is paid in 2020. Because the reduced deduction limit of $200,000 is greater than the $120,000 of DDR, N may deduct the entire $120,000 of DDR paid in 2020. The $200,000 deduction limit is reduced to $80,000 by the $120,000 in DDR because the limit is reduced by the amount of DDR to which the deduction limit applied ($200,000 − $120,000). The reduced deduction limit of $80,000 is then applied to the remaining $100,000 payment of DDR attributable to services performed by M in N's 2016 taxable year. Because the $100,000 payment by N for 2021 exceeds the reduced deduction limit of $80,000, N may deduct only $80,000 of the payment for the 2021 taxable year, and $20,000 of the $100,000 payment is not deductible by N for any taxable year.

Example 3 (Lump-sum payment attributable to multiple years from an account balance plan using the account balance ratio method). (i) N is an applicable individual of corporation M for all relevant taxable years. On January 1, 2015, N begins participating in a nonqualified deferred compensation plan sponsored by M that is an account balance plan. Under the plan, all amounts are fully vested at all times. The balances in N's account (including earnings) are $50,000 on December 31, 2015, $100,000 on December 31, 2016, and $200,000 on December 31, 2017. N's AIR from M is $425,000 for 2015, $450,000 for 2016, and $500,000 for 2017. On January 1, 2018, in accordance with the plan terms, M pays $200,000 to N, which is a payment of N's entire account balance under the plan. M uses the account balance ratio method to attribute amounts to services performed in taxable years.

(ii) To determine the extent to which M is entitled to a deduction for any portion of the $200,000 payment under the plan, the payment must first be attributed to services performed by N in M's taxable years in accordance with the attribution rules set forth in paragraph (d) of this section. The increase in N's account balance during 2015 is $50,000 ($50,000 − zero); the increase in N's account balance for 2016 is $50,000 ($100,000 − $50,000); and the increase in N's account balance for 2017 is $100,000 ($200,000 − $100,000). The sum of all the increases is $200,000 ($50,000 + $50,000 + $100,000). Accordingly, for N's 2015 taxable year, the attribution fraction is .25 ($50,000/$200,000); for N's 2016, taxable year, the attribution fraction is .25 ($50,000/$200,000); and for N's 2017 taxable year, the attribution fraction is .50 ($100,000/$200,000).

(iii) With respect to the $200,000 payment made on January 1, 2018, $50,000 ($200,000 × .25) of DDR is attributable to services performed by N in M's 2015 taxable year; $50,000 ($200,000 × .25) of DDR is attributable to services performed by N in M's 2016 taxable year; and $100,000 ($200,000 × .50) of DDR is attributable to services performed by N in M's 2017 taxable year.

(iv) The $500,000 deduction limitation for 2015 is applied first to N's $425,000 of AIR for 2015. Because the deduction limit is greater than the AIR, M may deduct the entire $425,000 of AIR paid in 2015. The $500,000 deduction limit is then reduced to $75,000 by the amount of AIR against which it is applied ($500,000 − $425,000). The reduced deduction limit is then applied to N's $50,000 of DDR attributable to services performed by N in M's 2015 taxable year that is paid in 2018. Because $50,000 does not exceed the reduced deduction limit of $75,000, all $50,000 of the DDR attributable to services performed by N in M's 2015 taxable year is deductible for 2018, the year of payment. The deduction limit for remuneration attributable to services performed by N in 2015 is then reduced to $25,000 ($75,000 − $50,000), and this reduced limit is applied to any future payment of DDR attributable to services performed by N in 2015. With respect to M's 2016 taxable year, the $500,000 deduction limit for 2016 is applied first to N's $450,000 of AIR for 2016. Because the deduction limit is greater than the AIR, M may deduct the entire $450,000 of AIR paid in 2016. The $500,000 deduction limit is then reduced to $50,000 by the AIR ($500,000 − $450,000). The reduced deduction limit is then applied to N's $50,000 of DDR attributable to services performed by N in M's 2016 taxable year that is paid in 2018. Because $50,000 does not exceed the reduced deduction limit of $50,000, all $50,000 of the DDR attributed to M's 2016 taxable year is deductible for 2018, the year of payment. The deduction limit for remuneration attributable to services performed by N in 2016 is then reduced to zero, and this reduced limit is applied to any future payment of DDR attributable to services performed by N in 2016. With respect to M's 2017 taxable year, the $500,000 deduction limit for 2017 is applied first to N's $500,000 of AIR for 2017. Because the deduction limit is not greater than the AIR, M may deduct the entire $500,000 of AIR paid in 2017. The $500,000 deduction limit is then reduced to zero by the amount of the AIR against which it is applied ($500,000 − $500,000). The reduced deduction limit is applied to N's $100,000 of DDR attributable to services performed by N in M's 2017 taxable year that is paid in 2018. Because $100,000 exceeds the reduced deduction limit of zero, the $100,000 of the DDR attributed to services performed by N in M's 2017 taxable year is not deductible for the year of payment (or any other taxable year). As a result, $100,000 of the $200,000 payment ($50,000 + $50,000 + $0) is deductible by M for M's 2018 taxable year, and the remaining $100,000 is not deductible by M for any taxable year.

Example 4 (Installment payments and in-service payment attributable to multiple taxable years from an account balance plan using the account balance ratio method). (i) O is an applicable individual of corporation L for all relevant taxable years. On January 1, 2016, O begins participating in a nonqualified deferred compensation plan sponsored by L that is an account balance plan. Under the plan, all amounts are fully vested at all times. L makes contributions to O's account each year and credits earnings based on a predetermined actual investment within the meaning of §31.3121(v)(2)–1(d)(2)(i)(B). The closing balances in O's account (including contributions, earnings, and distributions made during the year) are $100,000 on December 31, 2016, $250,000 on December 31, 2017, and $50,000 on December 31, 2018. O's AIR from L is $500,000 for 2016, $300,000 for 2017, and $450,000 for 2018. On December 31, 2018, L pays O $400,000 in accordance with the plan terms. On December 31, 2019, O's account balance is $200,000, reflecting additional credits of $125,000 made during the year and earnings on the account. O's AIR from L is $200,000 for 2019. O ceases providing services to L on December 31, 2019. On January 1, 2020, L pays O $200,000 in accordance with the plan terms. L uses the account balance ratio method to attribute amounts to services performed in taxable years.

(ii) To determine the extent to which L is entitled to a deduction for any portion of either of the payments under the plan, O's payments under the plan must first be attributed to services performed by O in L's taxable years in accordance with the attribution rules set forth in paragraph (d) of this section. For purposes of attributing the $400,000 payment made on December 31, 2018 to a taxable year, the increase in O's account balance during 2016 is $100,000 ($100,000 − zero); the increase in O's account balance for 2017 is $150,000 ($250,000 − $100,000); and the increase in O's account balance for 2018 is $200,000 ($50,000 − $250,000 + $400,000 (payment on December 31, 2018)). The sum of all the increases is $450,000 ($100,000 + $150,000 + $200,000). Thus, for L's 2016 taxable year, the attribution fraction is .2222 ($100,000/$450,000); for L's 2017 taxable year, the attribution fraction is .3333 ($150,000/$450,000); and for L's 2018 taxable year, the attribution fraction is .4444 ($200,000/$450,000). Accordingly, with respect to the $400,000 payment made on December 31, 2019, $88,889 ($400,000 × .2222) is attributable to services performed by O in L's 2016 taxable year; $133,333 ($400,000 × .3333) is attributable to services performed by O in L's 2017 taxable year; and $177,778 ($400,000 × .4444) is attributable to services performed by O in L's 2018 taxable year.

(iii) The portion of the $400,000 payment attributed to services performed in a disqualified taxable year under paragraph (d) of this section that exceeds the deduction limit for that disqualified taxable year, as reduced through the date of payment, is not deductible in any taxable year. The $500,000 deduction limit for 2016 is applied first to O's $500,000 of AIR for 2016. Because the deduction limit is equal to the $500,000 of AIR, L may deduct the entire $500,000 of AIR paid in 2016. The $500,000 deduction limit is then reduced to zero by the amount of the AIR ($500,000 − $500,000). The reduced deduction limit is applied to O's $88,889 of DDR attributable to services performed by O in L's 2016 taxable year that is paid in 2018. Because $88,889 exceeds the reduced deduction limit of zero, the $88,889 of DDR attributed to 2016 is not deductible for L's 2018 taxable year or any other taxable year. With respect to L's 2017 taxable year, the $500,000 deduction limitation for 2017 is applied first to O's $300,000 of AIR for 2017. Because the $500,000 deduction limit is greater than the $300,000 of AIR, L may deduct the entire $300,000 of AIR paid in 2017. The $500,000 deduction limit is reduced to $200,000 by the amount of the AIR ($500,000 − $300,000). The reduced deduction limit is then applied to O's $133,333 of DDR attributable to services performed by O in L's 2017 taxable year that is paid in 2018. Because $133,333 does not exceed that reduced deduction limit of $200,000, the $133,333 is deductible for 2018. The deduction limit for remuneration attributable to services performed by O in 2017 is then reduced to $66,667 ($200,000 − $133,333), and this reduced limit is applied to any future payment of DDR attributable to services performed by O in 2017. With respect to L's 2018 taxable year, the $500,000 deduction limit for 2018 is applied first to O's $450,000 of AIR for 2018. Because the deduction limit is greater than the AIR, L may deduct the entire $450,000 of AIR paid in 2017. The $500,000 deduction limit is reduced to $50,000 by the amount of the AIR ($500,000 − $450,000). The reduced deduction limit is applied to O's $177,778 attributable to services performed by O in L's 2018 taxable year that is paid in 2018. Because the $177,778 exceeds the reduced deduction limit of $50,000, $50,000 of DDR is deductible for L's 2018 taxable year, and $127,778 of the $177,778 is not deductible for L's 2018 taxable year or any other taxable year. As a result, $183,333 of the $400,000 payment ($0 + $133,333 + $50,000) is deductible by L for L's 2018 taxable year, and the remaining $216,667 is not deductible by L for any taxable year.

(iv) For purposes of attributing amounts paid or made available from the plan in future taxable years, the following adjustments are made to O's account balances to reflect the in-service payment of $400,000 in 2018. O's account balance as of December 31, 2016 is reduced by the $88,889 attributable to 2016; and for 2017 is reduced by the sum of the $133,333 attributable to 2017 and the $88,889 attributable to 2016. Therefore, after attributing the $400,000 payment, O's adjusted closing account balance as of December 31, 2016, is $11,111 ($100,000 − $88,889), and as of December 31, 2017, is $27,778 ($250,000 − $133,333 − $88,889).

(v) For purposes of attributing the $200,000 payment made on January 1, 2020, to services performed in the taxable years of S, the increase in O's account balance during 2016 is $11,111 ($11,111 − $0); the increase in O's account balance for 2017 is $16,667 ($27,778 − $11,111); the increase in O's account balance for 2018 is $22,222 ($50,000 − $27,778), and the increase in O's account balance for 2019 is $150,000 ($200,000 − $50,000). The sum of all such increases is $200,000 ($11,111 + $16,667 + $22,222 + $150,000). Thus, for O's 2016 taxable year, the attribution fraction is .0556 ($11,111/$200,000); for O's 2017, taxable year, the attribution fraction is .0833 ($16,667/$200,000); for O's 2018 taxable year, the attribution fraction is .1111 ($22,222/$200,000); for O's 2019 taxable year, the attribution fraction is .7500 ($150,000/$200,000). Accordingly, with respect to the $200,000 payment made on January 1, 2020, $11,111 ($200,000 × .0556) of DDR is attributable to services performed by O in L's 2016 taxable year; $16,667 ($200,000 × .0833) of DDR is attributable to services performed by O in L's 2017 taxable year; $22,222 ($200,000 × .1111) of DDR is attributable to services performed by O in L's 2018 taxable year; and $150,000 ($200,000 × .7500) of DDR is attributable to services performed by O in L's 2019 taxable year.

(vi) The portion of the DDR attributed to a disqualified taxable year under paragraph (d) of this section that exceeds the deduction limit for that disqualified taxable year, as reduced, is not deductible for any taxable year. For L's 2016 taxable year, the deduction limit is reduced to zero by the $500,000 of

AIR for that year. Because $11,111 exceeds the reduced deduction limit of zero, $11,111 of the DDR is not deductible for L's 2020 taxable year or any other taxable year. For L's 2017 taxable year, the deduction limit is reduced to $200,000 by the $300,000 of AIR for that year and further reduced to $66,667 by the $133,333 of DDR previously attributed to 2017. Because $16,667 does not exceed the $66,667 deduction limit, the $16,667 of DDR is deductible for L's 2020 taxable year, the year of payment. The deduction limit for remuneration attributable to services performed by O in 2017 is then reduced to $50,000 ($66,667 − $16,667), and this reduced limit is applied to any future payment attributable to services performed by O in 2017. For L's 2018 taxable year, the deduction limit is reduced to zero by the $450,000 of AIR for that year and the $50,000 of DDR previously attributed to 2018. Because $22,222 exceeds the reduced deduction limit of zero for 2018, the $22,222 of DDR is not deductible for L's 2020 taxable year or any other taxable year. For L's 2019 taxable year, the $500,000 deduction limit for 2019 is applied first to O's $200,000 of AIR for 2019. Because the deduction limit is greater than the AIR, L may deduct the entire $200,000 of AIR paid in 2019. The $500,000 deduction limit is reduced to $300,000 by the amount of the AIR ($500,000 − $200,000). The reduced deduction limit is applied to O's $150,000 of DDR attributable to services performed by O in L's 2019 taxable year that is paid in 2020. Because $150,000 does not exceed the $300,000 limit, the $150,000 of DDR is deductible for L's 2020 taxable year, the year of payment. The deduction limit for remuneration attributable to services performed by O in 2019 is then reduced to $150,000 ($500,000 − $200,000 − $150,000), and this reduced limit is applied to any future payment attributable to services performed by O in 2019. As a result, $166,667 of the $200,000 payment ($0 + $16,667 + $0 + $150,000) is deductible by L for L's 2020 taxable year, the year of payment, and the remaining $33,333 is not deductible by L for any taxable year.

Example 5 (Installment payments and in-service payment attributable to multiple taxable years from an account balance plan using the principal additions method). (i) The facts are the same as set forth in *Example 4*, paragraph (i), except that L uses the principal additions method for attributing remuneration from an account balance plan; principal additions under the plan are $100,000 in 2016, $125,000 in 2017, $150,000 in 2018, and $125,000 in 2019; as of the December 31, 2018 initial date of payment, earnings on the 2016, 2017, and 2018 principal additions are $40,000, $30,000, and $5,000 respectively. Under the terms of the plan, the $400,000 payment made on December 31, 2018, is from principal additions in 2016, 2017, and 2018, and earnings thereon, and the $200,000 payment made on January 1, 2020, is from principal additions in 2018 and 2019, and earnings thereon.

(ii) To determine the extent to which L is entitled to a deduction for any portion of either payment under the plan, the payments to O under the plan must first be attributed to services performed by O in F's taxable years in accordance with the attribution rules set forth in paragraph (d) of this section. Under the rules in paragraph (d)(3)(ii) of this section, the $400,000 payment on January 1, 2019, is attributed to services performed by O in the taxable year to which the payment relates under the terms of the plan. DDR including principal additions and earnings thereon are attributed to services performed by O in a taxable year of L when the $400,000 payment is made to O on December 31, 2018. Under the terms of the plan, the $400,000 payment made on December 31, 2018 is attributed to services performed by O in L's 2016 taxable year in the amount of $140,000, and is attributed to services performed by O in L's 2017 taxable year in the amount of $155,000, and the remaining $105,000 ($400,000 − $140,000 − $155,000) is attributed to services performed by O in L's 2018 taxable year.

(iii) The portion of the DDR attributable to services performed in a disqualified taxable year under paragraph (d) of this section that exceeds the deduction limit for that disqualified taxable year, as reduced, is not deductible for any taxable year. The $500,000 deduction limitation for 2016 is applied first to O's $500,000 of AIR for 2016. Because the deduction limit is equal to the $500,000 of AIR, L may deduct the entire $500,000 of AIR paid in 2016. The $500,000 deduction limit is then reduced to zero by the amount of the AIR ($500,000 − $500,000). The reduced deduction limit is applied to O's $140,000 of DDR attributable to services performed by O in L's 2016 taxable year that is paid in 2018. Because $140,000 exceeds the reduced deduction limit of zero, the $140,000 is not deductible for L's 2018 taxable year (the year of payment), or any other taxable year. For L's 2017 taxable year, the $500,000 deduction limit for 2017 is applied first to O's $300,000 of AIR for 2017. Because the deduction limit is greater than the AIR, L may deduct the entire $300,000 of AIR paid in 2017. The $500,000 deduction limit is then reduced to $200,000 by the amount of the AIR ($500,000 − $300,000). The reduced deduction limit is applied to O's $155,000 of DDR attributable to services performed by O in L's 2017 taxable year that is paid in 2018. Because $155,000 does not exceed the reduced deduction limit of $200,000, the $155,000 payment is deductible for 2018. For L's 2018 taxable year, the $500,000 deduction limitation for 2018 is applied first to O's $450,000 of AIR for 2018. Because the deduction limit is greater than the AIR, L may deduct the entire $450,000 of AIR paid in 2018. The $500,000 deduction limit is then reduced to $50,000 by the amount of the AIR ($500,000 − $450,000). The reduced deduction limit is applied to O's $105,000 of DDR attributable to services performed by O in L's 2018 taxable year that is paid in 2018. Because $105,000 exceeds the reduced deduction limit of $50,000, $55,000 of the $105,000 attributable to L's 2018 taxable year is not deductible for 2018 (the year of payment), or any other taxable year. As a result, $205,000 of the $400,000 payment ($0 + $155,000 + $50,000) is deductible by L for L's 2018 taxable year (the year of payment) and the remaining $195,000 is not deductible by L for any taxable year.

(iv) Earnings through January 1, 2020 on the principal addition for L's 2018 taxable year ($50,000) that was not paid as part of the December 31, 2018 payment are $5,000. Earnings through January 1, 2020 on the $125,000 credited to O's account on January 1, 2019 are $20,000. On December 31, 2018, after the $400,000 payment is applied to 2016, 2017, and 2018, the account balance for 2016 and 2017 is reduced to zero, and the account balance for 2018 is reduced to $50,000 ($150,000 + $5,000 (earnings) − $105,000). Under the terms of the plan, the $200,000 payment made on January 1, 2020, is attributable to services performed by O in L's 2018 and 2019 taxable years. Therefore, the $200,000 payment on January 1, 2020 is attributed to services performed by O in L's taxable years as follows: $55,000 ($50,000 + $5,000) to 2018 and $145,000 ($125,000 + $20,000) to 2019.

(v) The portion of the DDR attributed to a disqualified taxable year under paragraph (d) of this section that exceeds the deduction limit for that disqualified taxable year, as reduced, is not deductible for any taxable year. For L's 2018 taxable year, the deduction limit is reduced to zero by the $450,000 of AIR for that year and the payment of $50,000 of DDR attributable to that year. Because $55,000 exceeds the reduced deduction limit of zero, the $55,000 is not deductible for 2020, the year of payment (or any other taxable year). With respect to L's 2019 taxable year, the $500,000 deduction limit for 2019 is applied first to O's $200,000 of AIR for 2019. Because the deduction limit is greater than the AIR, L may deduct the entire $200,000 of AIR paid in 2019. The $500,000 deduction limit is then reduced to $300,000 by the amount of the AIR ($500,000 − $200,000). The reduced deduction limit is applied to O's $145,000 of DDR attributable to services performed by O in L's 2019 taxable year that is paid in 2020. Because $145,000 does not exceed the $300,000 reduced limit, the $145,000 is deductible for 2020 (the year of payment). As a result, $145,000 of the $200,000 payment ($0 + $145,000) is deductible for L's 2020 taxable year, and the remaining $55,000 is not deductible by L for any taxable year.

(4) *Application of deduction limitation to aggregated groups of covered health insurance providers*—(i) *In general*. The total combined deduction for AIR and DDR attributable to services performed by an applicable individual in a disqualified taxable year allowed for all members of an aggregated group that are covered health insurance providers for any taxable year is limited to $500,000. Therefore, if two or more members of an aggregated group that are covered health insurance providers may otherwise deduct AIR or DDR attributable to services performed by an applicable individual in a disqualified taxable year, the AIR and DDR otherwise deductible by all members of the aggregated group is combined, and the deduction limitation is applied to the total amount.

(ii) *Proration of deduction limitation*. If the total amount of AIR or DDR attributable to services performed by an applicable individual in a disqualified taxable year that is otherwise deductible by two or more members of an aggregated group in any taxable year exceeds the $500,000 deduction limit (as reduced by previously deductible AIR or DDR, if applicable), the deduction limit is prorated based on the AIR or DDR otherwise deductible by the members of the aggregated group in the taxable year and allocated to each member of the aggregated group. The deduction limit allocated to each member of the aggregated group is determined by multiplying the deduction limit for the disqualified taxable year (as previously reduced, if applicable) by a fraction, the numerator of which is the AIR or DDR otherwise deductible by that member in that taxable year that is attributable to services performed by the applicable individual in the disqualified taxable year, and the denominator of which is the total AIR or DDR otherwise deductible by all members of the aggregated group in that taxable year that is attributable to services performed by the applicable individual in the disqualified taxable year. The amount of AIR or DDR otherwise deductible by a member of the aggregated group in excess of the portion of the deduction limit allocated to that member is not deductible in any taxable year. If a covered health insurance provider is a member of more than one aggregated group, the deduction limit for that covered health insurance provider under section 162(m)(6) may in no event exceed $500,000 for AIR and DDR attributable to services performed by an applicable individual in a disqualified taxable year.

(5) *Examples.* The following examples illustrate the rules of paragraph (e)(4) of this section. For purposes of these examples, each corporation has a taxable year that is the calendar year and is a covered health insurance provider for all relevant taxable years, and DDR is otherwise deductible by the covered health insurance provider in the taxable year in which it is paid.

Example 1. (i) Corporations I, J, and K are members of the same aggregated group under paragraph (b)(3) of this section. At separate times during 2016, C is an employee of, and performs services for, I, J, and K. C's total AIR for 2016 is $1,500,000, which consists of $750,000 of AIR for services performed to K; $450,000 of AIR for services provided to J; and $300,000 of AIR for services to I.

(ii) Because I, J, and K are members of the same aggregated group, the AIR otherwise deductible by them is aggregated for purposes of applying the deduction limitation. Further, because the aggregate AIR otherwise deductible by I, J, and K for 2016 exceeds the deduction limitation for C for that taxable year, the deduction limit is prorated and allocated to the members of the aggregated group in proportion to the AIR otherwise deductible by each member of the aggregated group for that taxable year. Therefore, the deduction limit that applies to the AIR otherwise deductible by K is $250,000 ($500,000 × ($750,000/$1,500,000)); the deduction limit that applies to the AIR otherwise deductible by J is $150,000 ($500,000 × ($450,000/$1,500,000)); and the deduction limit that applies to AIR otherwise deductible by I is $100,000 ($500,000 × ($300,000/$1,500,000)). For the 2016 taxable year, K may not deduct $500,000 of the $750,000 of AIR paid to C ($750,000 − $250,000); J may not deduct $300,000 of the $450,000 of AIR paid to C ($450,000 − $150,000); and I may not deduct $200,000 of the $300,000 of AIR paid to C ($300,000 − $100,000).

Example 2. (i) The facts are the same as *Example 1*, except that C's total AIR for 2016 is $400,000, which consists of $75,000 for services provided to K; $150,000 for services provided to J; and $175,000 for services provided to I. In addition, C becomes entitled to $60,000 of DDR attributable to services provided to K in 2016, which is payable (and paid) on April 1, 2018, and $75,000 of DDR attributable to services provided to J in 2016, which is payable (and paid) on April 1, 2019.

(ii) Because C's total AIR of $400,000 for 2016 for services provided to K, J, and I do not exceed the $500,000 limitation, K, J, and I may deduct $75,000, $150,000, and $175,000, respectively, for 2016. The deduction limit is then reduced to $100,000 by the total AIR deductible by all members of the aggregated group ($500,000 − $400,000). The deduction limit, as reduced, is then applied to any DDR attributable to services provided by C in 2016 in the first subsequent taxable year that DDR becomes deductible. The first year that DDR for 2016 becomes deductible is 2018, due to the $60,000 payment made on April 1, 2018. Because the $60,000 of DDR otherwise deductible by K does not exceed the 2016 $100,000 deduction limit, K may deduct the entire $60,000 for its 2018 taxable year. The $100,000 deduction limit is then reduced by the $60,000 of DDR deductible by K for 2018, and the reduced deduction limit of $40,000 ($100,000 − $60,000) is applied to the $75,000 of DDR that is otherwise deductible for 2019. Because the DDR of $75,000 otherwise deductible by J exceeds the reduced deduction limit of $40,000, J may deduct only $40,000, and the remaining $35,000 ($75,000 − $40,000) is not deductible by J for that taxable year or any other taxable year.

Example 3. (i) The facts are the same as *Example 2*, except that C's DDR of $75,000 attributable to services performed by C in J's 2016 taxable year is payable (and paid) on July 1, 2018.

(ii) The results are the same as *Example 2*, except that the reduced deduction limit of $100,000 is prorated between K and J in proportion to the DDR otherwise deductible by them for 2018. Accordingly, $44,444 of the remaining deduction limit is allocated to K ($100,000 × ($60,000/$135,000)), and $55,556 of the remaining deduction limit is allocated to J ($100,000 × ($75,000/$135,000)). Because the $60,000 of DDR otherwise deductible by K exceeds the $44,444 deduction limit applied to that remuneration, K may deduct only $44,444 of the $60,000 payment, and $15,556 may not be deducted by K for the 2018 taxable year or any other taxable year. Similarly, because the $75,000 of DDR otherwise deductible by J exceeds the $55,556 deduction limit applied to that remuneration, J may deduct only $55,556 of the $75,000 payment, and $19,444 may not be deducted by J for that taxable year or any other taxable year.

(f) *Corporate transactions*—(1) *Treatment as a covered health insurance provider in connection with a corporate transaction.* Except as otherwise provided in this paragraph (f), a person that participates in a corporate transaction is a covered health insurance provider for the taxable year in which the corporate transaction occurs (and any other taxable year) if it would otherwise be a covered health insurance provider under paragraph (b)(4) of this section for that taxable year. For example, if a member of an aggregated group that did not previously include a health insurance issuer purchases a health insurance issuer that is a covered health insurance provider (so that the health insurance issuer becomes a member of the aggregated group), each member of the acquiring aggregated group will be a covered health insurance provider for its full taxable year in which the corporate transaction occurs and each subsequent taxable year in which the health insurance issuer continues to be a member of the group, if it would otherwise be a covered health insurance provider under paragraph (b)(4), except as otherwise provided in this paragraph (f). For purposes of this section, the term *corporate transaction* means a merger, acquisition or disposition of assets or stock, reorganization, consolidation, separation, or any other transaction resulting in a change in the composition of an aggregated group.

(2) *Transition period relief for a person becoming a covered health insurance provider solely as a result of a corporate transaction*—(i) *In general*. Except as provided in paragraph (f)(2)(ii) of this section, a person that is not a covered health insurance provider before a corporate transaction, but would (except for application of this paragraph (f)(2)(i)) become a covered health insurance provider solely because it becomes a member of an aggregated group with another person that is a health insurance issuer as a result of the corporate transaction, is not a covered health insurance provider subject to the deduction limitation of section 162(m)(6) for the taxable year of that person in which the corporate transaction occurs (the *transition period relief*).

(ii) *Certain applicable individuals*. The transition period relief described in paragraph (f)(2)(i) of this section does not apply with respect to the remuneration of any individual who is an applicable individual of a person that would have been a covered health insurance provider for the taxable year in which the corporate transaction occurred without regard to the occurrence of the corporate transaction (for example, the applicable individuals of a health insurance issuer and the members of its affiliated group that were covered health insurance issuers before the occurrence of a corporate transaction). This exception to the transition period relief applies even with respect to remuneration attributable to services performed by the applicable individual for a person that is eligible for the transition period relief described in paragraph (f)(1)(ii)(A) of this section. Accordingly, each member of an acquiring aggregated group that would become a covered health insurance provider solely as a result of a corporate transaction, but is not a covered health insurance provider under the transition period relief described in paragraph (f)(1)(ii)(A) of this section, is subject to the deduction limitation of section 162(m)(6) for its taxable year in which the corporate transaction occurs with respect to AIR and DDR attributable to services performed by any individual who is an applicable individual of the acquired health insurance issuer and any member of its aggregated group that would have been a covered health insurance provider in the taxable year in which the corporate transaction occurred, even if the corporate transaction had not occurred.

(3) *Transition relief from the attribution consistency requirements*—(i) *In general*. Paragraphs (d)(3)(i), (d)(4)(i) and (d)(5)(i)(B) of this section require a covered health insurance provider and all members of its aggregated group to use the same method for attributing remuneration to services performed by applicable individuals consistently for all taxable years (*attribution consistency requirements*). As a result of a corporate transaction, however, a covered health insurance provider that uses an attribution method for its account balance plans, nonaccount balance plans, or stock options or SARs may become a member of an aggregated group with another covered health insurance provider that uses a different attribution method for those types of plans or arrangements. In that case, neither member of the aggregated group will be treated as violating the attribution

consistency requirements merely because it uses an attribution method that is different from the attribution method used by another member of its aggregated group to attribute remuneration that becomes otherwise deductible in the taxable year in which the corporate transaction occurs. However, the attribution consistency requirements apply with respect to remuneration that becomes otherwise deductible in all subsequent taxable years. Following the date of the corporate transaction, any member of the aggregated group may change the attribution method that it used before the date of the corporate transaction to attribute remuneration under its account balance plans, nonaccount balance plans, or stock options or SARs to make its method consistent with the method used by any other member of the aggregated group. Notwithstanding the foregoing, the Secretary may subject this change in attribution method to limitations, or may otherwise modify the attribution consistency requirements, pursuant to a notice, revenue ruling, or other guidance of general applicability published in the Internal Revenue Bulletin.

(ii) *Exception for certain applicable individuals.* Notwithstanding the transition relief described in paragraphs (f)(2)(A) of this section, if a covered health insurance provider has attributed remuneration under a method described in paragraphs (d)(3), (d)(4), or (d)(5) of this section with respect to an applicable individual before a corporate transaction, the covered health insurance provider must continue at all times to use that attribution method for all other remuneration that becomes otherwise deductible under the same type of plan (that is, an account balance plan, a nonaccount balance plan, or a stock option or SAR) to which the applicable individual has a legally binding right as of the corporate transaction.

(4) *Deduction limitation not prorated for short taxable years.* If a corporate transaction results in a short taxable year for a covered health insurance provider, the $500,000 deduction limit for the short taxable year is neither prorated nor reduced. For example, if a corporate transaction results in a short taxable year of three months, the deduction limit under section 162(m)(6) for that short taxable year is $500,000 (and is not reduced to $125,000).

(5) *Effect of a corporate transaction on the application of the de minimis exception.* If a person becomes or ceases to be a member of an aggregated group, only the premiums and gross revenues of that person for the portion of its taxable year during which it is a member of the aggregated group are taken into account for purposes of determining whether the *de minimis* exception applies.

(6) *Examples.* The following examples illustrate the principles of this paragraph (f). For purposes of these examples, each corporation has a taxable year that is the calendar year unless stated otherwise, and none of the corporations qualify for the *de minimis* exception under paragraph (b)(4)(v) of this section.

Example 1. (i) Corporation J merges with and into corporation H on June 30, 2015, such that H is the surviving entity. As a result of the merger, J's taxable year ends on June 30, 2015. For its taxable year ending June 30, 2015, J is a health insurance issuer that is a covered health insurance provider. For all taxable years before the taxable year of the merger, H is not a covered health insurance provider.

(ii) Corporation J is a covered health insurance provider for its short taxable year ending June 30, 2015. As a result of the merger, H becomes a covered health insurance provider for its 2015 taxable year, but Corporation H is not a covered health insurance provider for its 2015 taxable year by reason of the transition period relief in paragraph (f)(1)(ii)(A) of this section. However, applicable individuals of J continue to be subject to the deduction limit under section 162(m)(6) for amounts that become otherwise deductible in the 2015 taxable year and DDR that is attributable to services performed by applicable individuals of J, and H is a covered health insurance provider for all subsequent taxable years for which it is a covered health insurance provider under paragraph (b)(4) of this section.

Example 2. (i) On January 1, 2016, corporations D, E, and F are members of a controlled group within the meaning of section 414(b). F is a health insurance issuer that is a covered health insurance provider under paragraph (b)(4)(i)(A) of this section. D and E are not health insurance issuers (but are covered health insurance providers pursuant to paragraphs (b)(4)(i)(C) and (D) of this section). D is the parent entity of the DEF aggregated group. F's taxable year ends on September 30. P is an applicable individual of F for all taxable years. On May 1, 2016, a controlled group within the meaning of section 414(b) consisting of corporations C and B purchases all of the stock of corporation F, resulting in a controlled group within the meaning of section 414(b) consisting of corporations C, B, and F. The amount of premiums received by F from providing minimum essential coverage during the portion of its taxable year when it was a member of the DEF aggregated group constitute more than two percent of the gross revenues of the aggregated group for the taxable year of D (the parent entity) ending on December 31, 2016, and the taxable years of E and F ending with or within D's taxable year (December 31, 2016 and May 1, 2016 respectively). C and B are not health insurance issuers. C is the parent entity of the CBF aggregated group. The CBF aggregated group is also a consolidated group within the meaning of §1.1502–1(h). Thus, F's taxable year ends on May 1, 2016 by reason of §1.1502–76(b)(1)(ii)(A)(*1*), and F becomes part of the CBF consolidated group for the taxable year ending December 31, 2016.

(ii) D and E are covered health insurance providers for the taxable year ending December 31, 2016, and the de minimis exception does not apply because the amount of premiums received by F from providing minimum essential coverage during the short taxable year that it was a member of the DEF aggregated group are more than two percent of the gross revenues of the aggregated group for the taxable years during which the members would otherwise be a covered health insurance providers under paragraph (b)(4)(i) of this section. Accordingly, D and E are subject to the deduction limitation under section 162(m)(6) for their taxable years ending December 31, 2016. C and B are not covered health insurance providers for their taxable year ending December 31, 2016, by reason of the transition period relief of paragraph (f)(1)(ii)(A) of this section.

(iii) As a result of leaving the aggregated group, F has a new taxable year beginning on May 2, 2016 and ending on December 31, 2016. F is a covered health insurance provider within the meaning of paragraph (b)(4) of this section for its new taxable year ending on December 31, 2016 (even though C and B are not covered health insurance providers for their taxable years ending December 31, 2016) unless the CBF aggregated group qualifies for the *de minimis* exception for that taxable year.

(iv) P is an applicable individual whose remuneration from F is subject to the deduction limitation under section 162(m)(6) for F's short taxable year ending May 1, 2016 and F's taxable year ending December 31, 2016. In addition, any remuneration provided to P by C or B at any time for services provided by P from May 1, 2016 to December 31, 2016 is also subject to the deduction limitation under section 162(m)(6), even though C and B are not covered health insurance providers for their taxable years ending December 31, 2016 by reason of the transition period relief of paragraph (f)(1)(ii)(A) of this section. Remuneration to which P had the legally binding right on or before the date of the transaction is subject to the deduction limitation when that remuneration becomes otherwise deductible.

Example 3. (i) The same facts as *Example 2*, except that E is a health insurance issuer that is a covered health insurance provider under paragraph (b)(4) of this section and thus receives premiums from providing minimum essential coverage (instead of F), and F is not a health insurance issuer.

(ii) F is a covered health insurance provider for its short taxable year ending May 1, 2016. However, because F is not a health insurance issuer that is a covered health insurance provider and there are no other health insurance issuers in the BCF aggregated group, F is not a covered health insurance provider for its short, post-acquisition taxable year ending December 31, 2016.

(iii) With respect to P, remuneration to which P had the legally binding right on or before the date of the transaction is subject to the deduction limitation. However, remuneration to which P obtains the legally binding right after the date of the corporate transaction is not subject to the deduction limitation.

Example 4. (i) Corporations N, O, and P are members of an aggregated group as described in paragraph (b)(2) of this section. N is a health insurance issuer that is a covered health insurance provider pursuant to paragraph (b)(4)(i)(A) of this section, but neither O nor P is a health insurance issuer. P is the parent entity of the aggregated group. On April 1, 2016, O ceases to be a member of the NOP aggregated group as the result of a corporate transaction. O's taxable year does not end as a result of the corporate transaction.

(ii) Because O was a member of the NOP aggregated group during a portion of its taxable year, O is a covered health insurance provider for its taxable year ending December 31, 2016.

Example 5. (i) Corporations V, W, and X are members of an aggregated group as described in paragraph (b)(2) of this section. V is a health insurance issuer that is a covered health insurance provider pursuant to paragraph (b)(4)(i)(A) of this section, but neither W nor X is a health insurance issuer. W is the parent entity of the aggregated group. V's taxable year ends on December 31; W's taxable year ends on June 30; and X's taxable year ends on September 30. For its taxable year ending June 30, 2017, W has $100x in gross revenue. For its taxable year ending September 30, 2016, X has $60x in gross revenue. For its taxable year ending December 31, 2016, V receives $4x of premiums from providing minimum essential coverage and has no other revenue. As of September 30, 2016, V ceases to be a member of the VWX aggregated group. V's taxable year does not end on September 30, 2016 as a result of the transaction. Of the $4x that that V receives for providing minimum essential coverage during its taxable year ending December 31, 2016, $3x is received during the period from January 1, 2016 through September 30, 2016. As a result of the corporate transaction, V's taxable year ends on September 30, 2016. The *de minimis* exception of paragraph (b)(4)(v)(A) of this section did not apply to the members of the VWX aggregated group for their immediately preceding taxable years ending December 31, 2015, June 30, 2016, and September 30, 2015, respectively.

(ii) For purposes of applying the *de minimis* exception to an aggregated group for a taxable year during which a person leaves or joins the aggregated group, only the premiums and revenues of the person for the portion of its taxable year during which it was a member of the aggregated group are taken into account. The premiums from providing minimum essential coverage received by the VWX aggregated group for W's taxable year ending June 30, 2017 are $3x. The revenues of the V, W, and X aggregated group for W's taxable year ending June 30, 2017 are $163x. Accordingly, the premiums received by the members of the aggregated group from providing minimum essential coverage are less than two percent of the gross revenues of the aggregated group ($3x is less than $3.26x (two percent of $163x)). Therefore, V, W and X are not covered health insurance providers for their taxable years ending December 31, 2016, June 30, 2017, and September 30, 2016, respectively.

Example 6. (i) The facts are the same as *Example 5*, except that F received $4x of premiums during the period from January 1, 2016 to September 30, 2016, and the members of the VWX aggregated group were not covered health insurance providers for their taxable years ending December 31, 2015, June 30, 2016, and September 30, 2015, respectively (their immediately preceding taxable years) solely by reason of the *de minimis* exception of paragraph (b)(4)(v)(A) of this section.

(ii) The premiums from providing minimum essential coverage received by the VWX aggregated group for W's taxable year ending June 30, 2017 are $4x. The revenues of the VWX aggregated group for W's taxable year ending June 30, 2017 are $164x. Accordingly, the premiums received by the members of the aggregated group from providing minimum essential coverage are greater than two percent of the gross revenues of the aggregated group ($4x is greater than $3.28x (two percent of $164x)). Therefore, V, W, and X do not qualify for the *de minimis* exception for their taxable years ending December 31, 2016, June 30, 2017, and September 30, 2016, respectively. However, V, W, and X are not covered health insurance providers for these taxable years by reason of the *de minimis* exception one year transition period described in paragraph (b)(4)(v)(B) of this section.

Example 7. (i) Corporation N is a health insurance issuer that is a covered health insurance provider. Corporation O is also a health insurance issuer that is a covered health insurance provider. Both N and O have taxable years ending December 31. N uses the account balance ratio method to attribute remuneration that becomes otherwise deductible under its account balance plans. O uses the principal additions method to attribute amounts that become otherwise deductible under its account balance plans. On June 30, 2016, O purchases all of the stock of N.

(ii) For the taxable year of N and O ending December 31, 2016, N may continue to attribute amounts that become deductible under its account balance plans using the account balance ratio method, and O can continue to attribute amounts that become otherwise deductible under its account balance plan using the principal additions method, even though they are members of the same aggregated group, pursuant to the transition period relief described in paragraph (f)(2) of this section. In all subsequent taxable years, N and O must use the same method to attribute amounts that become otherwise deductible under their account balance plans. Either N or O may change the method that it uses to attribute amounts under its account balance plans to be consistent with the attribution method used by the other.

Example 8. (i) The facts are the same as *Example 7*. In addition, B is an applicable individual of N before the corporate transaction and is a participant in an account balance plan of N. On December 31, 2015, N made a payment to B, and N used the account balance ratio method described in paragraph (d)(3)(ii) of this section to attribute the payment to services performed by B in taxable years of N.

(ii) Because N used the account balance ratio method described in paragraph (d)(3)(ii) of this section to attribute an amount that became otherwise deductible under the plan before the corporate transaction, N must continue to use the account balance ratio method for attributing amounts to which B had a legally binding right as of the corporate transaction, whenever those amounts become otherwise deductible.

(g) *Coordination*—(1) *Coordination with section 162(m)(1)*. If section 162(m)(1) and section 162(m)(6) both otherwise would apply with respect to the remuneration of an applicable individual, the deduction limitation under section 162(m)(6) applies without regard to section 162(m)(1). For example, if an applicable individual is both a covered employee of a publicly held corporation (see sections 162(m)(2) and (3); § 1.162–27) and an applicable individual within the meaning of paragraph (b)(7) of this section, remuneration earned by the applicable individual that is attributable to a disqualified taxable year of a covered health insurance provider is subject to the $500,000 deduction limitation under section 162(m)(6) with respect to such disqualified taxable year, without regard to section 162(m)(1).

(2) *Coordination with disallowed excess parachute payments*—(i) *In general.* The $500,000 deduction limitation of section 162(m)(6) is reduced (but not below zero) by the amount (if any) that would have been included in the AIR or DDR of the applicable individual for a taxable year but for the deduction for the AIR or DDR being disallowed by reason of section 280G.

(ii) *Example.* The following example illustrates the rule of this paragraph (g)(2).

Example. Corporation A, a covered health insurance provider, pays $750,000 of AIR to P, an applicable individual, during A's disqualified taxable year ending December 31, 2016. Of the $750,000, $300,000 is an excess parachute payment as defined in section 280G(b)(1), the deduction for which is disallowed by reason of that section. The excess parachute payment reduces the $500,000 deduction limit to $200,000 ($500,000 − $300,000). Therefore, A may deduct only $200,000 of the $750,000 in AIR, and $250,000 of the payment is not deductible by reason of section 162(m)(6).

(h) *Grandfathered amounts attributable to services performed in taxable years beginning before January 1, 2010*—(1) *In general.* The section 162(m)(6) deduction limitation does not apply to remuneration attributable to services performed in taxable years of a covered health insurance provider beginning before January 1, 2010 (*grandfathered amounts*). For purposes of this paragraph (h), whether remuneration is attributable to services performed in a taxable year beginning before January 1, 2010, is determined by applying an attribution method described in paragraph (h)(2) of this section.

(2) *Identification of services performed in taxable years beginning before January 1, 2010*—(i) *In general.* DDR described in paragraphs (d)(2) (legally binding right), (d)(3) (account balance plans), (d)(4) (nonaccount balance plans), (d)(6) (involuntary separation pay), (d)(7) (reimbursements), and (d)(8) (split dollar life insurance) of this section is attributable to services performed in a taxable year beginning before January 1, 2010 if it is attributable to services performed before that date under the rules of these paragraphs, without regard to whether that remuneration is subject to a substantial risk of forfeiture on or after that date. Notwithstanding the requirement under paragraph (d)(3)(i) of this section that a covered health insurance provider must use the same attribution method for its account balance plans for all taxable years, a covered health insurance provider that uses the account balance ratio method described in paragraph (d)(3)(i) of this section to attribute remuneration to services performed in taxable years beginning after December 31, 2009 may use the principal additions method described in paragraph (d)(3)(ii) of this section to attribute remuneration under an account balance plan to services performed in a taxable year beginning before January 1, 2010 for purposes of determining grandfathered amounts under the plan. (See paragraph (d)(3)(ii)(C)(*3*) of this section for required account balance adjustments if a covered health insurance provider generally uses the account balance ratio method to attribute amounts otherwise deductible under its account balance plans but uses the principal additions method to attribute remuneration to services performed in taxable years beginning before January 1, 2010.)

(ii) *Equity-based remuneration.* For purposes of this section, all remuneration resulting from a stock option, stock appreciation right, restricted stock, or restricted stock unit and the right to any associated dividends or dividend equivalents (together, referred to as *equity-based remuneration*) granted before the first day of the taxable year of the covered health insurance provider beginning on or after

January 1, 2010, is attributable to services performed in taxable years beginning before January 1, 2010, regardless of the date on which the equity-based remuneration is exercised (in the case of a stock option or SAR), the date on which the amounts due under the equity-based remuneration are paid or includible in income, or whether the equity-based remuneration is subject to a substantial risk of forfeiture on or after the first day of the taxable year of the covered health insurance provider beginning on or after January 1, 2010. For example, appreciation in the value of restricted shares granted before the first day of the taxable year beginning on or after January 1, 2010 is treated as remuneration that is attributable to services performed in taxable years beginning before January 1, 2010, regardless of whether the shares are vested at that time.

(i) *Transition rules for certain DDR*—(1) *Transition rule for DDR attributable to services performed in taxable years of the covered health insurance provider beginning after December 31, 2009 and before January 1, 2013.* The deduction limitation under section 162(m)(6) applies to DDR attributable to services performed in a disqualified taxable year of a covered health insurance provider beginning after December 31, 2009 and before January 1, 2013, only if that remuneration is otherwise deductible in a disqualified taxable year of the covered health insurance provider beginning after December 31, 2012. However, if the deduction limitation applies to DDR attributable to services performed by an applicable individual in a disqualified taxable year of a covered health insurance provider beginning after December 31, 2009 and before January 1, 2013, the deduction limitation is calculated as if it had been applied to the applicable individual's AIR and DDR deductible in those taxable years.

(2) *Examples.* The following examples illustrate the principles of this paragraph (i). For purposes of these examples, each corporation has a taxable year that is the calendar year, and DDR is otherwise deductible by the covered health insurance provider in the taxable year in which it is paid.

Example 1. (i) Q is an applicable individual of corporation Z. Z's 2010, 2011, and 2012 taxable years are disqualified taxable years. Z's 2013, 2014, and 2015 taxable years are not disqualified taxable years. However, Z's 2016 taxable year and all subsequent taxable years are disqualified taxable years. Q receives $200,000 of AIR from Z for 2012, and becomes entitled to $800,000 of DDR that is attributable to services performed by Q in 2012. Z pays Q $350,000 of the DDR in 2015, and the remaining $450,000 of the DDR in 2016. These payments are otherwise deductible by Z in 2015 and 2016, respectively.

(ii) DDR attributable to services performed by Q in Z's 2010, 2011, and 2012 taxable years that is otherwise deductible in Z's 2013, 2014, or 2015 taxable years is not subject to the deduction limitation under section 162(m)(6) by reason of the transition rule under paragraph (i)(1) of this section. However, DDR attributable to services performed in Z's 2010, 2011, and 2012 taxable years that is otherwise deductible in a later taxable year that is a disqualified taxable year (in this case, Z's 2016 and subsequent taxable years) is subject to the deduction limitation under section 162(m)(6). Accordingly, the deduction limitation with respect to AIR and DDR attributable to services performed by Q in 2012 is determined by reducing the $500,000 deduction limit by the $200,000 of AIR paid to Q by Z for 2012 ($500,000 − $200,000). Under the transition rule of paragraph (i)(1) of this section, no portion of the reduced deduction limit of $300,000 for the 2012 taxable year is applied against the $350,000 payment made in 2015, and accordingly, the deduction limit is not reduced by the amount of that payment. The reduced deduction limit is then applied to Q's $450,000 of DDR attributable to services performed by Q in 2012 that is paid to Q and becomes otherwise deductible in 2016. Because the reduced deduction limit of $300,000 is less than the $450,000 otherwise deductible by Z in 2016, Z may deduct only $300,000 of the DDR, and $150,000 of the $450,000 payment is not deductible by Z in that taxable year or any taxable year.

Example 2. (i) R is an applicable individual of corporation Y, which is a covered health insurance provider for all relevant taxable years. During 2010, Y pays R $400,000 in salary and grants R a right to $200,000 in DDR payable on a fixed schedule in 2011, 2012, and 2013. Pursuant to the fixed schedule, Y pays R $50,000 of DDR in 2011, $50,000 of DDR in 2012, and the remaining $100,000 of DDR in 2013.

(ii) Because the deduction limitation for DDR under section 162(m)(6)(A)(ii) is effective for DDR that is attributable to services performed by an applicable individual during any disqualified taxable year beginning after December 31, 2009 that would otherwise be deductible in a taxable year beginning after December 31, 2012, only the DDR paid by Y in 2013 is subject to the deduction limitation.

However, the limitation is applied as if section 162(m)(6) and paragraph (c)(2) of this section were effective for taxable years beginning after December 31, 2009 and before January 1, 2013. Accordingly, the deduction limitation with respect to remuneration for services performed by R in 2010 is determined by reducing the $500,000 deduction limit by the $400,000 of AIR paid to R for 2010 ($500,000 −$400,000). The reduced deduction limit of $100,000 is further reduced to zero by the $50,000 of DDR attributable to services performed by R in Y's 2010 taxable year that is deductible in each of 2011 and 2012 (($100,000 − $50,000 − $50,000). Because the deduction limit is reduced to zero, none of the $100,000 of DDR attributable to services performed by R in Y's 2010 taxable year and paid to R in 2013 is deductible.

(j) *Effective/applicability dates.* These regulations are effective on September 23, 2014. The regulations apply to taxable years beginning on or after September 23, 2014.

[T.D, 9694, 79 FR 56904, Sept. 23, 2014]

§ 1.162–32 Expenses paid or incurred for lodging when not traveling away from home.

(a) *In general.* Expenses paid or incurred for lodging of an individual who is not traveling away from home (local lodging) generally are personal, living, or family expenses that are nondeductible by the individual under section 262(a). Under certain circumstances, however, local lodging expenses may be deductible under section 162(a) as ordinary and necessary expenses paid or incurred in connection with carrying on a taxpayer's trade or business, including a trade or business as an employee. Whether local lodging expenses are paid or incurred in carrying on a taxpayer's trade or business is determined under all the facts and circumstances. One factor is whether the taxpayer incurs an expense because of a bona fide condition or requirement of employment imposed by the taxpayer's employer. Expenses paid or incurred for local lodging that is lavish or extravagant under the circumstances or that primarily provides an individual with a social or personal benefit are not incurred in carrying on a taxpayer's trade or business.

(b) *Safe harbor for local lodging at business meetings and conferences.* An individual's local lodging expenses will be treated as ordinary and necessary business expenses if—

(1) The lodging is necessary for the individual to participate fully in or be available for a bona fide business meeting, conference, training activity, or other business function;

(2) The lodging is for a period that does not exceed five calendar days and does not recur more frequently than once per calendar quarter;

(3) If the individual is an employee, the employee's employer requires the employee to remain at the activity or function overnight; and

(4) The lodging is not lavish or extravagant under the circumstances and does not provide any significant element of personal pleasure, recreation, or benefit.

(c) *Examples.* The provisions of the facts and circumstances test of paragraph (a) of this section are illustrated by the following examples. In each example the employer and the employees meet all other requirements (such as substantiation) for deductibility of the expense and for exclusion from income of the value of the lodging as a working condition fringe or of reimbursements under an accountable plan.

Example 1. (i) Employer conducts a seven-day training session for its employees at a hotel near Employer's main office. The training is directly connected with Employer's trade or business. Some employees attending the training are traveling away from home and some employees are not traveling away from home. Employer requires all employees attending the training to remain at the hotel overnight for the bona fide purpose of facilitating the training. Employer pays the costs of the lodging at the hotel directly to the hotel and does not treat the value as compensation to the employees.

(ii) Because the training is longer than five calendar days, the safe harbor in paragraph (b) of this section does not apply. However, the value of the lodging may be excluded from income if the facts and circumstances test in paragraph (a) of this section is satisfied.

(iii) The training is a bona fide condition or requirement of employment and Employer has a noncompensatory business purpose for paying the lodging expenses. Employer is not paying the expenses primarily to provide a social or personal benefit to the employees, and the lodging Employer provides is not lavish or extravagant. If the employees who are not traveling away from home had paid for their own lodging, the expenses would have been deductible by the employees under section 162(a) as ordinary and necessary business expenses. Therefore, the value of the lodging is excluded from the employees' income as a working condition fringe under section 132(a) and (d).

(iv) Employer may deduct the lodging expenses, including lodging for employees who are not traveling away from home, as ordinary and necessary business expenses under section a162(a).

Example 2. (i) The facts are the same as in *Example 1*, except that the employees pay the cost of their lodging at the hotel directly to the hotel, Employer reimburses the employees for the cost of the lodging, and Employer does not treat the reimbursement as compensation to the employees.

(ii) Because the training is longer than five calendar days, the safe harbor in paragraph (b) of this section does not apply. However, the reimbursement of the expenses for the lodging may be excluded from income if the facts and circumstances test in paragraph (a) of this section is satisfied.

(iii) The training is a bona fide condition or requirement of employment and Employer is reimbursing the lodging expenses for a noncompensatory business purpose and not primarily to provide a social or personal benefit to the employees and the lodging Employer provides is not lavish or extravagant. The employees incur the expenses in performing services for the employer. If Employer had not reimbursed the employees who are not traveling away from home for the cost of the lodging, the expenses would have been deductible by the employees under section 162(a) as ordinary and necessary business expenses. Therefore, the reimbursements to the employees are made under an accountable plan and are excluded from the employees' gross income.

(iv) Employer may deduct the lodging expense reimbursements, including reimbursements for employees who are not traveling away from home, as ordinary and necessary business expenses under section 162(a).

Example 3. (i) Employer is a professional sports team. Employer requires its employees (for example, players and coaches) to stay at a local hotel the night before a home game to conduct last minute training and ensure the physical preparedness of the players. Employer pays the lodging expenses directly to the hotel and does not treat the value as compensation to the employees.

(ii) Because the overnight stays occur more than once per calendar quarter, the safe harbor in paragraph (b) of this section does not apply. However, the value of the lodging may be excluded from income if the facts and circumstances test in paragraph (a) of this section is satisfied.

(iii) The overnight stays are a bona fide condition or requirement of employment and Employer has a noncompensatory business purpose for paying the lodging expenses. Employer is not paying the lodging expenses primarily to provide a social or personal benefit to the employees and the lodging Employer provides is not lavish or extravagant. If the employees had paid for their own lodging, the expenses would have been deductible by the employees under section 162(a) as ordinary and necessary business expenses. Therefore, the value of the lodging is excluded from the employees' income as a working condition fringe.

(iv) Employer may deduct the expenses for lodging the employees at the hotel as ordinary and necessary business expenses under section 162(a).

Example 4. (i) Employer hires Employee, who currently resides 500 miles from Employer's business premises. Employer pays for temporary lodging for Employee near Employer's business premises while Employee searches for a residence.

(ii) Employer is paying the temporary lodging expense primarily to provide a personal benefit to Employee by providing housing while Employee searches for a residence. Employer incurs the expense only as additional compensation and not for a noncompensatory business purpose. If Employee paid the temporary lodging expense, the expense would not be an ordinary and necessary employee business expense under section 162(a) because the lodging primarily provides a personal benefit to Employee. Therefore, the value of the lodging is includible in Employee's gross income as additional compensation.

(iii) Employer may deduct the lodging expenses as ordinary and necessary business expenses under section 162(a) and §1.162–25T.

Example 5. (i) Employee normally travels two hours each way between her home and her office. Employee is working on a project that requires Employee to work late hours. Employer provides Employee with lodging at a hotel near the office.

(ii) Employer is paying the temporary lodging expense primarily to provide a personal benefit to Employee by relieving her of the daily commute to her residence. Employer incurs the expense only as additional compensation and not for a noncompensatory business purpose. If Employee paid the temporary lodging expense, the expense would not be an ordinary and necessary business expense under section 162(a) because the lodging primarily provides a personal benefit to Employee. Therefore, the value of the lodging is includible in Employee's gross income as additional compensation.

(iii) Employer may deduct the lodging expenses as ordinary and necessary business expenses under section 162(a) and §1.162–25T.

Example 6. (i) Employer requires an employee to be "on duty" each night to respond quickly to emergencies that may occur outside of normal working hours. Employees who work daytime hours each serve a ''duty shift'' once each month in addition to their normal work schedule. Emergencies that require the duty shift employee to respond occur regularly. Employer has no sleeping facilities on its business premises and pays for a hotel room nearby where the duty shift employee stays until called to respond to an emergency.

(ii) Because an employee's expenses for lodging while on the duty shift occur more frequently than once per calendar quarter, the safe harbor in paragraph (b) of this section does not apply. However, the value of the lodging may be excluded from income if the facts and circumstances test in paragraph (a) of this section is satisfied.

(iii) The duty shift is a bona fide condition or requirement of employment and Employer has a noncompensatory business purpose for paying the lodging expenses. Employer is not providing the lodging to duty shift employees primarily to provide a social or personal benefit to the employees and the lodging Employer provides is not lavish or extravagant. If the employees had paid for their lodging, the expenses would have been deductible by the employees under section 162(a) as ordinary and necessary business expenses. Therefore, the value of the lodging is excluded from the employees' income as a working condition fringe.

(iv) Employer may deduct the lodging expenses as ordinary and necessary business expenses under section 162(a).

(d) *Effective/applicability date.* This section applies to expenses paid or incurred on or after October 1, 2014. However, taxpayers may apply these regulations to local lodging expenses that are paid or incurred in taxable years for which the period of limitation on credit or refund under section 6511 has not expired.

[T.D. 9696, 79 FR 59113, Oct. 1, 2014]

§ 1.162–33 Certain employee remuneration in excess of $1,000,000 not deductible for taxable years beginning after December 31, 2017.

(a) *Scope.* This section provides rules for the application of the $1 million deduction limitation under section 162(m)(1) for taxable years beginning after December 31, 2017. For rules concerning the applicability of section 162(m)(1) to taxable years beginning on or after January 1, 1994, and prior to January 1, 2018, see § 1.162–27. Paragraph (b) of this section provides the general rule limiting deductions under section 162(m)(1). Paragraph (c) of this section provides definitions of generally applicable terms. Paragraph (d) of this section provides rules for determining when a corporation becomes a publicly held corporation. Paragraph (e) of this section provides rules for payments that are subject to section 280G (golden parachute payments). Paragraph (f) of this section provides a special rule for coordination with section 4985 (stock compensation of insiders in expatriated corporations). Paragraph (g) of this section provides transition rules addressing the amendments made by Public Law 115–97, including the rules for contracts that are grandfathered. Paragraph (h) of this section sets forth the effective date provisions. For rules concerning the deductibility of compensation for services that are not covered by section 162(m)(1) and this section, see section 162(a)(1) and § 1.162–7. This section is not determinative as to whether compensation meets the requirements of section 162(a)(1). For rules concerning the deduction limitation under section 162(m)(6) applicable to certain health insurance providers, see § 1.162–31. For purposes of this section, references to an amount being paid to an employee refer to the event that otherwise would result in the availability of a deduction to the employer with respect to such amount, whether that results from an actual payment in cash, transfer of property, or other event.

(b) *Limitation on deduction.* Section 162(m)(1) precludes a deduction under chapter 1 of the Internal Revenue Code by any publicly held corporation for compensation paid to any covered employee to the extent that the compensation for the taxable year exceeds $1,000,000.

(c) *Definitions*—(1) *Publicly held corporation*—(i) *General rule.* A publicly held corporation means any corporation that issues securities required to be registered under section 12 of the Exchange Act or that is required to file reports under section 15(d) of the Exchange Act. In addition, a publicly held corporation means any S corporation (as defined in section 1361(a)(1)) that issues securities that are required to be registered under section 12(b) of the Exchange Act, or that is required to file reports under section 15(d) of the

Exchange Act. For purposes of this section, whether a corporation is publicly held is determined based solely on whether, as of the last day of its taxable year, the securities issued by the corporation are required to be registered under section 12 of the Exchange Act or the corporation is required to file reports under section 15(d) of the Exchange Act. Whether registration under the Exchange Act is required by rules other than those of the Exchange Act is irrelevant to this determination. A publicly traded partnership that is treated as a corporation under section 7704 (or otherwise) is a publicly held corporation if, as of the last day of its taxable year, its securities are required to be registered under section 12 of the Exchange Act or it is required to file reports under section 15(d) of the Exchange Act.

(ii) *Affiliated groups*—(A) *In general.* A publicly held corporation includes an affiliated group of corporations (affiliated group), as defined in section 1504 (determined without regard to section 1504(b)), that includes one or more publicly held corporations (as defined in paragraph (c)(1)(i) of this section). In the case of an affiliated group that includes two or more publicly held corporations as defined in paragraph (c)(1)(i) of this section, each member of the affiliated group that is a publicly held corporation as defined in paragraph (c)(1)(i) of this section is separately subject to this section, and, due to having at least one member that is a publicly held corporation, the affiliated group as a whole is subject to this section. Thus, for example, assume that a publicly held corporation (as defined in paragraph (c)(1)(i) of this section) is a wholly-owned subsidiary of another publicly held corporation (as defined in paragraph (c)(1)(i) of this section), which is a wholly-owned subsidiary of a privately held corporation. In this case, the two subsidiaries are separately subject to this section, and all three corporations are members of an affiliated group that is subject to this section. If an individual is a covered employee of both subsidiaries, each subsidiary has its own $1 million deduction limitation with respect to that covered employee. Furthermore, each subsidiary has its own set of covered employees as defined in paragraphs (c)(2)(i) through (iv) of this section (although the same individual may be a covered employee of both subsidiaries).

(B) *Proration of amount disallowed as a deduction.* If, in a taxable year, a covered employee (as defined in paragraphs (c)(2)(i) through (v) of this section) of one member of an affiliated group is paid compensation by more than one member of the affiliated group, compensation paid by each member of the affiliated group is aggregated with compensation paid to the covered employee by all other members of the affiliated group (excluding compensation paid by any other publicly held corporation in the affiliated group, as defined in paragraph (c)(1)(i) of this section, of which the individual is also a covered employee as defined in paragraphs (c)(2)(i) through (v) of this section). In the event that, in a taxable year, a covered employee (as defined in paragraphs (c)(2)(i) through (v) of this section) is paid compensation by more than one publicly held corporation in an affiliated group and is also a covered employee of more than one publicly held payor corporation (as defined in paragraph (c)(1)(i) of this section) in the affiliated group, the amount disallowed as a deduction is determined separately with respect to each publicly held corporation of which the individual is a covered employee. Any amount disallowed as a deduction by this section must be prorated among the payor corporations (excluding any other publicly held payor corporation of which the individual is also a covered employee) in proportion to the amount of compensation paid to the covered employee (as defined in paragraphs (c)(2)(i) through (v) of this section) by each such corporation in the taxable year. For purposes of this paragraph (c)(1)(ii)(B), the amount of compensation treated as paid by a payor corporation that is not a publicly held corporation (as defined in paragraph (c)(1)(i) of this section) is determined by prorating the amount actually paid by that payor corporation in proportion to the total amount paid by all of the publicly held corporations of which the individual is a covered employee (as defined in paragraph (c)(2)(i) through (v) of this section). This process is repeated for each publicly held payor corporation of which the individual is a covered employee.

(iii) *Disregarded entities.* For purposes of paragraph (c)(1) of this section, a publicly held corporation includes a corporation that owns an entity that is disregarded as an entity separate from its owner within the meaning of §301.7701–2(c)(2)(i) of this chapter if the disregarded entity issues securities required to be registered under section 12(b) of the Exchange Act, or is required to file reports under section 15(d) of the Exchange Act.

(iv) *Qualified subchapter S subsidiaries.* For purposes of paragraph (c)(1) of this section, a publicly held corporation includes an S corporation that owns a qualified subchapter S subsidiary as defined in section 1361(b)(3)(B) (QSub) if the QSub issues securities required to be registered under section 12(b) of the Exchange Act, or is required to file reports under section 15(d) of the Exchange Act.

(v) *Qualified real estate investment trust subsidiaries.* For purposes of paragraph (c)(1) of this section, a publicly held corporation includes a real estate investment trust as defined in section 856(a) that owns a qualified real estate investment trust subsidiary as defined in section 856(i)(2) (QRS), if the QRS issues securities required to be registered under section 12(b) of the Exchange Act or is required to file reports under section 15(d) of the Exchange Act.

(vi) *Examples.* The following examples illustrate the provisions of this paragraph (c)(1). For each example, assume that no corporation is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii) of this section. Furthermore, for each example, unless provided otherwise, a reference to a publicly held corporation means a publicly held corporation as defined in paragraph (c)(1)(i) of this section. Additionally, for each example, assume that the corporation is a calendar-year taxpayer and has a fiscal year ending December 31 for reporting purposes under the Exchange Act. The examples in this paragraph (c)(1)(vi) are not intended to provide guidance on the legal requirements of the Securities Act and Exchange Act and the rules thereunder (17 CFR part 240).

(A) *Example 1 (Corporation required to file reports under section 15(d) of the Exchange Act)*—(*1*) *Facts.* Corporation Z plans to issue debt securities in a public offering registered under the Securities Act. Corporation Z is not required to file reports under section 15(d) of the Exchange Act for any other class of securities and does not have another class of securities required to be registered under section 12 of the Exchange Act. On April 1, 2021, the SEC declares effective the Securities Act registration statement for Corporation Z's debt securities. As a result, Corporation Z is required to file reports under section 15(d) of the Exchange Act, and this requirement continues to apply as of December 31, 2021.

(*2*) *Conclusion.* Corporation Z is a publicly held corporation for its 2021 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(B) *Example 2 (Corporation not required to file reports under section 15(d) of the Exchange Act)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(A) of this section (*Example 1*), except that, on January 1, 2022, pursuant to section 15(d) of the Exchange Act, Corporation Z's obligation to file reports under section 15(d) is automatically suspended for the fiscal year ending December 31, 2022, because Corporation Z meets the statutory requirements for an automatic suspension. As of December 31, 2022, Corporation Z is not required to file reports under section 15(d) of the Exchange Act.

(*2*) *Conclusion.* Corporation Z is not a publicly held corporation for its 2022 taxable year because it is not required to file reports under section 15(d) of the Exchange Act as of as of the last day of its taxable year.

(C) *Example 3 (Corporation not required to file reports under section 15(d) of the Exchange Act)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(B) of this section (*Example 2*), except that, on January 1, 2022, pursuant to section 15(d) of the Exchange Act, Corporation

Z's obligation to file reports under section 15(d) is not automatically suspended for the fiscal year ending December 31, 2022. Instead, on May 2, 2022, Corporation Z is eligible to suspend its section 15(d) reporting obligation under 17 CFR 240.12h–3 (Rule 12h–3 under the Exchange Act) and files Form 15, Certification and Notice of Termination of Registration under Section 12(g) of the Securities Exchange Act of 1934 or Suspension of Duty to File Reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934, (or its successor) to suspend its section 15(d) reporting obligation for its fiscal year ending December 31, 2022. As of December 31, 2022, Corporation Z is not required to file reports under section 15(d) of the Exchange Act.

(*2*) *Conclusion*. Corporation Z is not a publicly held corporation for its 2022 taxable year because it is not required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year. If Corporation Z had not utilized Rule 12h–3 to suspend its section 15(d) reporting obligation, Corporation Z would be a publicly held corporation for its 2022 taxable year because it would have been required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(D) *Example 4 (Corporation required to file reports under section 15(d) of the Exchange Act)*—(*1*) *Facts*. Corporation Y is a wholly-owned subsidiary of Corporation X, which is required to file reports under the Exchange Act. Corporation Y issued a class of debt securities in a public offering registered under the Securities Act, and therefore is required to file reports under section 15(d) of the Exchange Act for its fiscal year ending December 31, 2020. Corporation Y has no other class of securities registered under the Exchange Act. In its Form 10–K, Annual Report Pursuant to section 13 or section 15(d) of the Securities Exchange Act of 1934, (or its successor) for the 2020 fiscal year, Corporation Y may omit Item 11, Executive Compensation (required by Part III of Form 10–K), which requires disclosure of compensation of certain executive officers, because it is wholly-owned by Corporation X and the other conditions of General Instruction I to Form 10–K are satisfied.

(*2*) *Conclusion*. Corporation Y is a publicly held corporation for its 2020 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(E) *Example 5 (Corporation not required to file reports under section 15(d) of the Exchange Act and not required to register securities under section 12 of the Exchange Act)*—(*1*) *Facts*. Corporation A has a class of securities registered under section 12(g) of the Exchange Act. For its 2020 taxable year, Corporation A is a publicly held corporation. On September 30, 2021, Corporation A is eligible to terminate the registration of its securities under section 12(g) of the Exchange Act pursuant to 17 CFR 240.12g–4(a)(2) (Rule 12g–4(a)(2) under the Exchange Act), but does not terminate the registration of its securities prior to December 31, 2021. Because Corporation A did not issue securities in a public offering registered under the Securities Act, Corporation A is not required to file reports under section 15(d) of the Exchange Act.

(*2*) *Conclusion*. Corporation A is not a publicly held corporation for its 2021 taxable year because, as of the last day of its taxable year, the securities issued by Corporation A are not required to be registered under section 12 of the Exchange Act and Corporation A is not required to file reports under section 15(d) of the Exchange Act.

(F) *Example 6 (Corporation required to file reports under section 15(d) of the Exchange Act)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(E) of this section (*Example 5*), except that Corporation A previously issued a class of securities in a public offering registered under the Securities Act. Furthermore, on October 1, 2021, Corporation A terminates the registration of its securities under section 12(g) of the Exchange Act. Because Corporation A issued a class of securities in a public offering registered under the Securities Act and is not eligible to suspend its reporting obligation under section 15(d) of the Exchange Act, as of December 31, 2021, Corporation A is required to file reports under section 15(d) of the Exchange Act.

(*2*) *Conclusion*. Corporation A is a publicly held corporation for its 2021 taxable year because it is required to file reports under section 15(d) of the Exchange Act as of the last day of its taxable year.

(G) *Example 7 (Corporation not required to file reports under section 15(d) of the Exchange Act and not required to register securities under section 12 of the Exchange Act)*—(*1*) *Facts*. On November 1, 2021, Corporation B is an issuer with only one class of equity securities. On November 5, 2021, Corporation B files a registration statement for its equity securities under section 12(g) of the Exchange Act. Corporation B's filing of its registration statement is voluntary because the Exchange Act does not require Corporation B to register its class of securities under section 12(g) of the Exchange Act based on the number and composition of its record holders. On December 1, 2021, the SEC declares effective the Exchange Act registration statement for Corporation B's securities. As of December 31, 2021, Corporation B continues to have its class of equity securities registered voluntarily under section 12 of the Exchange Act. Corporation B is not required to file reports under section 15(d) of the Exchange Act because it did not register any class of securities in a public offering under the Securities Act.

(*2*) *Conclusion*. Corporation B is not a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, the securities issued by Corporation B are not required to be registered under section 12 of the Exchange Act and Corporation B is not required to file reports under section 15(d) of the Exchange Act.

(H) *Example 8 (Corporation not required to file reports under section 15(d) of the Exchange Act and not required to register securities under section 12 of the Exchange Act)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(G) of this section (*Example 7*), except that, on December 31, 2022, because of a change in circumstances, Corporation B must register its class of equity securities under section 12(g) of the Exchange Act within 120 days of December 31, 2022. On February 1, 2023, the SEC declares effective the Exchange Act registration statement for Corporation B's securities.

(*2*) *Conclusion*. Corporation B is not a publicly held corporation for its 2022 taxable year because, as of the last day of that taxable year, Corporation B is not required to file reports under section 15(d) of the Exchange Act and the class of equity securities issued by Corporation B is not yet required to be registered under section 12 of the Exchange Act.

(I) *Example 9 (Securities of foreign private issuer in the form of ADRs traded in the over-the-counter market)*—(*1*) *Facts*. For its fiscal and taxable years ending December 31, 2021, Corporation W is a foreign private issuer. Because Corporation W has not registered an offer or sale of securities under the Securities Act, it is not required to file reports under section 15(d) of the Exchange Act. Corporation W qualifies for an exemption from registration of its securities under section 12(g) of the Exchange Act pursuant to 17 CFR 240.12g3–2(b) (Rule 12g3–2(b) under the Exchange Act). Corporation W wishes to have its securities traded in the U.S. in the over-the-counter market in the form of ADRs. Because Corporation W qualifies for an exemption pursuant to Rule 12g3–2(b), Corporation W is not required to register its securities underlying the ADRs under section 12 of the Exchange Act; however, the depositary bank is required to register the ADRs under the Securities Act. Even though the depositary bank is required to register the ADRs under the Securities Act, the registration of the ADRs does not result in either the depositary bank or Corporation W being required to file reports under section 15(d) of the Exchange Act. On February 3, 2021, the SEC declares effective the Securities Act registration statement for the ADRs. On February 4, 2021, Corporation W's ADRs begin trading in the over-the-counter market. On December 31, 2021, the securities of Corporation W are not required to be registered under section 12 of the Exchange Act because Corporation W qualifies for an exemption pursuant to Rule 240.12g3–2(b). Furthermore, on December 31, 2021, Corporation W is not required to file reports under section 15(d) of the Exchange Act.

(*2*) *Conclusion*. Corporation W is not a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, the securities underlying the ADRs are not required to be registered under section 12 of the Exchange Act and Corporation W is not required to file reports under section 15(d) of the Exchange Act. The result would be the same if Corporation W had its securities traded in the over-the-counter market other than in the form of ADRs.

(J) *Example 10 (Securities of foreign private issuer in the form of ADRs quoted on Over the Counter Bulletin Board)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(I) of this section (*Example 9*), except that Corporation W has its securities quoted on the Over the Counter Bulletin Board (OTCBB) in the form of ADRs. Because Corporation W qualifies for an exemption pursuant to 17 CFR 240.12g3–2(b) (Rule 12g3–2(b) under the Exchange Act), Corporation W is not required to register its securities underlying the ADRs under section 12 of the Exchange Act. However, the depositary bank is required to register the ADRs under the Securities Act. In addition, section 6530(b)(1) of the OTCBB Rules requires that a foreign equity security may be quoted on the OTCBB only if the security is registered with the SEC pursuant to section 12 of the Exchange Act and the issuer of the security is current in its reporting obligations. To comply with the OTCBB Rules, on February 5, 2021, Corporation W files a registration statement for its class of securities underlying the ADRs under section 12(g) of the Exchange Act. On February 26, 2021, the SEC declares effective the Exchange Act registration statement for Corporation W's securities. As of December 31, 2021, Corporation W is subject to the reporting obligations under section 12 of the Exchange Act as a result of the section 12 registration.

(*2*) *Conclusion*. Corporation W is not a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, its ADRs and the securities underlying the ADRs are not required by the Exchange Act to be registered under section 12 and Corporation W is not required to file reports under section 15(d) of the Exchange Act. The Securities Act requirement applicable to the bank pursuant to the OTCBB rules is irrelevant. The result would be the same if Corporation W had its securities traded on the OTCBB other than in the form of ADRs.

(K) *Example 11 (Securities of foreign private issuer in the form of ADRs listed on a national securities exchange without a capital raising transaction)*—(*1*) *Facts*. For its fiscal and taxable years ending December 31, 2021, Corporation V is a foreign private issuer. Corporation V wishes to list its securities on the New York Stock Exchange (NYSE) in the form of ADRs without a capital raising transaction. Under the Exchange Act, Corporation V is required to register its securities underlying the ADRs under section 12(b) of the Exchange Act. Because the ADRs and the deposited securities are separate securities, the depositary bank is required to register the ADRs under the Securities Act. On February 2, 2021, the SEC declares effective Corporation V's registration statement under section 12(b) of the Exchange Act in connection with the underlying securities, and the depositary bank's registration statement under the Securities Act in connection with the ADRs. On March 1, 2021, Corporation V's securities begin trading on the NYSE in the form of ADRs. As of December 31, 2021, Corporation V is not required to file reports under section 15(d) of the Exchange Act; however, the securities underlying the ADRs are required to be registered under section 12(b) of the Exchange Act.

(*2*) *Conclusion*. Corporation V is a publicly held corporation for its 2021 taxable year because, as of the last day of that taxable year, the securities underlying the ADRs are required to be registered under section 12 of the Exchange Act. The result would be the same if Corporation V had its securities listed on the NYSE other than in the form of ADRs. The result also would be the same if Corporation V had wished to raised capital during its 2021 taxable year and been required to register the offer of securities underlying the ADRs under the Securities Act and to register the class of those securities under section 12(b) of the Exchange

Act, and the depositary bank was required to register the ADRs under the Securities Act.

(L) *Example 12 (Foreign private issuer incorporates subsidiary in the United States to issue debt securities and subsequently issues a guarantee)*—(*1*) *Facts.* For its fiscal and taxable years ending December 31, 2021, Corporation T is a foreign private issuer. Corporation T wishes to access the U.S. capital markets. Corporation T incorporates Corporation U, a wholly-owned subsidiary, in the U.S. to issue debt securities. On January 15, 2021, the SEC declares effective Corporation U's Securities Act registration statement. To enhance Corporation U's credit and the marketability of Corporation U's debt securities, Corporation T issues a guarantee of Corporation U's securities and, as required, registers the guarantee under the Securities Act on Corporation U's registration statement. On December 31, 2021, Corporations T and U are required to file reports under section 15(d) of the Exchange Act.

(*2*) *Conclusion.* Corporations T and U are publicly held corporations for their 2021 taxable years because they are required to file reports under section 15(d) of the Exchange Act as of the last day of their taxable years.

(M) *Example 13 (Affiliated group comprised of two corporations, one of which is a publicly held corporation)*—(*1*) *Facts.* Employee D, a covered employee of Corporation N, receives compensation from, Corporations N and O, members of an affiliated group. Corporation N, the parent corporation, is a publicly held corporation. Corporation O is a direct subsidiary of Corporation N and is a privately held corporation. The total compensation paid to Employee D from the affiliated group members is $3,000,000 for the taxable year, of which Corporation N pays $2,100,000 and Corporation O pays $900,000.

(*2*) *Conclusion.* Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m)(1), $2,000,000 of the aggregate compensation paid is nondeductible. Corporations N and O each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. Corporation N has a nondeductible compensation expense of $1,400,000 ($2,100,000 × $2,000,000/$3,000,000). Corporation O has a nondeductible compensation expense of $600,000 ($900,000 × $2,000,000/ $3,000,000).

(N) *Example 14 (Affiliated group comprised of two corporations, one of which is a publicly held corporation)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(M) of this section (*Example 13*), except that Corporation O is a publicly held corporation, Corporation N is a privately held corporation, and Employee D is a covered employee of Corporation O (instead of Corporation N).

(*2*) *Conclusion.* The result is the same as in paragraph (c)(1)(vi)(M) of this section (*Example 13*). Even though subsidiary Corporation O is the publicly held corporation, Corporations N and O still comprise an affiliated group. Accordingly, $2,000,000 of the aggregate compensation paid is nondeductible, and Corporations N and O each are treated as paying a ratable portion of the nondeductible compensation.

(O) *Example 15 (Affiliated group comprised of two publicly held corporations)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(M) of this section (*Example 13*), except that Corporation O is a publicly held corporation. As in paragraph (c)(1)(vi)(M) of this section (*Example 13*), Employee D is not a covered employee of Corporation O.

(*2*) *Conclusion.* The result is the same as in paragraph (c)(1)(vi)(M) of this section (*Example 13*). Even though Corporations N and O each are publicly held corporations, Corporations N and O comprise an affiliated group for purposes of prorating the amount disallowed as a deduction. Accordingly, $2,000,000 of the aggregate compensation paid is nondeductible, and Corporations N and O each are treated as paying a ratable portion of the nondeductible compensation.

(P) *Example 16 (Affiliated group comprised of two publicly held corporations)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(1)(vi)(O) of this section (*Example 15*), except that Employee D also is a covered employee of Corporation O.

(*2*) *Conclusion.* Corporations N and O each are publicly held corporations and separately subject to this section, but also comprise an affiliated group. Because Employee D is a covered employee of both Corporations N and O, each of which is a separate publicly held corporation, the determination of the amount disallowed as a deduction is made separately for each publicly held corporation. Corporation N has a nondeductible compensation expense of $1,100,000 (the excess of $2,100,000 over $1,000,000), and Corporation O has no nondeductible compensation expense because the amount it paid to Employee D did not exceed $1,000,000.

(Q) *Example 17 (Affiliated group comprised of three corporations, one of which is a publicly held corporation)*—(*1*) *Facts*. Employee C, a covered employee of publicly held parent Corporation P, receives compensation from Corporations P, Q, and R, members of an affiliated group. Corporation Q is a direct subsidiary of Corporation P, and Corporation R is a direct subsidiary of Corporation Q. Corporations Q and R both are privately held. The total compensation paid to Employee C from the affiliated group members is $3,000,000 for the taxable year, of which Corporation P pays $1,500,000, Corporation Q pays $900,000, and Corporation R pays $600,000.

(*2*) *Conclusion*. Because the compensation paid by affiliated group members is aggregated for purposes of section 162(m)(1), $2,000,000 of the aggregate compensation paid is nondeductible. Corporations P, Q, and R each are treated as paying a ratable portion of the nondeductible compensation. Thus, two thirds of each corporation's payment will be nondeductible. The nondeductible compensation expense for Corporation P is $1,000,000 ($1,500,000 × $2,000,000/$3,000,000); for Corporation Q is $600,000 ($900,000 × $2,000,000/$3,000,000); and for Corporation R is $400,000 ($600,000 × $2,000,000/$3,000,000).

(R) *Example 18 (Affiliated group comprised of three corporations, one of which is a publicly held corporation)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*), except that Corporation Q is a publicly held corporation and Corporation P is a privately held corporation, and Employee C is a covered employee of Corporation Q (instead of Corporation P).

(*2*) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*). Even though Corporation Q, the subsidiary, is the publicly held corporation, Corporations P, Q, and R comprise an affiliated group. Accordingly, $2,000,000 of the aggregate compensation paid is nondeductible, and Corporations P, Q, and R each are treated as paying a ratable portion of the nondeductible compensation.

(S) *Example 19 (Affiliated group comprised of three corporations, two of which are publicly held corporations)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(R) of this section (*Example 18*), except that Corporation R also is a publicly held corporation. As in paragraph (c)(1)(vi)(R) of this section (*Example 18*), Corporation Q is a publicly held corporation, Corporation P is a privately held corporation, and Employee C is a covered employee of Corporation Q but not a covered employee of Corporation R.

(*2*) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(R) of this section (*Example 18*). Even though Corporation R also is a publicly held corporation, Corporations P, Q, and R comprise an affiliated group. Accordingly, $2,000,000 of the aggregate compensation paid is nondeductible, and Corporations P, Q, and R each are treated as paying a ratable portion of the nondeductible compensation.

(T) *Example 20 (Affiliated group comprised of three publicly held corporations)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*), except that Corporations Q and R also are publicly held corporations, and Employee C is a covered employee of both Corporations P and Q but is not a covered employee of Corporation R.

(*2*) *Conclusion*. Even though Corporations P, Q, and R each are publicly held corporations, they comprise an affiliated group. Because Employee C is a covered employee of both Corporations P and Q, the determination of the amount disallowed as a deduction is separately prorated among Corporations P and R and among Corporations Q and R. For each separate calculation of the total amount of the disallowed deduction and the proration of the disallowed deduction, the amount paid by

Corporation R is taken into account in proportion to the total compensation paid by Corporations P and Q. With respect to Corporations P and R, $875,000 of the aggregate compensation is nondeductible (the excess of $1,875,000 (the sum of the compensation paid by Corporation P ($1,500,000) and the portion of compensation paid by Corporation R that is treated as allocable to Employee C being a covered employee of Corporation P ($600,000 × $1,500,000/($1,500,000 + $900,000) = $375,000) over the $1,000,000 deduction limitation). Corporations P and R each are treated as paying a ratable portion of the nondeductible compensation. Corporation P has a nondeductible compensation expense of $700,000 ($1,500,000 × $875,000/$1,875,000), and Corporation R has a nondeductible compensation expense of $175,000 ($375,000 × $875,000/$1,875,000). For Corporations Q and R, $125,000 of the aggregate compensation is nondeductible (the excess of $1,125,000 (the sum of the compensation paid by Corporation Q ($900,000) and the portion of compensation paid by Corporation R that is treated as allocable to Employee C being a covered employee of Corporation Q ($600,000 × $900,000/($1,500,000 + $900,000) = $225,000) over the $1,000,000 deduction limitation). Corporation Q has a nondeductible compensation expense of $100,000 ($900,000 × $125,000/$1,125,000), and Corporation R has a nondeductible compensation expense of $25,000 ($225,000 × $125,000/$1,125,000). The total nondeductible compensation expense for Corporation R is $200,000.

(U) *Example 21 (Affiliated group comprised of three publicly held corporations)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(T) of this section (*Example 20*), except that Employee C does not receive any compensation from Corporation R.

(*2*) *Conclusion*. Even though Corporations P, Q, and R each are publicly held corporations and separately subject to this section, they comprise an affiliated group. Because Employee C is a covered employee of, and receives compensation from, both Corporations P and Q, each of which is a separate publicly held corporation, the determination of the amount disallowed as a deduction is made separately for Corporations P and Q. Corporation P has a nondeductible compensation expense of $500,000 (the excess of $1,500,000 over $1,000,000), and Corporation Q has no nondeductible compensation expense because the amount it paid to Employee C was below $1,000,000.

(V) *Example 22 (Affiliated group comprised of three corporations, one of which is a publicly held corporation)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*), except that Corporation R is a direct subsidiary of Corporation P (and not a direct subsidiary of Corporation Q).

(*2*) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(Q) of this section (*Example 17*). Corporations P, Q, and R comprise an affiliated group. Accordingly, $2,000,000 of the aggregate compensation paid is nondeductible, and Corporations P, Q, and R each are treated as paying a ratable portion of the nondeductible compensation.

(W) *Example 23 (Affiliated group comprised of three publicly held corporations)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(1)(vi)(V) of this section (*Example 22*), except that Corporations Q and R also are publicly held corporations, and Employee C is a covered employee of both Corporations P and Q but not of Corporation R.

(*2*) *Conclusion*. The result is the same as in paragraph (c)(1)(vi)(V) of this section (*Example 22*). Even though Corporations P, Q, and R each are publicly held corporations, they comprise an affiliated group. Because Employee C is a covered employee of both Corporations P and Q, the amount disallowed as a deduction is prorated separately among Corporations P and R and among Corporations Q and R.

(X) *Example 24 (Disregarded entity)*—(*1*) *Facts*. Corporation G is privately held for its 2020 taxable year. Entity H, a limited liability company, is wholly-owned by Corporation G and is disregarded as an entity separate from its owner under §301.7701–2(c)(2)(i) of this chapter. As of December 31, 2020, Entity H is required to file reports under section 15(d) of the Exchange Act.

(2) *Conclusion*. Because Entity H is required to file reports under section 15(d) of the Exchange Act and is disregarded as an entity separate from its owner, Corporation G is a publicly held

corporation for its 2020 taxable year. The result would be the same if Corporation G was a REIT under section 856(a) and Entity H was a QRS under section 856(i)(2).

(2) *Covered employee*—(i) *General rule*. Except as provided in paragraph (c)(2)(vi) of this section, with respect to a publicly held corporation as defined in paragraph (c)(1) of this section (without regard to paragraph (c)(1)(ii) of this section), for the publicly held corporation's taxable year, a covered employee means any of the following—

(A) The principal executive officer (PEO) or principal financial officer (PFO) of the publicly held corporation serving at any time during the taxable year, including individuals acting in either such capacity.

(B) The three highest compensated executive officers of the publicly held corporation for the taxable year (other than the principal executive officer or principal financial officer, or an individual acting in such capacity), regardless of whether the executive officer is serving at the end of the publicly held corporation's taxable year, and regardless of whether the executive officer's compensation is subject to disclosure for the last completed fiscal year under the executive compensation disclosure rules under the Exchange Act. For purposes of this paragraph (c)(2)(i)(B), the term ''executive officer'' means an executive officer as defined in 17 CFR 240.3b–7. The amount of compensation used to identify the three most highly compensated executive officers for the taxable year is determined pursuant to the executive compensation disclosure rules under the Exchange Act (using the taxable year as the fiscal year for purposes of making the determination), regardless of whether the corporation's fiscal year and taxable year end on the same date.

(C) Any individual who was a covered employee of the publicly held corporation (or any predecessor of a publicly held corporation, within the meaning of paragraph (c)(2)(ii) of this section) for any preceding taxable year beginning after December 31, 2016. For taxable years beginning prior to January 1, 2018, covered employees are identified in accordance with the rules in §1.162–27(c)(2).

(ii) *Predecessor of a publicly held corporation*—(A) *Publicly held corporations that become privately held*. For purposes of this paragraph (c)(2)(ii), a predecessor of a publicly held corporation includes a publicly held corporation that, after becoming a privately held corporation, again becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the corporation's U.S. Federal income tax return (disregarding any extensions) for the last taxable year for which the corporation was previously publicly held.

(B) *Corporate reorganizations*. A predecessor of a publicly held corporation includes a publicly held corporation the stock or assets of which are acquired in a corporate reorganization (as defined in section 368(a)(1)).

(C) *Corporate divisions*. A predecessor of a publicly held corporation includes a publicly held corporation that is a distributing corporation (within the meaning of section 355(a)(1)(A)) that distributes the stock of a controlled corporation (within the meaning of section 355(a)(1)(A)) to its shareholders in a distribution or exchange qualifying under section 355(a)(1) (corporate division). The rule of this paragraph (c)(2)(ii)(C) applies only with respect to covered employees of the distributing corporation who begin performing services for the controlled corporation (or for a corporation affiliated with the controlled corporation that receives stock of the controlled corporation in the corporate division) within the period beginning 12 months before and ending 12 months after the distribution.

(D) *Affiliated groups*. A predecessor of a publicly held corporation includes any other publicly held corporation that becomes a member of its affiliated group (as defined in paragraph (c)(1)(ii) of this section).

(E) *Asset acquisitions*. If a publicly held corporation, including one or more members of an affiliated group as defined in paragraph (c)(1)(ii) of this section (acquiror), acquires at least 80% of the gross operating assets (determined by fair market value on the date of acquisition) of another publicly held corporation (target), then the target is a predecessor of the acquiror.

For an acquisition of assets that occurs over time, only assets acquired within a 12-month period are taken into account to determine whether at least 80% of the target's gross operating assets were acquired. However, this 12-month period is extended to include any continuous period that ends on, or begins on, any day during which the acquiror has an arrangement to purchase, directly or indirectly, assets of the target. A shareholder's additions to the assets of target made as part of a plan or arrangement to avoid the application of this subsection to acquiror's purchase of target's assets are disregarded in applying this paragraph (c)(2)(ii)(E). This paragraph (c)(2)(ii)(E) applies only with respect to the target's covered employees who begin performing services for the acquiror (or a corporation affiliated with the acquiror) within the period beginning 12 months before and ending 12 months after the date of the transaction as defined in paragraph (c)(2)(ii)(I) of this section (incorporating any extensions to the 12-month period made pursuant to this paragraph).

(F) *Predecessor of a predecessor*. For purposes of this paragraph (c)(2)(ii), a predecessor of a corporation includes each predecessor of the corporation and the predecessor or predecessors of any prior predecessor or predecessors.

(G) *Corporations that are not publicly held at the time of the transaction and sequential transactions*—(*1*) *Predecessor corporation is not publicly held at the time of the transaction*. This paragraph (c)(2)(ii)(G)(*1*) applies if a corporation that was previously publicly held (the first corporation) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that the first corporation is not a publicly held corporation at the time of the relevant transaction (or transactions). If this paragraph (c)(2)(ii)(G)(*1*) applies, the first corporation is a predecessor of a publicly held corporation if the second corporation is a publicly held corporation at the time of the relevant transaction (or transactions) and the relevant transaction (or transactions) take place during a taxable year ending before the 36-month anniversary of the due date for the first corporation's U.S. Federal income tax return (excluding any extensions) for the last taxable year for which the first corporation was previously publicly held.

(*2*) *Second corporation is not publicly held at the time of the transaction*. This paragraph (c)(2)(ii)(G)(*2*) applies if a corporation that is publicly held (the first corporation) at the time of the relevant transaction (or transactions) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that the second corporation is not a publicly held corporation at the time of the relevant transaction (or transactions). If this paragraph (c)(2)(ii)(G)(*2*) applies, the first corporation is a predecessor of a publicly held corporation if the second corporation becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the first corporation's U.S. Federal income tax return (excluding any extensions) for the first corporation's last taxable year in which the transaction is taken into account.

(*3*) *Neither corporation is publicly held at the time of the transaction*. This paragraph (c)(2)(ii)(G)(*3*) applies if a corporation that was previously publicly held (the first corporation) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that neither the first corporation nor the second corporation is a publicly held corporation at the time of the relevant transaction (or transactions). If this paragraph (c)(2)(ii)(G)(*3*) applies, the first corporation is a predecessor of a publicly held corporation if the second corporation becomes a publicly held corporation for a taxable year ending before the 36-month anniversary of the due date for the first corporation's U.S. Federal income tax return (excluding any extensions) for the last taxable year for which the first corporation was previously publicly held.

(*4*) *Sequential transactions*. If a corporation that was previously publicly held (the first corporation) would be a predecessor to another corporation (the second corporation) under the rules of this paragraph (c)(2)(ii) but for the fact that the first corporation is (or its assets are) transferred to one or more intervening corporations prior to being transferred to the second corporation, and if each intervening corporation would be a predecessor of a publicly held corporation with respect to the second corporation if the intervening corporation or corporations were publicly held corporations, then paragraphs (c)(2)(ii)(G)(*1*) through (*3*) of this section also apply without regard to the intervening corporations.

(H) *Elections under sections 336(e) and 338.* For purposes of this paragraph (c)(2), if a corporation makes an election to treat as an asset purchase either the sale, exchange, or distribution of stock pursuant to regulations under section 336(e) (§§ 1.336–1 through 1.336–5) or the purchase of stock pursuant to regulations under section 338 (§§ 1.338–1 through 1.338–11, 1.338(h)(10)–1, and 1.338(i)–1), the corporation that issued the stock is treated as the same corporation both before and after such transaction.

(I) *Date of transaction.* For purposes of this paragraph (c)(2)(ii), the date that a transaction is treated as having occurred is the date on which all events necessary for the transaction to be described in the relevant provision in this paragraph (c)(2)(ii) have occurred.

(J) *Publicly traded partnership.* For purposes of applying this paragraph (c)(2)(ii), a publicly traded partnership is a predecessor of a publicly held corporation if under the same facts and circumstances a corporation substituted for the publicly traded partnership would be a predecessor of the publicly held corporation, and at the time of the transaction the publicly traded partnership is treated as a publicly held corporation as defined in paragraph (c)(1)(i) of this section. In making this determination, the rules in paragraphs (c)(2)(ii)(A) through (I) of this section apply by analogy to publicly traded partnerships.

(iii) *Disregarded entities.* If a publicly held corporation under paragraph (c)(1) of this section owns an entity that is disregarded as an entity separate from its owner under § 301.7701–2(c)(2)(i) of this chapter, then the covered employees of the publicly held corporation are determined pursuant to paragraphs (c)(2)(i) and (ii) of this section. The executive officers of the entity that is disregarded as an entity separate from its corporate owner under § 301.7701–2(c)(2)(i) of this chapter are neither covered employees of the entity nor of the publicly held corporation unless they meet the definition of covered employee in paragraphs (c)(2)(i) and (ii) of this section with respect to the publicly held corporation, in which case they are covered employees for its taxable year.

(iv) *Qualified subchapter S subsidiaries.* If a publicly held corporation under paragraph (c)(1) of this section owns an entity that is a QSub under section 1361(b)(3)(B), then the covered employees of the publicly held corporation are determined pursuant to paragraphs (c)(2)(i) and (ii) of this section. The executive officers of the QSub are neither covered employees of the QSub nor of the publicly held corporation unless they meet the definition of covered employee in paragraphs (c)(2)(i) and (ii) of this section with respect to the publicly held corporation, in which case they are covered employees for the taxable year of the publicly held corporation.

(v) *Qualified real estate investment trust subsidiaries.* If a publicly held corporation under paragraph (c)(1) of this section owns an entity that is a QRS under section 856(i)(2), then the covered employees of the publicly held corporation are determined pursuant to paragraphs (c)(2)(i) and (ii) of this section. The executive officers of the QRS are neither covered employees of the QRS nor of the publicly held corporation unless they meet the definition of covered employee in paragraphs (c)(2)(i) and (ii) of this section with respect to the publicly held corporation, in which case they are covered employees for the taxable year of the publicly held corporation.

(vi) *Covered employee of an affiliated group.* A person who is identified as a covered employee in paragraphs (c)(2)(i) through (v) of this section for a publicly held corporation's taxable year is also a covered employee for the taxable year of an affiliated group treated as a publicly held corporation pursuant to paragraph (c)(1)(ii) of this section (treatment of an affiliated group).

(vii) *Examples.* The following examples illustrate the provisions of this paragraph (c)(2). For each example, assume that the corporation has a taxable year that is a calendar year and has a fiscal year ending December 31 for reporting purposes under the Exchange Act. Also, for each example, unless provided otherwise, assume that none of the employees were covered employees for any taxable year preceding the first taxable year set forth in that example (since being a covered employee for a preceding taxable year would provide a separate, independent basis for classifying that employee as a covered employee for a subsequent taxable year).

(A) *Example 1 (Covered employees of members of an affiliated group)*—(*1*) *Facts.* Corporations A, B, and C are direct wholly-owned subsidiaries of Corporation D. Corporations D and A are each publicly held corporations as of December 31, 2020. Corporations B and C are not publicly held corporations for their 2020 taxable years. Employee E served as the PEO of Corporation D from January 1, 2020, to March 31, 2020. Employee F served as the PEO of Corporation D from April 1, 2020, to December 31, 2020. Employee G served as the PEO of Corporation A for its entire 2020 taxable year. Employee H served as the PEO of Corporation B for its entire 2020 taxable year. Employee I served as the PEO of Corporation C for its entire 2020 taxable year. From April 1, 2020, through September 30, 2020, Employee E served as an advisor (not as a PEO) to Employee I and received compensation from Corporation C for these services. In 2020, all four corporations paid compensation to their respective PEOs.

(*2*) *Conclusion (Employees E and F).* Because both Employees E and F served as the PEO of Corporation D during its 2020 taxable year, both Employees E and F are covered employees of Corporation D for its 2020 and subsequent taxable years.

(*3*) *Conclusion (Employee G).* Because Employee G served as the PEO of Corporation A, Employee G is a covered employee of Corporation A for its 2020 and subsequent taxable years.

(*4*) *Conclusion (Employee H).* Even though Employee H served as the PEO of Corporation B, Employee H is not a covered employee of Corporation B for its 2020 taxable year, because Corporation B is considered a publicly held corporation solely by reason of being a member of an affiliated group as defined in paragraph (c)(1)(ii) of this section.

(*5*) *Conclusion (Employee I).* Even though Employee I served as the PEO of Corporation C, Employee I is not a covered employee of Corporation C for its 2020 taxable year, because Corporation C is considered a publicly held corporation solely by reason of being a member of an affiliated group as defined in paragraph (c)(1)(ii) of this section.

(B) *Example 2 (Covered employees of a publicly held corporation)*—(*1*) *Facts.* Corporation J is a publicly held corporation. Corporation J is not a smaller reporting company or emerging growth company for purposes of reporting under the Exchange Act. For 2020, Employee K served as the sole PEO of Corporation J and Employees L and M both served as the PFO of Corporation J at separate times during the year. Employees N, O, and P were, respectively, the first, second, and third highest compensated executive officers of Corporation J for 2020 other than the PEO and PFO, and all three retired before December 31, 2020. Employees Q, R, and S were, respectively, Corporation J's fourth, fifth, and sixth highest compensated executive officers other than the PEO and PFO for 2020, and all three were serving as of December 31, 2020. On March 1, 2021, Corporation J filed its Form 10–K, Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934 with the SEC. With respect to Item 11, Executive Compensation (as required by Part III of Form 10–K, or its successor), Corporation J disclosed the compensation of Employee K for serving as the PEO, Employees L and M for serving as the PFO, and Employees Q, R, and S pursuant to 17 CFR 229.402(a)(3)(iii) (Item 402 of Regulation S–K). Corporation J also disclosed the compensation of Employees N and O pursuant to 17 CFR 229.402(a)(3)(iv) (Item 402 of Regulation S–K).

(*2*) *Conclusion (Employee K).* Because Employee K served as the PEO during 2020, Employee K is a covered employee for Corporation J's 2020 taxable year.

(*3*) *Conclusion (Employees L and M).* Because Employees L and M served as the PFO during 2020, Employees L and M are covered employees for Corporation J's 2020 taxable year.

(*4*) *Conclusion (Employees N, O, P, Q, R, and S).* Even though the executive compensation disclosure rules under the Exchange Act require Corporation J to disclose the compensation of Employees N, O, Q, R, and S for 2020, Corporation J's three highest compensated executive officers who are covered employees for its 2020 taxable year are Employees N, O, and P, because these are the three highest compensated executive officers other than the PEO and PFO for 2020.

(C) *Example 3 (Covered employees of a smaller reporting company)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(B) of this section (*Example 2*), except that Corporation J is a smaller reporting company or emerging growth company for purposes of reporting under the Exchange Act. With respect to Item 11, Executive Compensation, Corporation J disclosed the compensation of Employee K for serving as the PEO, Employees Q and R pursuant to 17 CFR 229.402(m)(2)(ii) (Item 402(m) of Regulation S–K), and Employees N and O pursuant to 17 CFR 229.402(m)(2)(iii) (Item 402(m) of Regulation S–K).

(*2*) *Conclusion.* The result is the same as in paragraph (c)(2)(vii)(L) of this section (*Example 2*). For purposes of identifying a corporation's covered employees, it is irrelevant whether the reporting obligation under the Exchange Act for smaller reporting companies and emerging growth companies apply to the corporation, and it is irrelevant whether the specific executive officers' compensation must be disclosed pursuant to the disclosure rules under the Exchange Act applicable to the corporation.

(D) *Example 4 (Covered employees of a publicly held corporation that is not required to file a Form 10–K)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(B) of this section (*Example 2*), except that on February 4, 2021, Corporation J files Form 15, Certification and Notice of Termination of Registration under Section 12(g) of the Securities Exchange Act of 1934 or Suspension of Duty to File Reports under Sections 13 and 15(d) of the Securities Exchange Act of 1934, (or its successor) to terminate the registration of its securities. Corporation J's duty to file reports under Section 13(a) of the Exchange Act is suspended upon the filing of the Form 15 and, as a result, Corporation J is not required to file a Form 10–K and disclose the compensation of its executive officers for 2020.

(*2*) *Conclusion.* The result is the same as in paragraph (c)(2)(vii)(B) of this section (*Example 2*). Covered employees include executive officers of a publicly held corporation even if the corporation is not required to disclose the compensation of its executive officers under the Exchange Act. Therefore, Employees K, L, M, N, O, and P are covered employees for 2020. The result would be different if Corporation J filed Form 15 to terminate the registration of its securities prior to December 31, 2020. In that case, Corporation J would not be a publicly held corporation for its 2020 taxable year, and, therefore, Employees K, L, M, N, O, and P would not be covered employees for Corporation J's 2020 taxable year.

(E) *Example 5 (Covered employees of two publicly held corporations after a corporate transaction)*—(*1*) *Facts.* Corporation T is a publicly held corporation for its 2019 taxable year. Corporation U is a privately held corporation for its 2019 and 2020 taxable years. On July 31, 2020, Corporation U acquires for cash 80% of the only class of outstanding stock of Corporation T. The affiliated group (comprised of Corporations U and T) elects to file a consolidated Federal income tax return. As a result of this election, Corporation T has a short taxable year ending on July 31, 2020. Corporation T does not change its fiscal year for reporting purposes under the Exchange Act to correspond to the short taxable year. Corporation T remains a publicly held corporation for its short taxable year ending on July 31, 2020, and its subsequent taxable year ending on December 31, 2020, for which it files a consolidated Federal income tax return with Corporation U.

For Corporation T's taxable year ending July 31, 2020, Employee V serves as the only PEO, and Employee W serves as the only PFO. Employees X, Y, and Z are the three most highly compensated executive officers of Corporation T for the taxable year ending July 31, 2020, other than the PEO and PFO. As a result of the acquisition, effective July 31, 2020, Employee V ceases to serve as the PEO of Corporation T. Instead, Employee AA starts serving as the PEO of Corporation T on August 1, 2020. Employee V continues to provide services for Corporation T but never serves as PEO again (or as an individual acting in such capacity). For Corporation T's taxable year ending December 31, 2020, Employee AA serves as the only PEO, and Employee W serves as the only PFO. Employees X, Y, and Z continue to serve as executive officers of Corporation T during the taxable year ending December 31, 2020. Employees BB, CC, and DD are the three most highly compensated executive officers of Corporation T, other than the PEO and PFO, for the taxable year ending December 31, 2020.

(*2*) *Conclusion (Employee V)*. Because Employee V served as the PEO during Corporation T's short taxable year ending July 31, 2020, Employee V is a covered employee for Corporation T's short taxable year ending July 31, 2020, even though Employee V's compensation is required to be disclosed pursuant to the executive compensation disclosure rules under the Exchange Act only for the fiscal year ending December 31, 2020. Because Employee V was a covered employee for Corporation T's short taxable year ending July 31, 2020, Employee V is also a covered employee for Corporation T's short taxable year ending December 31, 2020.

(*3*) *Conclusion (Employee W)*. Because Employee W served as the PFO during Corporation T's short taxable years ending July 31, 2020, and December 31, 2020, Employee W is a covered employee for both taxable years, even though Employee W's compensation is required to be disclosed pursuant to the executive compensation disclosure rules under the Exchange Act only for the fiscal year ending December 31, 2020. Because Employee W was a covered employee for Corporation T's short taxable year ending July 31, 2020, Employee W would be a covered employee for Corporation T's short taxable year ending December 31, 2020, even if Employee W did not serve as the PFO during this taxable year.

(*4*) *Conclusion (Employee AA)*. Because Employee AA served as the PEO during Corporation T's short taxable year ending December 31, 2020, Employee AA is a covered employee for that short taxable year.

(*5*) *Conclusion (Employees X, Y, and Z)*. Employees X, Y, and Z are covered employees for Corporation T's short taxable years ending July 31, 2020, and December 31, 2020. Employees X, Y, and Z are covered employees for Corporation T's short taxable year ending July 31, 2020, because those employees are the three highest compensated executive officers for that short taxable year. Because they were covered employees for Corporation T's short taxable year ending July 31, 2020, Employees X, Y, and Z are covered employees for Corporation T's short taxable year ending December 31, 2020 and would be covered employees for that later short taxable year even if their compensation would not be required to be disclosed pursuant to the executive compensation disclosure rules under the Exchange Act.

(*6*) *Conclusion (Employees BB, CC, and DD)*. Employees BB, CC, and DD are covered employees for Corporation T's short taxable year ending December 31, 2020, because those employees are the three highest compensated executive officers for that short taxable year.

(F) *Example 6 (Predecessor of a publicly held corporation)*—(*1*) *Facts*. Corporation EE is a publicly held corporation for its 2021 taxable year. Corporation EE is a privately held corporation for its 2022 and 2023 taxable years. For its 2024 taxable year, Corporation EE is a publicly held corporation.

(*2*) *Conclusion*. For its 2024 taxable year, Corporation EE is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(A) of this section because, after ceasing to be a publicly held corporation, it again became a publicly held corporation for a taxable year ending prior to April 15, 2025. Therefore, for Corporation EE's

2024 taxable year, the covered employees of Corporation EE include the covered employees of Corporation EE for its 2021 taxable year and any additional covered employees determined pursuant to this paragraph (c)(2).

(G) *Example 7 (Predecessor of a publicly held corporation)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(F) of this section (*Example 6*), except that Corporation EE remains a privately held corporation until it becomes a publicly held corporation for its 2027 taxable year.

(*2*) *Conclusion.* Corporation EE is not a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(A) of this section because it became a publicly held corporation for a taxable year ending after April 15, 2025. Therefore, any covered employee of Corporation EE for its 2021 taxable year is not a covered employee of Corporation EE for its 2027 taxable year due to that individual's status as a covered employee of Corporation EE for a preceding taxable year (beginning after December 31, 2016) but may be a covered employee due to that individual's status during the 2027 taxable year.

(H) *Example 8 (Predecessor of a publicly held corporation that is party to a merger)*—(*1*) *Facts.* On June 30, 2021, Corporation FF (a publicly held corporation) merged into Corporation GG (a publicly held corporation) in a transaction that qualifies as a reorganization under section 368(a)(1)(A), with Corporation GG as the surviving corporation. As a result of the merger, Corporation FF has a short taxable year ending June 30, 2021. Corporation FF is a publicly held corporation for this short taxable year. Corporation GG does not have a short taxable year and is a publicly held corporation for its 2021 taxable year.

(*2*) *Conclusion.* Corporation FF is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(B) of this section. Therefore, any covered employee of Corporation FF for its short taxable year ending June 30, 2021, is a covered employee of Corporation GG for its 2021 taxable year. For Corporation GG's 2021 and subsequent taxable years, the covered employees of Corporation GG include the covered employees of Corporation FF (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(I) *Example 9 (Predecessor of a publicly held corporation that is party to a merger)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(H) of this section (*Example 8*), except that, after the merger, Corporation GG is a privately held corporation for its 2021 taxable year.

(*2*) *Conclusion.* Because Corporation GG is a privately held corporation for its 2021 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(J) *Example 10 (Predecessor of a publicly held corporation that is party to a merger)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(I) of this section (*Example 9*), except that Corporation GG, becomes a publicly held corporation (as defined in paragraph (c)(1)(i) of this section) on June 30, 2023, and is a publicly held corporation for its 2023 taxable year.

(*2*) *Conclusion.* Because Corporation GG became a publicly held corporation for a taxable year ending prior to April 15, 2025, Corporation FF is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. For Corporation GG's 2023 and subsequent taxable years, the covered employees of Corporation GG include the covered employees of Corporation FF (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(K) *Example 11 (Predecessor of a publicly held corporation that is party to a merger)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(J) of this section (*Example 10*), except that Corporation FF is a privately held corporation for its taxable year ending June 30, 2021, but was a publicly held corporation for its 2020 taxable year.

(*2*) *Conclusion.* Even though Corporation FF was a privately held corporation when it merged with Corporation GG on June 30, 2021, Corporation FF will be a predecessor corporation if Corporation GG becomes a publicly held corporation within a taxable year ending prior to April 15, 2024. Because Corporation GG became a publicly held corporation for its taxable year ending December 31, 2023, Corporation FF is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. For Corporation GG's 2023 and subsequent taxable years, the covered employees of Corporation GG include the covered employees of Corporation FF (for a preceding taxable year beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(L) *Example 12 (Predecessor of a publicly held corporation that is party to a merger and subsequently becomes member of an affiliated group)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(J) of this section (*Example 10*), except that, on June 30, 2022, Corporation GG becomes a publicly held corporation by becoming a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section). Corporation II is the parent corporation of the group and is a publicly held corporation. Employee HH was a covered employee of Corporation FF for its taxable year ending June 30, 2021. On July 1, 2022, Employee HH becomes an employee of Corporation II.

(*2*) *Conclusion*. By becoming a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section) on June 30, 2022, Corporation GG became a publicly held corporation for a taxable year ending prior to April 15, 2025. Therefore, Corporation FF is a predecessor of a publicly held corporation (Corporation GG) within the meaning of paragraph (c)(2)(ii)(G) of this section. Furthermore, Corporation FF is also a predecessor of Corporation II, a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. For Corporation II's 2022 and subsequent taxable years, Employee HH is a covered employee of the affiliated group that includes Corporation II because Employee HH was a covered employee of Corporation FF for its taxable year ending June 30, 2021.

(M) *Example 13 (Predecessor of a publicly held corporation that is party to a merger and subsequently becomes member of an affiliated group)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(L) of this section (*Example 12*), except that Corporation FF was a privately held corporation for its taxable year ending June 30, 2021, and Employee HH was a covered employee of Corporation FF for its taxable year ending December 31, 2020.

(*2*) *Conclusion*. Even though Corporation FF was a privately held corporation when it merged with Corporation GG on June 30, 2021, Corporation FF will be a predecessor corporation if Corporation GG becomes a publicly held corporation for a taxable year ending prior to April 15, 2024. Because Corporation GG became a publicly held corporation for its 2022 taxable year by becoming a member of an affiliated group (as defined in paragraph (c)(1)(ii) of this section), Corporation FF is a predecessor of a publicly held corporation (Corporation GG) within the meaning of paragraph (c)(2)(ii)(G) of this section. Furthermore, Corporation FF is also a predecessor of Corporation II, a publicly held corporation within the meaning of paragraph (c)(2)(ii)(G) of this section. Therefore, any covered employee of Corporation FF for its 2020 taxable year is a covered employee of the affiliated group that includes Corporation II for its 2022 and subsequent taxable years. For Corporation II's 2022 taxable year, Employee HH is a covered employee of the affiliated group that includes Corporation II because Employee HH was a covered employee of Corporation FF for its 2020 taxable year.

(N) *Example 14 (Predecessor of a publicly held corporation that is a party to a merger)*—(*1*) *Facts*. Corporation JJ is a publicly held corporation for its 2019 taxable year and is incorporated in State KK. On June 1, 2019, Corporation JJ formed a wholly-owned subsidiary, Corporation LL. Corporation LL is a publicly held corporation incorporated in State MM. On June 30, 2021, Corporation JJ merged into Corporation LL under State MM law in a transaction that qualifies as a reorganization under section 368(a)(1)(A), with Corporation LL as the surviving corporation. As a result of the merger, Corporation JJ has a short taxable year ending June 30, 2021. Corporation JJ is a publicly held corporation for this short taxable year.

(*2*) *Conclusion.* Corporation JJ is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(B) of this section. For Corporation LL's taxable years ending after June 30, 2021, the covered employees of Corporation LL include the covered employees of Corporation JJ for its short taxable year ending June 30, 2021 (as well as preceding taxable years beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(O) *Example 15 (Predecessor of a publicly held corporation becomes member of an affiliated group)*—(*1*) *Facts.* On June 30, 2021, Corporation OO acquires for cash 100% of the only class of outstanding stock of Corporation NN. The affiliated group (comprised of Corporations NN and OO) elects to file a consolidated Federal income tax return. As a result of this election, Corporation NN has a short taxable year ending on June 30, 2021. Corporation NN is a publicly held corporation for its taxable year ending June 30, 2021, and a privately held corporation for subsequent taxable years. On June 30, 2022, Corporation OO completely liquidates Corporation NN. Corporation OO is a publicly held corporation for its 2021 and 2022 taxable years.

(*2*) *Conclusion.* After Corporation OO acquired Corporation NN, Corporations NN and OO comprise an affiliated group as defined in paragraph (c)(1)(ii) of this section. Thus, Corporation NN is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(D) of this section. For Corporation OO's taxable years ending after June 30, 2021, the covered employees of Corporation OO include the covered employees of Corporation NN for its short taxable year ending June 30, 2021 (as well as preceding taxable years beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(P) *Example 16 (Predecessor of a publicly held corporation becomes member of an affiliated group)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(O) of this section (*Example 15*), except that Corporation OO is a privately held corporation on June 30, 2021, and for its 2021 and 2022 taxable years.

(*2*) *Conclusion.* Because Corporation OO is a privately held corporation for its 2021 and 2022 taxable years, it is not subject to section 162(m)(1) for these taxable years.

(Q) *Example 17 (Predecessor of a publicly held corporation becomes member of an affiliated group)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(P) of this section (*Example 16*), except that, on October 1, 2022, the SEC declares effective Corporation OO's Securities Act registration statement in connection with its initial public offering, and Corporation OO is a publicly held corporation for its 2022 taxable year.

(*2*) *Conclusion (Taxable Year Ending December 31, 2021).* Because Corporation OO is a privately held corporation for its 2021 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(*3*) *Conclusion (Taxable Year Ending December 31, 2022).* For the 2022 taxable year, Corporations NN and OO comprise an affiliated group as defined in paragraph (c)(1)(ii) of this section. Corporation NN is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(D) and (G) of this section because Corporation OO became a publicly held corporation for a taxable year ending prior to April 15, 2025. For Corporation OO's 2022 and subsequent taxable years, the covered employees of Corporation OO include the covered employees of Corporation NN for its short taxable year ending June 30, 2021 (as well as preceding taxable years beginning after December 31, 2016) and any additional covered employees determined pursuant to this paragraph (c)(2).

(R) *Example 18 (Predecessor of a publicly held corporation and asset acquisition)*—(*1*) *Facts.* Corporations VV, WW, and XX are publicly held corporations for their 2020 and 2021 taxable years. Corporations VV and WW are members of an affiliated group. Corporation WW is a direct subsidiary of Corporation VV. On June 30, 2021, Corporation VV acquires for cash 40% of the gross operating assets (determined by fair market value as of January 31, 2022) of Corporation XX. On January 31, 2022, Corporation WW acquires an additional 40% of the gross operating assets (determined by fair market value as of January 31, 2022) of Corporation XX. Employees EB, EC, and EA are covered employees for Corporation XX's 2020 taxable year. Employees ED and EF are also covered employees for Corporation XX's 2021 taxable year. On January 15, 2021, Employee EA started performing services as an employee of Corporation WW. On July 1, 2021, Employee EB started performing services as an employee of Corporation WW. On February 1, 2022, Employees EC and ED started performing services as employees of Corporation WW. On June 30, 2023, Employee EF started performing services as an employee of Corporation WW.

(*2*) *Conclusion*. Because an affiliated group, comprised of Corporations VV and WW, acquired 80% of Corporation XX's gross operating assets (determined by fair market value) within a twelve-month period, Corporation XX is a predecessor of a publicly held corporation within the meaning of paragraph (c)(2)(ii)(E) of this section. Therefore, any covered employee of Corporation XX for its 2020 and 2021 taxable years (who started performing services as an employee of Corporation WW within the period beginning 12 months before and ending 12 months after the date of the January 31, 2022, acquisition (determined under paragraph (c)(2)(ii)(I) of this section) is a covered employee of Corporation WW for its 2021, 2022, and subsequent taxable years. For Corporation WW's 2021 and subsequent taxable years, the covered employees of Corporation WW include Employee EB and any additional covered employees determined pursuant to paragraph (c)(2)(i) of this section. For Corporation WW's 2022 and subsequent taxable years, the covered employees of Corporation WW include Employees EB, EC, and ED, and any additional covered employees determined pursuant to this paragraph (c)(2). Because Employee EA started performing services as an employee of Corporation WW before January 31, 2021, Employee EA is not a covered employee of Corporation WW for its 2021 taxable year and subsequent taxable years by reason of paragraph (c)(2)(ii)(E) of this section, but may be a covered employee of Corporation WW by application of other rules in this paragraph (c)(2). Because Employee EF started performing services as an employee of Corporation WW after January 31, 2023, Employee EF is not a covered employee of Corporation WW for its 2023 taxable year by reason of paragraph (c)(2)(ii)(E) of this section, but may be a covered employee of Corporation WW by application of other rules in this paragraph (c)(2).

(S) *Example 19 (Predecessor of a publicly held corporation and asset acquisition)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(R) of this section (*Example 18*), except that Corporations VV and WW are not publicly held corporations on June 30, 2021, or for their 2021 taxable years.

(*2*) *Conclusion*. Because Corporations VV and WW are not publicly held corporations for their 2021 taxable years, they are not subject to section 162(m)(1) for their 2021 taxable years.

(T) *Example 20 (Predecessor of a publicly held corporation and asset acquisition)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(R) of this section (*Example 18*), except that, on October 1, 2022, the SEC declares effective Corporation VV's Securities Act registration statement in connection with its initial public offering, and Corporation VV is a publicly held corporation for its 2022 taxable year.

(*2*) *Conclusion (2021 taxable year)*. Because Corporations VV and WW are not publicly held corporations for their 2021 taxable years, they are not subject to section 162(m)(1) for their 2021 taxable years.

(*3*) *Conclusion (2022 taxable year)*. Corporation XX is a predecessor of a publicly held corporation within the meaning of paragraphs (c)(2)(ii)(E) and (G) of this section because a member of the affiliated group comprised of Corporations VV and WW acquired 80% of Corporation XX's gross operating assets (determined by fair market value) within a twelve-month period ending on January 31, 2022, and the parent of the affiliated group, Corporation VV, subsequently became a publicly held corporation for a taxable year ending prior to April 15, 2024. Therefore, any covered employee of Corporation XX for its 2020 and 2021 taxable years (who started performing services as an employee of Corporation WW within the period beginning 12 months before and ending 12 months after the acquisition) is a covered employee of the affiliated group comprised of Corporations VV and WW for its 2022 and subsequent taxable years. For Corporation WW's 2022 and subsequent taxable years, the covered employees of Corporation WW include Employees EB, EC, and ED, and any additional covered employees determined pursuant to this paragraph (c)(2).

(U) *Example 21 (Predecessor of a publicly held corporation and a division)*—(*1*) *Facts*. Corporation CA is a publicly held corporation for its 2021 and 2022 taxable years. On March 2, 2021, Corporation DDD forms a wholly-owned subsidiary, Corporation CB, and transfers assets to it. On April 1, 2022, Corporation CA distributes all shares of Corporation CB to its shareholders in a transaction described in section 355(a)(1). On April 1, 2022, the SEC declares effective Corporation CB's Securities Act registration statement in connection with its initial public offering. Corporation CB is a publicly held corporation for its 2022 taxable year. Employee EG serves as the PFO of Corporation CA from January 1, 2022, to March 31, 2022. On April 2, 2022, Employee EG starts performing services as an employee of Corporation CB advising the PFO of Corporation CB. After March 31, 2022, Employee EG ceases to provide services for Corporation CA.

(*2*) *Conclusion*. Because the distribution of the stock of Corporation CB is a transaction described under section 355(a)(1), Corporation CA is a predecessor of Corporation CB within the meaning of paragraph (c)(2)(ii)(C) of this section. Because Employee EG was a covered employee of Corporation CA for its 2022 taxable year, Employee ED is a covered employee of Corporation CB for its 2022 taxable year. The result is the same whether Employee EG performs services as an advisor for Corporation CB as an employee or an independent contractor.

(V) *Example 22 (Predecessor of a publicly held corporation and a division)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(U) of this section (*Example 21*), except that Corporation CA distributes 100% of the shares of Corporation CB to Corporation CD in exchange for all of Corporation CD's stock in Corporation CA in a transaction described in section 355(a)(1) and Corporation CB does not register any class of securities with the SEC. Also, Employee EG performs services as an employee of Corporation CD instead of as an employee of Corporation CB. Corporation CD is a privately held corporation for its 2022 taxable year. On October 1, 2023, the SEC declares effective Corporation CD's Securities Act registration statement in connection with its initial public offering. Corporation CD is a publicly held corporation for its 2023 taxable year. On January 1, 2028, Employee EG starts performing services as an employee of Corporation CA. Corporation CA is a publicly held corporation for its 2028 taxable year.

(*2*) *Conclusion (2022 taxable year)*. Because Corporation CD is a privately held corporation for its 2022 taxable year, it is not subject to section 162(m)(1) for this taxable year.

(*3*) *Conclusion (2023 taxable year)*. Because the exchange of the stock of Corporation CB for the stock of Corporation CA is a transaction described in section 355(a)(1), Corporations CB and CD are an affiliated group, and Corporation CD became a publicly held corporation for a taxable year ending prior to April 15, 2026, Corporation CA is a predecessor of Corporation CD within the meaning of paragraphs (c)(2)(ii)(D) and (G) of this section. Employee EG was a covered employee of Corporation CA for its 2022 taxable year, and started performing services as an employee of Corporation CD following April 1, 2021, and before April 1, 2023. Therefore, Employee ED is a covered employee of Corporation CD for its 2023 taxable year.

(*4*) *Conclusion (2028 taxable year)*. Because Employee EG served as the PFO of Corporation CA from January 1, 2022, to March 31, 2022, Employee EG was a covered employee of Corporation CA for its 2022 taxable year. Because an individual who is a covered employee for a taxable year remains a covered employee for all subsequent taxable years (even after the individual has separated from service), Employee EG is a covered employee of Corporation CA for its 2028 taxable year.

(W) *Example 23 (Predecessor of a publicly held corporation and a division)*—(*1*) *Facts.* The facts are the same as in paragraph (c)(2)(vii)(V) of this section (*Example 22*), except that Employee EG starts performing services as an employee of Corporation CD on June 30, 2023, instead of on April 2, 2022, and never performs services for Corporation CA after June 30, 2023. Furthermore, on June 30, 2023, Employee EH, a covered employee of Corporation CB for all of its taxable years, starts performing services for Corporation EF as an independent contractor advising its PEO but not serving as a PEO.

(*2*) *Conclusion (2023 taxable year).* Because the exchange of the stock of Corporation CB for the stock of Corporation CA is a transaction described in section 355(a)(1) and Corporation CD became a publicly held corporation for a taxable year ending before April 15, 2026, Corporation CA is a predecessor of Corporation CD within the meaning of paragraphs (c)(2)(ii)(D) and (G) of this section. Even though Employee EG was a covered employee of Corporation CA for its 2022 taxable year, because Employee EG started performing services as an employee of Corporation CD after April 1, 2023, Employee EG is not a covered employee of Corporation CD for its 2023 taxable year under paragraph (c)(2)(ii)(C) of this section. However, Employee EG may be a covered employee of Corporation CD by application of other rules in this paragraph (c)(2). Because Employee EH was a covered employee of Corporation CB for its 2022 taxable year, Employee EH is a covered employee of Corporation CD for its 2023 taxable year.

(X) *Example 24 (Predecessor of a publicly held corporation and election under section 338(h)(10))*—(*1*) *Facts.* Corporation CE is the common parent of a group of corporations filing consolidated returns that includes Corporation CF as a member. Corporation CE wholly-owns Corporation CF, a publicly held corporation within the meaning of paragraph (c)(1)(i) of this section. On June 30, 2021, Corporation CG purchases Corporation CF from Corporation CE. Corporation CE and Corporation CG make a timely election under section 338(h)(10) with respect to the purchase of Corporation CF stock. For its taxable year ending December 31, 2021, Corporation CF continues to be a publicly held corporation within the meaning of paragraph (c)(1)(i) of this section.

(*2*) *Conclusion.* As provided in paragraph (c)(2)(ii)(H) of this section, Corporation CF is treated as the same corporation after the section 338(h)(10) transaction as before the transaction for purposes for purposes of this paragraph (c)(2). Any covered employee of Corporation CF for its short taxable year ending June 30, 2021, is a covered employee of Corporation CF for its short taxable year ending on December 31, 2021, and subsequent taxable years.

(Y) *Example 25 (Disregarded entity)*—(*1*) *Facts.* Corporation CH is a privately held corporation for its 2020 taxable year. Entity CI is a wholly-owned limited liability company and is disregarded as an entity separate from its owner, Corporation CH, under §301.7701–2(c)(2)(i) of this chapter. As of December 31, 2020, Entity CI is required to file reports under section 15(d) of the Exchange Act. For the 2020 taxable year, Employee EI is the PEO and Employee EJ is the PFO of Corporation CH. Employees EK, EL, and EM, are the three most highly compensated executive officers of Corporation CH (other than Employees EI and EJ). Employee EN is the PFO of Entity CI and does not perform any policy making functions for Corporation CH. Entity CI has no other executive officers.

(*2*) *Conclusion.* Because Entity CI is disregarded as an entity separate from its owner, Corporation CH, and is required to file reports under section 15(d) of the Exchange Act, Corporation CH is a publicly held corporation under paragraph (c)(1)(iii) of this section for its 2020 taxable year. Even though Employee EN is a PFO of Entity CI, Employee EN is not considered a PFO of Corporation CH under paragraph (c)(2)(iii) of this section. As PEO and PFO, Employees EI and EJ are covered employees of Corporation CH under paragraph (c)(2)(i) of this section. Additionally, as the three most highly compensated executive officers of Corporation CH (other than Employees EI and EJ), Employees EK, EL, and EM also are covered employees of Corporation CH under paragraph (c)(2)(i) of this section for Corporation CH's 2020 taxable year. The result would be the same if Entity CI was not required to file reports under section 15(d) of the Exchange Act and Corporation CH was a publicly held corporation pursuant to paragraph (c)(1)(i) instead of paragraph (c)(1)(iii) of this section.

(Z) *Example 26 (Disregarded entity)*—(*1*) *Facts*. The facts are the same as in paragraph (c)(2)(vii)(Y) of this section (*Example 25*), except that Employee EN performs a policy making function for Corporation CH. If Corporation CH were subject to the SEC executive compensation disclosure rules, then Employee EN would be treated as an executive officer of Corporation CH pursuant to 17 CFR 240.3b–7 for purposes of determining the three highest compensated executive officers for Corporation CH's 2020 taxable year. Employee EN is compensated more than Employee EK, but less than Employees EL and EM.

(*2*) *Conclusion*. Because Entity CI is disregarded as an entity separate from its owner, Corporation CH, and is required to file reports under section 15(d) of the Exchange Act, Corporation CH is a publicly held corporation under paragraph (c)(1)(iii) of this section for its 2020 taxable year. As PEO and PFO, Employees EI and EJ are covered employees of Corporation CH under paragraph (c)(2)(i) of this section. Employee EN is one of the three highest compensated executive officers for Corporation CH's taxable year. Because Employees EN, EL, and EM are the three most highly compensated executive officers of Corporation CH (other than Employees EI and EJ), they are covered employees of Corporation CH under paragraph (c)(2)(i) of this section for Corporation CH's 2020 taxable year. The result would be the same if Entity CI was not required to file reports under section 15(d) of the Exchange Act and Corporation CH was a publicly held corporation pursuant to paragraph (c)(1)(i) instead of paragraph (c)(1)(iii) of this section.

(AA) *Example 27 (Individual as covered employee of a publicly held corporation that includes the affiliated group)*—(*1*) *Facts*. Corporations CJ and CK are publicly held corporations for their 2020, 2021, and 2022 taxable years. Corporation CK is a direct subsidiary of Corporation CJ. Employee EO is an employee, but not a covered employee (as defined in paragraph (c)(2)(i) of this section), of Corporation CJ for its 2020, 2021, and 2022 taxable years. From April 1, 2020, to September 30, 2020, Employee EO serves as the PFO of Corporation CK. Employee EO does not perform any services for Corporation CK for its 2021 and 2022 taxable years, however, employee EO is a covered employee (as defined in paragraph (c)(2)(i) of this section) of Corporation CK for its 2020, 2021, and 2022 taxable years. For the 2020 taxable year, Employee EO receives compensation of $1,500,000 for services provided to Corporations CJ and CK. Employee EO receives $2,000,000 from Corporation CJ for performing services for Corporation CJ during each of its 2021 and 2022 taxable years. On June 30, 2022, Corporation CK pays $500,000 to Employee EO from a nonqualified deferred compensation plan that complies with section 409A.

(*2*) *Conclusion (2020 taxable year)*. Because Employee EO is a covered employee of Corporation CK and because the affiliated group (comprised of Corporations CJ and CK) is a publicly held corporation, Employee EO is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section. Compensation paid by Corporations CJ and CK is aggregated for purposes of section 162(m)(1) and, as a result, $500,000 of the aggregate compensation paid is nondeductible. The result would be the same if Corporation CJ was a privately held corporation for its 2020 taxable year.

(*3*) *Conclusion (2021 taxable year)*. Because Employee EO is a covered employee of Corporation CK pursuant to paragraph (c)(2)(i)(C) of this section and because the affiliated group (comprised of Corporations CJ and CK) is a publicly held corporation, Employee

EO is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section. Compensation paid by Corporations CJ and CK is aggregated for purposes of section 162(m)(1) and, as a result, $1,000,000 of the aggregate compensation paid is nondeductible. The result would be the same if Corporation CJ was a privately held corporation for its 2021 taxable year.

(*4*) *Conclusion (2022 taxable year).* Because Employee EO is a covered employee of Corporation CK pursuant to paragraph (c)(2)(i)(C) of this section and because the affiliated group (comprised of Corporations CJ and CK) is a publicly held corporation, Employee EO is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section. Compensation paid by Corporations CJ and CK is aggregated for purposes of section 162(m)(1) and, as a result, $1,500,000 of the aggregate compensation paid is nondeductible. The result would be the same if Corporation CJ was a privately held corporation for its 2022 taxable year.

(BB) *Example 28 (Individual as covered employee of a publicly held corporation that includes the affiliated group)*—(*1*) *Facts.* Corporation CL is a publicly held corporation for its 2020 through 2023 taxable years. Corporations CM and CN are direct subsidiaries of Corporation CL and are privately held corporations for their 2020 through 2022 taxable years. Employee EP serves as the PFO of Corporation CL from January 1, 2020 to December 31, 2020, when Employee EP terminates employment from Corporation CL. On January 1, 2021, Employee EP starts performing services as an employee of Corporation CM. In 2021, Employee EP receives compensation from Corporation CM in excess of $1,000,000. On April 1, 2022, Employee EP starts performing services as an employee of Corporation CN. On September 30, 2022, Employee EP terminates employment from Corporations CM and CN. In 2022, Employee EP receives compensation from Corporations CM and CN in excess of $1,000,000. For the 2021 and 2022 taxable years, Employee EP does not serve as either the PEO or PFO of Corporations CM and CN, and is not one of the three highest compensated executive officers (other than the PEO or PFO) of Corporations CM and CN. On April 1, 2023, Corporation CL distributes all the shares of Corporation CM to its shareholders in a transaction described in section 355(a)(1). On April 1, 2023, the SEC declares effective Corporation CM's Securities Act registration statement in connection with its initial public offering. Corporation CM is a publicly held corporation for its 2023 taxable year. On April 2, 2023, Employee EP starts performing services as an employee of Corporation CM but is not an executive officer of Corporation CM.

(*2*) *Conclusion (2021 taxable year).* Employee EP is a covered employee of Corporation CL for the 2020 and subsequent taxable years. Because Employee EP is a covered employee of Corporation CL and because the affiliated group (comprised of Corporations CL, CM, and CN) is a publicly held corporation, Employee EP is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section for the 2020 and subsequent taxable years. Therefore, Corporation CM's deduction for compensation paid to Employee EP for the 2021 taxable year is subject to section 162(m)(1). The result would be the same if Corporation CM was a publicly held corporation as defined in paragraph (c)(1)(i) of this section.

(*3*) *Conclusion (2022 taxable year).* Because Employee EP is a covered employee of Corporation CL and because the affiliated group (comprised of Corporations CL, CM, and CN) is a publicly held corporation, Employee EP is a covered employee of the publicly held corporation that is the affiliated group pursuant to paragraph (c)(2)(vi) of this section. Therefore, Corporation CM's and CN's deduction for compensation paid to Employee EP for the 2022 taxable year is subject to section 162(m)(1). Because the compensation paid by all affiliated group members is aggregated for purposes of section 162(m)(1), $1,000,000 of the aggregate compensation paid is nondeductible. Corporations CM and CN are each treated as paying a ratable portion of the nondeductible compensation. The result would be the same if either Corporation CM or CN (or both) was a publicly held corporation as defined in paragraph (c)(1)(i) of this section.

(*4*) *Conclusion (2023 taxable year).* Because the distribution of the stock of Corporation CM is a transaction described in section 355(a)(1), Corporation CL is a predecessor of Corporation CM within the meaning of paragraph (c)(2)(ii)(C) of this section. However, because Employee EP started performing services as an employee of Corporation CM on January 1, 2021, and the distribution of stock of Corporation CM did not occur until April 1, 2023, Employee EP is not a covered employee of Corporation CM for its 2023 taxable year.

(3) *Compensation*—(i) *In general.* For purposes of the deduction limitation described in paragraph (b) of this section, compensation means the aggregate amount allowable as a deduction to the publicly held corporation under chapter 1 of the Internal Revenue Code for the taxable year (determined without regard to section 162(m)(1)) for remuneration for services performed by a covered employee in any capacity, whether or not the services were performed during the taxable year. Compensation includes an amount that is includible in the income of, or paid to, a person other than the covered employee (including a beneficiary after the death of the covered employee) for services performed by the covered employee.

(ii) *Compensation paid by a partnership.* For purposes of paragraph (c)(3)(i) of this section, compensation includes an amount equal to a publicly held corporation's distributive share of a partnership's deduction for compensation expense attributable to the remuneration paid by the partnership to a covered employee of the publicly held corporation for services performed by the covered employee, including a payment for services under section 707(a) or under section 707(c).

(iii) *Exceptions.* Compensation does not include—

(A) Remuneration covered in section 3121(a)(5)(A) through (D) (concerning remuneration that is not treated as wages for purposes of the Federal Insurance Contributions Act);

(B) Remuneration consisting of any benefit provided to or on behalf of an employee if, at the time the benefit is provided, it is reasonable to believe that the employee will be able to exclude it from gross income; or

(C) Salary reduction contributions described in section 3121(v)(1).

(iv) *Examples.* The following examples illustrate the provisions of this paragraph (c)(3). For each example, assume that the corporation is a calendar year taxpayer.

(A) *Example 1*—(*1*) *Facts.* Corporation Z is a publicly held corporation for its 2020 taxable year, during which Employee A serves as the PEO of Corporation Z and also serves on the board of directors of Corporation Z. In 2020, Corporation Z paid $1,200,000 to Employee A plus a $50,000 fee for serving as a director of Corporation Z. These amounts are otherwise deductible for Corporation Z's 2020 taxable year.

(*2*) *Conclusion.* The $1,200,000 paid to Employee A in 2020 plus the $50,000 director's fee paid to Employee A in 2020 are compensation within the meaning of this paragraph (c)(3). Therefore, Corporation Z's $1,250,000 deduction for the 2020 taxable year is subject to the section 162(m)(1) limit.

(B) *Example 2*—(*1*) *Facts.* Corporation X is a publicly held corporation for its 2020 and all subsequent taxable years. Employee B serves as the PEO of Corporation X for its 2020 taxable year and is a participant in the Corporation X nonqualified retirement plan that meets the requirements of section 409A. The plan provides for the distribution of benefits over a three-year period beginning after a participant separates from service. Employee B terminates employment in 2021. In 2022, Employee B receives a $75,000 fee for services as a director and $1,500,000 as the first payment under the retirement plan. Employee B continues to serve on the board of directors until 2023 when Employee B dies before receiving the retirement benefit for 2023 and before becoming entitled to any director's fees for 2023. In 2023 and 2024, Corporation X pays the $1,500,000 annual retirement benefits to Person C, a beneficiary of Employee B.

(*2*) *Conclusion (2022 Taxable Year).* In 2022, Corporation X paid Employee B

$1,575,000, including $1,500,000 under the retirement plan and $75,000 in director's fees. The retirement benefit and the director's fees are compensation within the meaning of this paragraph (c)(3). Therefore, Corporation X's $1,575,000 deduction for the 2022 taxable year is subject to the section 162(m)(1) limit.

(*3*) *Conclusion (2023 and 2024 Taxable Years).* In 2023 and 2024, Corporation X made payments to Person C of $1,500,000 under the retirement plan. The retirement benefits are compensation within the meaning of this paragraph (c)(3). Therefore, Corporation X's deduction for each annual payment of $1,500,000 for the 2023 and 2024 taxable years is subject to the section 162(m)(1) limit.

(C) *Example 3*—(*1*) *Facts*. Corporation T is a publicly held corporation for its 2021 taxable year. Corporation S is a privately held corporation for its 2021 taxable year. On January 2, 2021, Corporations S and T form a general partnership. Under the partnership agreement, Corporations S and T each have a 50% distributive share of the partnership's income, gain, loss, and deductions. For the taxable year ending December 31, 2021, Employee D, a covered employee of Corporation T, performs services for the partnership, and the partnership pays $800,000 to Employee D for these services, the deduction of $400,000 of which is allocated to Corporation T. Corporation T's $400,000 distributive share of the partnership's deduction is reported separately to Corporation T pursuant to §1.702–1(a)(8)(iii).

(*2*) *Conclusion*. Because Corporation T's $400,000 distributive share of the partnership's deduction is attributable to the compensation paid by the partnership for services performed by Employee D, a covered employee of Corporation T, the $400,000 is compensation within the meaning of this paragraph (c)(3) and Corporation T's deduction for this expense for its 2021 taxable year is subject to the section 162(m)(1) limit. Corporation T's $400,000 allocation of the partnership's deduction is aggregated with Corporation T's deduction for compensation paid to Employee D, if any, in determining the amount allowable as a deduction to Corporation T for compensation paid to Employee D for Corporation T's 2021 taxable year. The result is the same whether Employee D performs services for the partnership as a common law employee, an independent contractor, or a partner, and whether the payment to Employee D is a payment under section 707(a) or section 707(c).

(4) *Securities Act*. The Securities Act means the Securities Act of 1933.

(5) *Exchange Act*. The Exchange Act means the Securities Exchange Act of 1934.

(6) *SEC*. The SEC means the United States Securities and Exchange Commission.

(7) *Foreign Private Issuer*. A foreign private issuer means an issuer as defined in 17 CFR 240.3b–4(c).

(8) *American Depositary Receipt (ADR)*. An American Depositary Receipt or ADR means a negotiable certificate that evidences ownership of a specified number (or fraction) of a foreign private issuer's securities held by a depositary (typically, a U.S. bank).

(9) *Privately held corporation*. A privately held corporation is a corporation that is not a publicly held corporation as defined in paragraph (c)(1) of this section (without regard to paragraph (c)(1)(ii) of this section).

(d) *Corporations that become publicly held*—(1) *In general*. In the case of a corporation that was a privately held corporation and then becomes a publicly held corporation, the deduction limitation of paragraph (b) of this section applies to any compensation that is otherwise deductible for the taxable year ending on or after the date that the corporation becomes a publicly held corporation. A corporation is considered to become publicly held on the date that its registration statement becomes effective either under the Securities Act or the Exchange Act. The rules in this section apply to a partnership that becomes a publicly traded partnership that is a publicly held corporation within the meaning of paragraph (c)(1)(i) of this section.

(2) *Example*. The following example illustrates the provision of this paragraph (d).

(i) *Facts*. In 2021, Corporation E plans to issue debt securities in a public offering registered under the Securities

Act. Corporation E is not required to file reports under section 15(d) of the Exchange Act with respect to any other class of securities and does not have another class of securities required to be registered under section 12 of the Exchange Act. On December 18, 2021, the SEC declares effective the Securities Act registration statement for Corporation E's debt securities.

(ii) *Conclusion.* Corporation E becomes a publicly held corporation on December 18, 2021 because it is then required to file reports under section 15(d) of the Exchange Act. The deduction limitation of paragraph (b) of this section applies to any compensation that is otherwise deductible for Corporation E's taxable year ending on or after December 18, 2021.

(e) *Coordination with disallowed excess parachute payments under section 280G.* The $1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) that would have been included in the compensation of the covered employee for the taxable year but for being disallowed by reason of section 280G. For example, assume that during a taxable year a corporation pays $1,500,000 to a covered employee, of which $600,000 is an excess parachute payment, as defined in section 280G(b)(1), and a deduction for that excess parachute payment is disallowed by reason of section 280G(a). Because the $1,000,000 limitation in paragraph (b) of this section is reduced by the amount of the excess parachute payment, the corporation may deduct $400,000 ($1,000,000 − $600,000), and $500,000 of the otherwise deductible amount is nondeductible by reason of section 162(m)(1). Thus $1,100,000 (of the total $1,500,000 payment) is non-deductible, reflecting the disallowance related to the excess parachute payment under section 280G and the application of section 162(m)(1).

(f) *Coordination with excise tax on specified stock compensation.* The $1,000,000 limitation in paragraph (b) of this section is reduced (but not below zero) by the amount (if any) of any payment (with respect to such employee) of the tax imposed by section 4985 directly or indirectly by the expatriated corporation (as defined in section 4985(e)(2)) or by any member of the expanded affiliated group (as defined in section 4985(e)(4)) that includes such corporation.

(g) *Transition rules*—(1) *Amount of compensation payable under a written binding contract that was in effect on November 2, 2017*—(i) *General rule.* This section does not apply to the deduction for compensation payable under a written binding contract that was in effect on November 2, 2017, and that is not modified in any material respect on or after that date (a grandfathered amount). Instead, section 162(m), as in effect prior to its amendment by Public Law 115–97, applies to limit the deduction for that compensation. Because §1.162–27 implemented section 162(m) as in effect prior to its amendment by Public Law 115–97, the rules of §1.162–27 determine the applicability of the deduction limitation under section 162(m) with respect to the payment of a grandfathered amount (including the potential application of the separate grandfathering rules contained in §1.162–27(h)). Compensation is a grandfathered amount only to the extent that as of November 2, 2017, the corporation was and remains obligated under applicable law (for example, state contract law) to pay the compensation under the contract if the employee performs services or satisfies the applicable vesting conditions. This section applies to the deduction for any amount of compensation that exceeds the grandfathered amount. If a grandfathered amount and non-grandfathered amount are otherwise deductible for the same taxable year and, under the rules of §1.162–27, the deduction of some or all of the grandfathered amount may be limited (for example, the grandfathered amount does not satisfy the requirements of §1.162–27(e)(2) through (5) as qualified performance-based compensation), then the grandfathered amount is aggregated with the non-grandfathered amount to determine the deduction disallowance for the taxable year under section 162(m)(1) (so that the deduction limit applies to the excess of the aggregated amount over $1 million).

(ii) *Contracts that are terminable or cancelable.* If a written binding contract is renewed after November 2, 2017, this section (and not § 1.162–27) applies to any payments made after the renewal. A written binding contract that is terminable or cancelable by the corporation without the employee's consent after November 2, 2017, is treated as renewed as of the earliest date that any such termination or cancellation, if made, would be effective. Thus, for example, if the terms of a contract provide that it will be automatically renewed or extended as of a certain date unless either the corporation or the employee provides notice of termination of the contract at least 30 days before that date, the contract is treated as renewed as of the date that termination would be effective if that notice were given. Similarly, for example, if the terms of a contract provide that the contract will be terminated or canceled as of a certain date unless either the corporation or the employee elects to renew within 30 days of that date, the contract is treated as renewed by the corporation as of that date (unless the contract is renewed before that date, in which case, it is treated as renewed on the earlier date). Alternatively, if the corporation will remain legally obligated by the terms of a contract beyond a certain date at the sole discretion of the employee, the contract will not be treated as renewed as of that date if the employee exercises the discretion to keep the corporation bound to the contract. A contract is not treated as terminable or cancelable if it can be terminated or canceled only by terminating the employment relationship of the employee. A contract is not treated as renewed if upon termination or cancellation of the contract the employment relationship continues but would no longer be covered by the contract. However, if the employment continues after the termination or cancellation, payments with respect to the post-termination or post-cancellation employment are not made pursuant to the contract (and, therefore, are not grandfathered amounts).

(iii) *Compensation payable under a plan or arrangement.* If a compensation plan or arrangement is a written binding contract in effect on November 2, 2017, the deduction for the amount that the corporation is obligated to pay to an employee pursuant to the plan or arrangement is not subject to this section solely because the employee was not eligible to participate in the plan or arrangement as of November 2, 2017, provided the employee was employed on November 2, 2017, by the corporation that maintained the plan or arrangement, or the employee had the right to participate in the plan or arrangement under a written binding contract as of that date.

(iv) *Compensation subject to recovery by corporation.* If the corporation is obligated or has discretion to recover compensation paid in a taxable year only upon the future occurrence of a condition that is objectively outside of the corporation's control, then the corporation's right to recovery is disregarded for purposes of determining the grandfathered amount for the taxable year. Whether or not the corporation exercises its discretion to recover any compensation does not affect the amount of compensation that the corporation remains obligated to pay under applicable law.

(v) *Compensation payable from an account balance plan*—(A) *In general.* Except as otherwise provided in this paragraph (g), the grandfathered amount of payments from an account balance plan (as defined in § 1.409A–1(c)(2)(i)(A)) that is a written binding contract in effect as of November 2, 2017, is the amount that the corporation is obligated to pay pursuant to the terms of the account balance plan in effect as of that date, as determined under applicable law. If under the terms of the plan, the corporation is obligated to pay the employee the account balance that is credited with earnings and losses and has no right to terminate or materially amend the plan, then the grandfathered amount would be the account balance as of November 2, 2017, plus any additional contributions and earnings and losses that the corporation is obligated to credit to the account balance in accordance with the terms of the plan as of November 2, 2017, through the date of payment.

(B) *Account balance plan providing right to terminate.* If under the terms of the account balance plan in effect as of November 2, 2017, the corporation may terminate the contract and distribute the account balance to the employee, then the grandfathered amount would be the account balance determined as if the corporation had terminated the plan on November 2, 2017 or, if later, the earliest possible date the plan could be terminated in accordance with the terms of the plan (termination date). Whether additional contributions and earnings and losses credited to the account balance after the termination date, through the earliest possible date the account balance could have been distributed to the employee in accordance with the terms of the plan, are grandfathered depends on whether the terms of the plan require the corporation to make those contributions or credit those earnings and losses through that distribution date. Notwithstanding the foregoing, the corporation may treat the account balance as of the termination date as the grandfathered amount regardless of when the amount is paid and regardless of whether it has been credited with additional contributions or earnings or losses prior to payment.

(C) *Account balance plan providing right to discontinue future contributions.* If under the terms of the account balance plan in effect as of November 2, 2017, the corporation has no right to terminate the plan, but may discontinue future contributions and distribute the account balance in accordance with the terms of the plan, then the grandfathered amount would be the account balance determined as if the corporation had exercised the right to discontinue contributions on November 2, 2017, or, if later, the earliest permissible date the corporation could exercise that right in accordance with the terms of the plan (the freeze date). If, after the freeze date, the plan requires the crediting of earnings and losses on the account balance through the payment date, then the earnings and losses credited to the grandfathered account balance would also be grandfathered. Notwithstanding the foregoing, the corporation may treat the account balance as of the freeze date as the grandfathered amount regardless of when the amount is paid and regardless of whether it has been credited with earnings or losses prior to payment.

(vi) *Compensation payable from a nonaccount balance plan*—(A) *In general.* Except as otherwise provided in this paragraph (g), the grandfathered amount of payments from a nonaccount balance plan (as defined in §1.409A–1(c)(2)(i)(C)) that is a written binding contract in effect as of November 2, 2017, is the amount that the corporation is obligated to pay pursuant to the terms of the nonaccount balance plan in effect as of that date, as determined under applicable law. If under the terms of the plan, the corporation is obligated to pay the employee the benefit under the plan and has no right to terminate or materially amend the plan, then the grandfathered amount would be the benefit under the plan as of November 2, 2017, plus any additional accrued benefits that the corporation is obligated to pay in accordance with the terms of the plan as of November 2, 2017, through the date of payment.

(B) *Nonaccount balance plan providing right to terminate.* If under the terms of the nonaccount balance plan in effect as of November 2, 2017, the corporation may terminate the plan and distribute the total benefit to the employee, then the grandfathered amount would be the present value of the total benefit (lump sum value) determined as if the corporation had terminated the plan on November 2, 2017 or, if later, the earliest possible date the plan could be terminated in accordance with the terms of the plan (termination date). Whether an increase or decrease in the lump sum value after the termination date, through the earliest possible date the lump sum value could have been distributed to the employee, is grandfathered depends on whether the terms of the plan require the corporation to increase or decrease the lump sum value through the distribution date. For example, if the plan did not require the corporation to make further service or compensation credits, then any increase in the lump sum value for these credits after the termination date is not grandfathered. Notwithstanding the foregoing, the corporation may treat the lump sum value as of the termination date as the grandfathered amount regardless of when the amount is paid and regardless of whether it has increased or decreased prior to payment. For purposes of this paragraph (g)(1)(vi)(B), the lump sum value is determined based on the actuarial methods and assumptions provided in the plan in effect on November 2, 2017, if the assumptions are reasonable, or any reasonable actuarial assumptions if the plan does not provide for applicable actuarial methods and assumptions or the terms of the plan were not reasonable. The determination of the lump sum value may not take into account the likelihood that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. If the benefit provided under the plan in effect on November 2, 2017, is paid as a life annuity or other form of benefit that is not a single lump sum payment, the application of the grandfathered amount to the payments of the benefit is determined in accordance with the ordering rule of paragraph (g)(1)(viii) of this section.

(C) *Nonaccount balance plan providing right to discontinue future accrual of benefits.* If under the terms of the nonaccount balance plan in effect as of November 2, 2017, the corporation has no right to terminate the plan, but may discontinue future accruals of benefits and distribute the benefit in accordance with the terms of the plan, then the grandfathered amount would be the lump sum value of the total benefit (lump sum value) determined as if the corporation had exercised the right to discontinue the future accrual of benefits on November 2, 2017, or, if later, the earliest permissible date the corporation could exercise such right in accordance with the terms of the plan (the freeze date). If, after the freeze date, the plan required the corporation to increase or decrease the lump sum value through the payment date, then any increase to the grandfathered lump sum would also be grandfathered. Notwithstanding the foregoing, the corporation may treat the lump sum value determined as of the freeze date as the grandfathered amount regardless of when the amount is paid and regardless of whether it has been increased or decreased prior to payment. For purposes of this paragraph (g)(1)(vi)(C), the lump sum value is determined based on the actuarial methods and assumptions provided in the plan in effect on November 2, 2017, if the assumptions are reasonable, or any reasonable actuarial assumptions if the plan does not provide for applicable actuarial methods and assumptions or the terms of the plan were not reasonable. The determination of the lump sum value may not take into account the likelihood that payments will not be made (or will be reduced) because of the unfunded status of the plan, the risk that the employer, the trustee, or another party will be unwilling or unable to pay, the possibility of future plan amendments, the possibility of a future change in the law, or similar risks or contingencies. If the benefit paid under the plan in effect on November 2, 2017, is paid as a life annuity or other form of benefit that is not a single lump sum payment, the application of the grandfathered amount to the payments of the benefit is determined in accordance with the ordering rule of paragraph (g)(1)(viii) of this section.

(vii) *Grandfathered amount limited to a particular plan or arrangement.* The grandfathered amount under a plan or arrangement applies solely to the amounts paid under that plan or arrangement, so that regardless of whether all of the grandfathered amount is paid to the participant (for example, regardless of whether some or all of the grandfathered amount under the plan is forfeited under the terms of the plan), no portion of that grandfathered amount may be treated as a grandfathered amount under any other separate plan or arrangement in which the employee is a participant.

(viii) *Ordering rule.* If a portion of the amount payable under a plan or arrangement is a grandfathered amount and a portion is subject to this section, and payment under the plan or arrangement is made in a series of payments (including payments as a life annuity), the grandfathered amount is allocated to the first payment of an amount under the plan or arrangement that is otherwise deductible. If the grandfathered amount exceeds the initial payment, the excess is allocated to the next payment of an amount under the plan or arrangement that is otherwise deductible, and this process is repeated until the entire grandfathered amount has been paid. Notwithstanding the foregoing, for amounts otherwise deductible for taxable years ending before December 20, 2019, the grandfathered amount may be allocated to each payment on a pro rata basis or to the last otherwise deductible payment. If one of these two methods was used for taxable years ending before December 20, 2019, then, for taxable years ending on or after December 20, 2019, the method must be changed to allocate any remaining grandfathered amount to the first payment for the remaining payments (treating as the first payment the first otherwise deductible amount for taxable years ending on or after December 20, 2019).

(2) *Material modifications*. (i) If a written binding contract is modified on or after November 2, 2017, this section (and not §1.162–27) applies to any payments made after the modification. A material modification occurs when the contract is amended to increase the amount of compensation payable to the employee. If a written binding contract is materially modified, it is treated as a new contract entered into as of the date of the material modification. Thus, amounts received by an employee under the contract before a material modification are not affected, but amounts received subsequent to the material modification are treated as paid pursuant to a new contract, rather than as paid pursuant to a written binding contract in effect on November 2, 2017.

(ii) A modification of the contract that accelerates the payment of compensation is a material modification unless the amount of compensation paid is discounted to reasonably reflect the time value of money. If the contract is modified to defer the payment of compensation, any compensation paid or to be paid that is in excess of the amount that was originally payable to the employee under the contract will not be treated as resulting in a material modification if the additional amount is based on applying to the amount originally payable either a reasonable rate of interest or the rate of return on a predetermined actual investment as defined in §31.3121(v)(2)–1(d)(2)(i)(B) of this chapter (whether or not assets associated with the amount originally owed are actually invested therein) such that the amount payable by the employer at the later date will be based on the reasonable rate of interest or the actual rate of return on the predetermined actual investment (including any decrease, as well as any increase, in the value of the investment). For an arrangement under which the grandfathered amounts are subject to increase or decrease based on the performance of a predetermined actual investment, the addition or substitution of a predetermined actual investment or reasonable interest rate as an investment alternative for amounts deferred is not treated as a material modification. However, a modification of a contract to defer payment of a grandfathered amount that results in payment of additional amounts (such as additional earnings) does not necessarily mean that the additional amounts are grandfathered amounts; for rules concerning the determination of grandfathered amounts see paragraph (g) of this section. Notwithstanding the foregoing, if compensation attributable to an option to purchase stock (other than an incentive stock option described in section 422 or a stock option granted under an employee stock purchase plan described in section 423) or a stock appreciation right is grandfathered, an extension of the exercise period that is extended in compliance with §1.409A–1(b)(5)(v)(C)(*1*) will not be treated as a material modification and the amount of compensation paid upon the exercise of the stock option or stock appreciation right will be grandfathered.

(iii) The adoption of a supplemental contract or agreement that provides for increased compensation, or the payment of additional compensation, is a material modification of a written binding contract if the facts and circumstances demonstrate that the additional compensation to be paid is based on substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract. However, a material modification of a written binding contract does not include a supplemental payment that is equal to or less than a reasonable cost-of-living increase over the payment made in the preceding year under that written binding contract. In addition, the failure, in whole or in part, to exercise negative discretion under a contract does not result in the material modification of that contract (although the existence of the negative discretion under the contract may impact the initial determination of whether amounts under the contract are grandfathered amounts).

(iv) If a grandfathered amount is subject to a substantial risk of forfeiture (as defined in §1.409A–1(d)), then a modification of the contract that results in a lapse of the substantial risk of forfeiture is not considered a material modification. Furthermore, for compensation received pursuant to the substantial vesting of restricted property, or the exercise of a stock option or stock appreciation right that does not provide for a deferral of compensation (as defined in §1.409A–1(b)(5)(i) and (ii)), a modification of a written binding contract in effect on November 2, 2017, that results in a lapse of the substantial risk of forfeiture (as defined §1.83–3(c)) is not considered a material modification.

(3) *Examples.* The following examples illustrate the provisions of this paragraph (g). For each example, assume for all relevant years that the corporation is a publicly held corporation within the meaning of paragraph (c)(1) of this section and is a calendar year taxpayer, and is not a ''smaller reporting company'' or ''emerging growth company'' for purposes of reporting under the Exchange Act. Furthermore, assume that, for each example, if any arrangement is subject to section 409A, then the arrangement complies with section 409A, and that no arrangement is subject to section 457A.

(i) *Example 1 (Multi-year agreement for annual salary)*—(A) *Facts.* On October 2, 2017, Corporation X executed a three-year employment agreement with Employee A for an annual salary of $2,000,000 beginning on January 1, 2018. Employee A serves as the PFO of Corporation X for the 2017 through 2020 taxable years. The agreement provides for automatic extensions after the three-year term for additional one-year periods, unless the corporation exercises its option to terminate the agreement within 30 days before the end of the three-year term or, thereafter, within 30 days before each anniversary date. Termination of the employment agreement does not require the termination of Employee A's employment with Corporation X. Under applicable law, the agreement for annual salary constitutes a written binding contract in effect on November 2, 2017, to pay $2,000,000 of annual salary to Employee A for three years through December 31, 2020.

(B) *Conclusion.* If this section applies, Employee A is a covered employee for Corporation X's 2018 through 2020 taxable years. Because the October 2, 2017, employment agreement is a written binding contract to pay Employee A an annual salary of $2,000,000, this section does not apply (and §1.162–27 does apply) to the deduction for Employee A's annual salary. Pursuant to §1.162–27(c)(2), Employee A is not a covered employee for Corporation X's 2018 through 2020 taxable years. The deduction for Employee A's annual salary for the 2018 through 2020 taxable years is not subject to section 162(m)(1). However, the employment agreement is treated as renewed on January 1, 2021, unless it is previously terminated, and the deduction limit of this §1.162–33 (and not §1.162–27) will apply to the deduction for any payments made under the employment agreement on or after that date.

(ii) *Example 2 (Agreement for severance based on annual salary and discretionary bonus)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(i) of this section (*Example 1*), except that the employment agreement also requires Corporation X to pay Employee A severance if Corporation X terminates the employment relationship without cause during the term of the agreement. The amount of severance is equal to the sum of two times Employee A's annual salary plus two times Employee A's discretionary bonus (if any) paid within 24 months preceding termination. Under applicable law, the agreement for severance constitutes a written binding contract in effect on November 2, 2017, to pay $4,000,000 (two times Employee A's $2,000,000 annual salary) if Corporation X terminates Employee A's employment without cause during the term of the agreement.

(B) *Conclusion.* If this section applies, Employee A is a covered employee for Corporation X's 2018 through 2020 taxable years. Because the October 2, 2017, employment agreement is a written binding contract to pay Employee A $4,000,000 if Employee A is terminated without cause prior to December 31, 2020, this section does not apply (and §1.162–27 does apply) to the deduction for $4,000,000 of Employee A's severance. Pursuant to §1.162–27(c)(2), Employee A is not a covered employee for Corporation X's 2018 through 2020 taxable years. The deduction for $4,000,000 of Employee A's severance is not subject to section 162(m)(1). However, the employment agreement is treated as renewed on January 1, 2021, unless it is previously terminated, and this §1.162–33 (and not §1.162–27) will apply to the deduction for any payments made under the employment agreement, including for severance, on or after that date.

(iii) *Example 3 (Effect of discretionary bonus payment on agreement for severance based on annual salary and discretionary bonus)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(ii) of this section (*Example 2*), except that, on October 31, 2017, Corporation X paid Employee A a discretionary bonus of $100,000, on May 14, 2018, Corporation X paid Employee A a discretionary bonus of $600,000, and on April 30, 2019, terminated Employee A's employment without cause. Pursuant to the terms of the employment agreement for severance, on May 1, 2019, Corporation X paid to Employee A a $5,400,000 severance payment (the sum of two times the $2,000,000 annual salary, two times the $100,000 discretionary bonus, and two times the $600,000 discretionary bonus).

(B) *Conclusion.* If this section applies, Employee A is a covered employee for Corporation X's 2019 taxable year. Because the October 2, 2017, agreement is a written binding contract to pay Employee A $4,000,000 if Employee A is terminated without cause prior to December 31, 2020, and $200,000 if Corporation X terminates Employee A's employment without cause prior to October 31, 2019, this section does not apply (and §1.162–27 does apply) to the deduction for $4,200,000 of Employee A's severance payment. The deduction for $4,200,000 of Employee A's severance payment is not subject to section 162(m)(1). Because the October 2, 2017, agreement is not a written binding contract to pay Employee A's $600,000 discretionary bonus (since, as of November 2, 2017, Corporation X was not obligated under applicable law to make the bonus payment), the deduction for $1,200,000 of the $5,400,000 payment is subject to this section (and not §1.162–27).

(iv) *Example 4 (Effect of adjustment to annual salary on severance)*—(A) *Facts.* The facts are the same as in paragraph (g)(3)(ii) of this section (*Example 2*), except that the employment agreement provides for discretionary increases in salary and, on January 1, 2019, Corporation X increased Employee A's annual salary from $2,000,000 to $2,050,000, an increase that was less than a reasonable, cost-of-living adjustment.

(B) *Conclusion (Annual salary).* If this section applies, Employee A is a covered employee for Corporation X's 2018 through 2020 taxable years. Because the October 2, 2017, agreement is a written binding contract to pay Employee A an annual salary of $2,000,000, this section does not apply (and §1.162–27 does apply) to the deduction for Employee A's annual salary unless the change in the salary is a material modification. Even though the $50,000 increase is paid on the basis of substantially the same elements or conditions as the salary that is otherwise paid under the contract, the $50,000 increase does not constitute a material modification because it is less than or equal to a reasonable cost-of-living increase to the $2,000,000 annual salary Corporation X is required to pay under applicable law as of November 2, 2017. However, the deduction for the $50,000 increase is subject to this section (and not §1.162–27).

(C) *Conclusion (Severance payment).* Because the October 2, 2017, agreement is a written binding contract to pay Employee A severance of $4,000,000, this section would not apply (and §1.162–27 would apply) to the deduction for this amount of severance unless the change in the employment agreement is a material modification. Even though the $100,000 increase in severance (two times the $50,000 increase in salary) would be paid on the basis of substantially the same elements or conditions as the severance that would otherwise be paid pursuant to the written binding contract, the $50,000 increase in salary on which it is based does not constitute a material modification of the written binding contract since it is less than or equal to a reasonable cost-of-living increase. However, the deduction for the $100,000 increase in severance is subject to this section (and not §1.162–27).

(v) *Example 5 (Effect of adjustment to annual salary on severance)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(iv) of this section (*Example 4*), except that, on January 1, 2019, Corporation X increased Employee A's annual salary from $2,000,000 to $3,000,000, an increase that exceeds a reasonable, cost-of-living adjustment.

(B) *Conclusion (Annual salary)*. If this section applies, Employee A is a covered employee for Corporation X's 2018 through 2020 taxable years. Because the October 2, 2017, agreement is a written binding contract to pay Employee A an annual salary of $2,000,000, this section does not apply (and §1.162–27 does apply) to the deduction for Employee A's annual salary unless the change in the employment agreement is a material modification. The $1,000,000 increase is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the compensation that is otherwise paid pursuant to the written binding contract, and it exceeds a reasonable, annual cost-of-living increase from the $2,000,000 annual salary for 2018 that Corporation X is required to pay under applicable law as of November 2, 2017. Because the written binding contract is materially modified as of January 1, 2019, the deduction for all annual salary paid to Employee A in 2019 and thereafter is subject to this section (and not §1.162–27).

(C) *Conclusion (Severance payment)*. Because the October 2, 2017, agreement is a written binding contract to pay Employee A severance of $4,000,000, this section would not apply (and §1.162–27 would apply) to the deduction for this amount of severance unless the change in the employment agreement is a material modification. The additional $2,000,000 severance payment (two times the $1,000,000 increase in annual salary) constitutes a material modification of the written binding contract because the $1,000,000 increase in salary on which it is based constitutes a material modification of the written binding contract since it exceeds a reasonable cost-of-living increase from the $2,000,000 annual salary for 2018 that Corporation X is required to pay under applicable law as of November 2, 2017. Because the agreement is materially modified as of January 1, 2019, the deduction for any amount of severance paid to Employee A under the agreement is subject to this section (and not §1.162–27).

(vi) *Example 6 (Elective deferral of an amount that corporation was obligated to pay under applicable law)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(i) of this section (*Example 1*), except that, on December 15, 2018, Employee A makes a deferral election under a nonqualified deferred compensation (NQDC) plan to defer $200,000 of annual salary earned and payable in 2019. Pursuant to the NQDC plan, the $200,000, including earnings, is to be paid in a lump sum on the date six months following Employee A's separation from service. The earnings are based on the Standard & Poor's 500 Index. Under applicable law, pursuant to the written binding contract in effect on November 2, 2017, (and absent the deferral agreement) Corporation X would have been obligated to pay $200,000 to Employee A in 2019, but is not obligated to pay any earnings on the $200,000 deferred pursuant to the deferral election Employee A makes on December 15, 2018. Employee A separates from service on December 15, 2020. On June 15, 2021, Corporation X pays $250,000 (the deferred $200,000 of salary plus $50,000 in earnings).

(B) *Conclusion*. If this section applies, Employee A is a covered employee for Corporation X's 2021 taxable year. Employee A's NQDC plan is not a material modification of the written binding contract in effect on November 2, 2017, because the earnings to be paid under the NQDC plan are based on a predetermined actual investment (as defined in §31.3121(v)(2)–1(d)(2)(i)(B) of this chapter). The deduction for the $50,000 of earnings to be paid that exceed the amount originally payable to Employee A under the written binding contract ($200,000 of salary) are subject to this section (and not §1.162–27). This section does not apply (and §1.162–27 does apply) to the deduction for the $200,000 portion of the $250,000 payment that Corporation X was obligated under applicable law to pay as of November 2, 2017. Pursuant to §1.162–27(c)(2), Employee A is not a covered employee for Corporation X's 2021 taxable year; thus, the deduction for the $200,000 payment is not subject to section 162(m)(1).

(vii) *Example 7 (Compensation subject to discretionary recovery by corporation)*—(A) *Facts*. Employee B serves as the PFO of Corporation Z for its 2017 through 2019 taxable years. On October 2, 2017, Corporation Z executed a bonus agreement with Employee B that requires Corporation Z to pay Employee B a performance bonus of $3,000,000 on May 1, 2019, if Corporation Z's net earnings increase by at least 10% for its 2018 taxable year based on the financial statements filed with the SEC. The agreement does not permit Corporation Z to reduce the amount of the bonus payment for any reason if the Corporation Z attains the net earnings performance target. However, the agreement provides that, if the bonus is paid and subsequently the financial statements are restated to show that the net earnings did not increase by at least 10%, then Corporation Z may, in its discretion, recover the $3,000,000 from Employee B within six months of the restatement. Under applicable law, the agreement for the performance bonus constitutes a written binding contract in effect on November 2, 2017, to pay $3,000,000 to Employee B if Corporation Z's net earnings increase by at least 10% for its 2018 taxable year based on the financial statements filed with the SEC. On May 1, 2019, Corporation Z pays $3,000,000 to Employee B because its net earnings increased by at least 10% of its 2018 taxable year.

(B) *Conclusion*. If this section applies, Employee B is a covered employee for Corporation Z's 2019 taxable year. Because the October 2, 2017, agreement is a written binding contract to pay Employee B $3,000,000 if the applicable conditions are met, this section does not apply (and §1.162–27 does apply) to the deduction for the $3,000,000 regardless of whether Corporation Z's financial statements are restated to show that its net earnings did not increase by at least 10%, and regardless of whether Corporation Z exercises its discretion to recover the bonus if Corporation Z's financial statements are restated to show that its net earnings did not increase by at least 10%.

(viii) *Example 8 (Performance bonus plan with negative discretion)*—(A) *Facts*. Employee E serves as the PEO of Corporation V for the 2017 and 2018 taxable years. On February 1, 2017, Corporation V establishes a bonus plan, under which Employee E will receive a cash bonus of $1,500,000 if a specified performance goal is satisfied. The compensation committee retains the right, if the performance goal is met, to reduce the bonus payment to no less than $400,000 if, in its judgment, other subjective factors warrant a reduction. On November 2, 2017, under applicable law, which takes into account the employer's ability to exercise negative discretion, the bonus plan established on February 1, 2017, constitutes a written binding contract to pay $400,000. On March 1, 2018, the compensation committee certifies that the performance goal was satisfied, but exercises its discretion to reduce the award to $500,000. On April 1, 2018, Corporation V pays $500,000 to Employee E. The payment satisfies the requirements of §1.162–27(e)(2) through (5) as qualified performance-based compensation.

(B) *Conclusion*. If this section applies, Employee E is a covered employee for Corporation V's 2018 taxable year. Because the February 1, 2017, plan is a written binding contract to pay Employee E $400,000 if the performance goal is satisfied, this section does not apply (and §1.162–27 does apply) to the deduction for the $400,000 portion of the

$500,000 payment. Furthermore, pursuant to paragraph (g)(2)(iii) of this section, the failure of the compensation committee to exercise its discretion to reduce the award further to $400,000, instead of $500,000, does not result in a material modification of the contract. Pursuant to § 1.162–27(e)(1), the deduction for the $400,000 payment is not subject to section 162(m)(1) because the payment satisfies the requirements of § 1.162–27(e)(2) through (5) as qualified performance-based compensation. The deduction for the remaining $100,000 of the $500,000 payment is subject to this section (and not § 1.162–27) and therefore the status as qualified performance-based compensation is irrelevant to the application of section 162(m)(1) to this remaining amount.

(ix) *Example 9 (Equity-based compensation with underlying grants made prior to November 2, 2017)*—(A) *Facts.* On January 2, 2017, Corporation T executed a 4-year employment agreement with Employee G to serve as its PEO, and Employee G serves as the PEO for the four-year term. Pursuant to the employment agreement, on January 2, 2017, Corporation T executed a grant agreement and granted to Employee G nonqualified stock options to purchase 1,000 shares of Corporation T stock, stock appreciation rights (SARs) on 1,000 shares, and 1,000 shares of Corporation T restricted stock. On the date of grant, the stock options had no readily ascertainable fair market value as defined in § 1.83–7(b), and neither the stock options nor the SARs provided for a deferral of compensation under § 1.409A–1(b)(5)(i)(A) and (B). The stock options, SARs, and shares of restricted stock are subject to a substantial risk of forfeiture and all substantially vest on January 2, 2020. Employee G may exercise the stock options and the SARs at any time from January 2, 2020, through January 2, 2027. On January 2, 2020, Employee G exercises the stock options and the SARs, and the 1,000 shares of restricted stock become substantially vested (as defined in § 1.83–3(b)). The grant agreement pursuant to which grants of the stock options, SARs, and shares of restricted stock are made constitutes a written binding contract under applicable law. The compensation attributable to the stock options and the SARs satisfy the requirements of § 1.162–27(e)(2) through (5) as qualified performance-based compensation.

(B) *Conclusion.* If this section applies, Employee G is a covered employee for Corporation T's 2020 taxable year. Because the January 2, 2017, grant agreement constitutes a written binding contract, this section does not apply (and § 1.162–27 does apply) to the deduction for compensation received pursuant to the exercise of the stock options and the SARs, or the restricted stock becoming substantially vested (as defined in § 1.83–3(b)). Pursuant to § 1.162–27(e)(1), the deduction attributable to the stock options and the SARs is not subject to section 162(m)(1) because the compensation satisfies the requirements of § 1.162–27(e)(2) through (5) as qualified performance-based compensation. However, the deduction attributable to the restricted stock is subject to section 162(m)(1) because the compensation does not satisfy the requirements of § 1.162–27(e)(2) through (5) as qualified performance-based compensation.

(x) *Example 10 (Plan in which an employee is not a participant on November 2, 2017)*—(A) *Facts.* On October 2, 2017, Employee H executes an employment agreement with Corporation Y to serve as its PFO, and begins employment with Corporation Y. The employment agreement, which is a written binding contract under applicable law, provides that if Employee H continues in his position through April 1, 2018, Employee H will become a participant in the NQDC plan of Corporation Y and that Employee H's benefit accumulated on that date will be $3,000,000. On April 1, 2021, Employee H receives a payment of $4,500,000 (the increase from $3,000,000 to $4,500,000 is not a result of a material modification as defined in paragraph (g)(2) of this section), which is the entire benefit accumulated under the plan through the date of payment.

(B) *Conclusion.* If this section applies, Employee H is a covered employee for Corporation Y's 2021 taxable year. Even though Employee H was not eligible to participate in the NQDC plan on November 2, 2017, Employee H had the right to participate in the plan under a written binding contract as of that date. Because the amount required to be paid pursuant to the written binding contract is $3,000,000, this section does not apply (and § 1.162–27 does apply) to the deduction for the $3,000,000 portion of the $4,500,000. Pursuant to § 1.162–27(c)(2), Employee H is not a covered employee of Corporation Y for the 2021 taxable year. The deduction for the $3,000,000 portion of the $4,500,000 is not subject to section 162(m)(1). The deduction for the remaining $1,500,000 portion of the payment is subject to this section (and not § 1.162–27).

(xi) *Example 11 (Material modification of annual salary)*—(A) *Facts*. On January 2, 2017, Corporation R executed a 5-year employment agreement with Employee I to serve as Corporation R's PFO, providing for an annual salary of $1,800,000. The agreement constitutes a written binding contract under applicable law. In 2017 and 2018, Employee I receives the salary of $1,800,000 per year. In 2019, Corporation R increases Employee I's salary by $40,000, which is less than a reasonable cost-of-living increase from $1,800,000. On January 1, 2020, Corporation R increases Employee I's salary to $2,400,000. The $560,000 increase exceeds a reasonable, annual cost-of-living increase from $1,840,000.

(B) *Conclusion ($1,840,000 Payment in 2019)*. If this section applies, Employee I is a covered employee for Corporation R's 2018 through 2020 taxable years. Because the January 1, 2017, agreement is a written binding contract to pay Employee I an annual salary of $1,800,000, this section does not apply (and § 1.162–27 does apply) to the deduction for Employee I's annual salary unless the change in the employment agreement is a material modification. Pursuant to § 1.162–27(c)(2), Employee I is not a covered employee of Corporation R for the 2019 taxable year, so the deduction for the $1,800,000 salary is not subject to section 162(m)(1). Even though the $40,000 increase is made on the basis of substantially the same elements or conditions as the salary, the $40,000 increase does not constitute a material modification of the written binding contract because the $40,000 is less than or equal to a reasonable cost-of-living increase. However, the deduction for the $40,000 increase is subject to this section (and not § 1.162–27).

(C) *Conclusion (Salary increase to $2,400,000 in 2020)*. The $560,000 increase in salary in 2020 is a material modification of the written binding contract because the additional compensation is paid on the basis of substantially the same elements or conditions as the salary, and it exceeds a reasonable, annual cost-of-living increase from $1,840,000. Because the written binding contract is materially modified as of January 1, 2020, the deduction for all salary paid to Employee I on and after January 1, 2020, is subject is subject to this section (and not § 1.162–27).

(xii) *Example 12 (Additional payment not considered a material modification)*—(A) *Facts*. The facts are the same as in paragraph (g)(3)(xi) of this section (*Example 11*), except that instead of an increase in salary, in 2020 Employee I receives a restricted stock grant subject to Employee I's continued employment for the balance of the contract.

(B) *Conclusion*. The restricted stock grant is not a material modification of the written binding contract because any additional compensation paid to Employee I under the grant is not paid on the basis of substantially the same elements and conditions as Employee I's salary. However, the deduction attributable to the restricted stock grant is subject to this section (and not § 1.162–27).

(h) *Effective/Applicability dates*—(1) *Effective date*. This section is effective on December 30, 2020.

(2) *Applicability dates*—(i) *General applicability date*. Except as otherwise provided in paragraph (h)(2)(ii) of this section, this section applies to taxable years beginning on or after December 30, 2020. Taxpayers may choose to apply this section for taxable years beginning after December 31, 2017, and before December 30, 2020 provided the taxpayer applies this section in its entirety and in a consistent manner.

(ii) *Special applicability dates*—(A) *Definition of covered employee*. The definition of covered employee in paragraph (c)(2)(i) of this section applies to taxable years ending on or after September 10, 2018. However, for a corporation whose fiscal year and taxable year do not end on the same date, the rule in paragraph (c)(2)(i)(B) of this section requiring the determination of the three most highly compensated executive officers to be made pursuant to the rules under the Exchange Act applies to taxable years ending on or after December 20, 2019.

(B) *Definition of predecessor of a publicly held corporation*—(*1*) *Publicly held corporations that become privately held.* The definition of predecessor of a publicly held corporation in paragraph (c)(2)(ii)(A) of this section applies to any publicly held corporation that becomes a privately held corporation for a taxable year beginning after December 31, 2017, and, subsequently, again becomes a publicly held corporation on or after December 30, 2020. The definition of predecessor of a publicly held corporation in paragraph (c)(2)(ii)(A) of this section does not apply to any publicly held corporation that became a privately held corporation for a taxable year beginning before January 1, 2018, with respect to the earlier period as a publicly held corporation; or a publicly held corporation that becomes a privately held corporation for a taxable year beginning after December 31, 2017, and, subsequently, again becomes a publicly held corporation before December 30, 2020.

(*2*) *Corporate transactions.* The definition of predecessor of a publicly held corporation in paragraphs (c)(2)(ii)(B) through (H) of this section applies to corporate transactions that occur (as provided in the transaction timing rule of paragraph (c)(2)(ii)(I) of this section) on or after December 30, 2020. With respect to any of the following corporate transactions occurring after December 20, 2019, and before December 30, 2020, excluding target corporations from the definition of the term ''predecessor'' is not a reasonable good faith interpretation of the statute:

(*i*) A publicly held target corporation the stock or assets of which are acquired by another publicly held corporation in a transaction to which section 381(a) applies.

(*ii*) A publicly held target corporation, at least 80% of the total voting power of the stock of which, and at least 80% of the total value of the stock of which, are acquired by a publicly held acquiring corporation (including an affiliated group).

(C) *Definition of compensation.* The definition of compensation provided in paragraph (c)(3)(ii) of this section (relating to distributive share of partnership deductions for compensation paid) applies to any deduction for compensation that is paid after December 18, 2020. The definition of compensation in paragraph (c)(3)(ii) does not apply to compensation paid pursuant to a written binding contract that is in effect on December 20, 2019, and that is not materially modified after that date. For purposes of this paragraph (h)(3), written binding contract and material modification have the same meanings as provided in paragraphs (g)(1) and (2) of this section.

(D) *Corporations that become publicly held.* The rule in paragraph (d) of this section (providing that the deduction limitation of paragraph (b) of this section applies to a deduction for any compensation that is otherwise deductible for the taxable year ending on or after the date that a privately held corporation becomes a publicly held corporation) applies to corporations that become publicly held after December 20, 2019. A privately held corporation that becomes a publicly held corporation on or before December 20, 2019, may rely on the transition rules provided in §1.162–27(f)(1) until the earliest of the events provided in §1.162–27(f)(2). A subsidiary that is a member of an affiliated group (as defined in §1.162–27(c)(1)(ii)) may rely on transition relief provided in §1.162–27(f)(4) if it becomes a separate publicly held corporation (whether in a spin-off transaction or otherwise) on or before December 20, 2019.

(E) *Transition rules.* Except for the transition rules in paragraphs (g)(1)(v) through (vii) of this section, the transition rules in paragraphs (g)(1) and (2) of this section (providing that this section does not apply to compensation payable under a written binding contract which was in effect on November 2, 2017, and which is not modified in any material respect on or after such date) apply to taxable years ending on or after September 10, 2018.

[T.D. 9932, 85 FR 86492, Dec. 30, 2020]

§ 1.162(k)–1 Disallowance of deduction for reacquisition payments.

(a) *In general.* Except as provided in paragraph (b) of this section, no deduction otherwise allowable is allowed under Chapter 1 of the Internal Revenue Code for any amount paid or incurred by a corporation in connection with the reacquisition of its stock or the stock of any related person (as defined in section 465(b)(3)(C)). Amounts paid or incurred in connection with the reacquisition of stock include amounts paid by a corporation to reacquire its stock from an ESOP that are used in a manner described in section 404(k)(2)(A). See § 1.404(k)–3.

(b) *Exceptions.* Paragraph (a) of this section does not apply to any—

(1) Deduction allowable under section 163 (relating to interest);

(2) Deduction for amounts that are properly allocable to indebtedness and amortized over the term of such indebtedness;

(3) Deduction for dividends paid (within the meaning of section 561); or

(4) Amount paid or incurred in connection with the redemption of any stock in a regulated investment company that issues only stock which is redeemable upon the demand of the shareholder.

(c) *Effective date.* This section applies with respect to amounts paid or incurred on or after August 30, 2006.

[T.D. 9282, 71 FR 51473, Aug. 30, 2006]

§ 1.162(l)–0 Table of Contents.

This section lists the table of contents for § 1.162(l)–1.

[T.D. 9822, 82 FR 34610, July 26, 2017]

§ 1.162(l)–1 Deduction for health insurance costs of self-employed individuals.

(a) *Coordination of section 162(l) deduction for taxpayers subject to section 36B*—(1) *In general.* A taxpayer is allowed a deduction under section 162(l) for specified premiums, as defined in paragraph (a)(2) of this section, not to exceed an amount equal to the lesser of—

(i) The specified premiums less the premium tax credit attributable to the specified premiums; and

(ii) The sum of the specified premiums not paid through advance credit payments, as described in paragraph (a)(3) of this section, and the additional tax (if any) imposed under section 36B(f)(2)(A) and § 1.36B–4(a)(1) with respect to the specified premiums after application of the limitation on additional tax in section 36B(f)(2)(B) and § 1.36B–4(a)(3).

(2) *Specified premiums.* For purposes of paragraph (a)(1) of this section, specified premiums means premiums for a specified qualified health plan or plans for which the taxpayer may otherwise claim a deduction under section 162(l). For purposes of this paragraph (a)(2), a specified qualified health plan is a qualified health plan, as defined in § 1.36B–1(c), covering the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer (enrolled family member) for a month that is a coverage month within the meaning of § 1.36B–3(c) for the enrolled family member. If a specified qualified health plan covers individuals other than enrolled family members, the specified premiums include only the portion of the premiums for the specified qualified health plan that is allocable to the enrolled family members under rules similar to § 1.36B–3(h), which provides rules for determining the amount under § 1.36B–3(d)(1) when two families are enrolled in the same qualified health plan.

(3) *Specified premiums not paid through advance credit payments.* For purposes of paragraph (a)(1)(ii) of this section, specified premiums not paid through advance credit payments equal the amount of the specified premiums minus the advance credit payments attributable to the specified premiums.

(b) *Additional guidance.* The Secretary may provide by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) additional guidance on coordinating the deduction allowed under section 162(l) and the credit provided under section 36B.

(c) *Applicability date.* This section applies for taxable years beginning after December 31, 2013.

[T.D. 9822, 82 FR 34610, July 26, 2017]

§ 1.163–1 Interest deduction in general.

(a) Except as otherwise provided in sections 264 to 267, inclusive, interest paid or accrued within the taxable year on indebtedness shall be allowed as a deduction in computing taxable income. For rules relating to interest on certain deferred payments, see section 483 and the regulations thereunder.

(b) Interest paid by the taxpayer on a mortgage upon real estate of which he is the legal or equitable owner, even though the taxpayer is not directly liable upon the bond or note secured by such mortgage, may be deducted as interest on his indebtedness. Pursuant to the provisions of section 163(c), any annual or periodic rental payment made by a taxpayer on or after January 1, 1962, under a redeemable ground rent, as defined in section 1055(c) and paragraph (b) of §1.1055–1, is required to be treated as interest on an indebtedness secured by a mortgage and, accordingly, may be deducted by the taxpayer as interest on his indebtedness. Section 163(c) has no application in respect of any annual or periodic rental payment made prior to January 1, 1962, or pursuant to an arrangement which does not constitute a ''redeemable ground rent'' as defined in section 1055(c) and paragraph (b) of §1.1055–1. Accordingly, annual or periodic payments of Pennsylvania ground rents made before, on, or after January 1, 1962, are deductible as interest if the ground rent is redeemable. An annual or periodic rental payment under a Maryland redeemable ground rent made prior to January 1, 1962, is deductible in accordance with the rules and regulations applicable at the time such payment was made. Any annual or periodic rental payment under a Maryland redeemable ground rent made by the taxpayer on or after January 1, 1962, is, pursuant to the provisions of section 163(c), treated as interest on an indebtedness secured by a mortgage and, accordingly, is deductible by the taxpayer as interest on his indebtedness. In any case where the ground rent is irredeemable, any annual or periodic ground rent payment shall be treated as rent and shall be deductible only to the extent that the payment constitutes a proper business expense. Amounts paid in redemption of a ground rent shall not be treated as interest. For treatment of redeemable ground rents and real property held subject to liabilities under redeemable ground rents, see section 1055 and the regulations thereunder.

(c) Interest calculated for costkeeping or other purposes on account of capital or surplus invested in the business which does not represent a charge arising under an interest-bearing obligation, is not an allowable deduction from gross income. Interest paid by a corporation on scrip dividends is an allowable deduction. So-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing taxable income. (See, however, section 583.) In the case of banks and loan or trust companies, interest paid within the year on deposits, such as interest paid on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank or loan or trust company, may be deducted from gross income.

(d) To the extent of assistance payments made in respect of an indebtedness of the taxpayer during the taxable year by the Department of Housing and Urban Development under section 235 of the National Housing Act (12 U.S.C. 1715z), as amended, no deduction shall be allowed under section 163 and this section for interest paid or accrued with respect to such indebtedness. However, such payments shall not affect the amount of any deduction under any section of the Code other than section 163. The provisions of this paragraph shall apply to taxable years beginning after December 31, 1974.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6821, 30 FR 6216, May 4, 1965; T.D. 6873, 31 FR 941, Jan. 25, 1966; T.D. 7408, 41 FR 9547, Mar. 5, 1976]

§ 1.163–2 Installment purchases where interest charge is not separately stated.

(a) *In general.* (1) Whenever there is a contract with a seller for the purchase of personal property providing for payment of part or all of the purchase price in installments and there is a separately stated carrying charge (including a finance charge, service charge, and the like) but the actual interest charge cannot be ascertained, a portion of the payments made during the taxable year under the contract shall be treated as interest and is deductible under section 163 and this section. Section 163(b) contains a formula, described in paragraph (b) of this section, in accordance with which the amount of interest deductible in the taxable year must be computed. This formula is designed to operate automatically in the case of any installment purchase, without regard to whether payments under the contract are made when due or are in default. For applicable limitations when an obligation to pay is terminated, see paragraph (c) of this section.

(2) Whenever there is a contract with an educational institution for the purchase of educational services providing for payment of part or all of the purchase price in installments and there is a separately stated carrying charge (including a finance charge, service charge, and the like) but the actual interest charge cannot be ascertained, a portion of the payments made during the taxable year under the contract shall be treated as interest and is deductible under section 163 and this section. See paragraphs (b) and (c) of this section for the applicable computation and limitations rules. For purposes of section 163(b) and this section, the term ''educational services'' means any service (including lodging) which is purchased from an educational institution (as defined in section 151(e)(4) and paragraph (c) of §1.151–3) and which is provided for a student of such institution.

(3) Section 163(b) and this section do not apply to a contract for the loan of money, even if the loan is to be repaid in installments and even if the borrowed amount is used to purchase personal property or educational services. In cases to which the preceding sentence applies, the portion of the installment payment which constitutes interest (as distinguished from payments of principal and charges such as payments for credit life insurance) is deductible under section 163(a) and §1.163–1.

(b) *Computation.* The portion of any such payments to be treated as interest shall be equal to 6 percent of the average unpaid balance under the contract during the taxable year. For purposes of this computation, the average unpaid balance under the contract is the sum of the unpaid balance outstanding on the first day of each month beginning during the taxable year, divided by 12.

(c) *Limitations.* The amount treated as interest under section 163(b) and this section for any taxable year shall not exceed the amount of the payments made under the contract during the taxable year nor the aggregate carrying charges properly attributable to each contract for such taxable year. In computing the amount to be treated as interest if the obligation to pay is terminated as, for example, in the case of a repossession of the property, the unpaid balance on the first day of the month during which the obligation is terminated shall be zero.

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

Example 1. On January 20, 1955, A purchased a television set for $400, including a stated carrying charge of $25. The down payment was $50, and the balance was paid in 14 monthly installments of $25 each, on the 20th day of each month commencing with February. Assuming that A is a cash method, calendar year taxpayer and that no other installment purchases were made, the amount to be treated as interest in 1955 is $12.38, computed as follows:

YEAR 1955

First day of	Unpaid balance outstanding
January	0
February	$350
March	325
April	300
May	275
June	250
July	225
August	200
September	175
October	150
November	125
December	100
	2,475

Sum of unpaid balances $2,475 ÷ 12 = $206.25; 6 percent thereof = $12.38.

Example 2. On November 20, 1955, B purchased a furniture set for $1,250, including a stated carrying charge of $48. The down payment was $50 and the balance was payable in 12 monthly installments of $100 each, on the first day of each month commencing with December 1955. Assume that B is a cash method, calendar year taxpayer and that no other installment purchases were made. Assume further that B made the first payment when due, but made only one other payment on June 1, 1956. The amount to be treated as interest in 1955 is $4, and the amount to be treated as interest in 1956 is $33, computed as follows:

YEAR 1955

First day of	Unpaid balance outstanding
December	$1,200

Sum of unpaid balances $1,200 ÷ 12 = $100; 6 percent thereof = $6.

Carrying charges attributable to 1955 = $4.

YEAR 1956

First day of	Unpaid balance outstanding
January	$1,100
February	1,000
March	900
April	800
May	700
June	600
July	500
August	400
September	300
October	200
November	100
	6,600

Sum of unpaid balances $6,600 ÷ 12 = $550; 6 percent thereof = $33.

Carrying charges attributable to 1956 = $44 ($4 × 11).

Example 3. Assume the same facts as in example (2), except that the furniture was repossessed and B's obligation to pay terminated as of July 15, 1956. The amount to be treated as interest in 1955 is $4, computed as in example (2) above. The amount to be treated as interest in 1956 is $25.50, computed as follows:

YEAR 1956

First day of	Unpaid balance outstanding
January	$1,100
February	1,000
March	900
April	800
May	700
June	600
July-November	0
	5,100

Sum of unpaid balances $5,100 ÷ 12 = $425. 6 percent thereof = $25.50.

Carrying charges attributable to 1956 = $44 ($4 × 11).

Example 4. (i) On September 15, 1968, C registered at X University for the 1968–69 academic year. C entered into an agreement with the X University for the purchase during such academic year of educational services (including lodging and tuition) for a total fee of $1,000, including a separately stated carrying charge of $50. Under the terms of the agreement, an initial payment of $200 was to be made by C on September 15, 1968, and the balance was to be paid in 8 monthly installments of $100 each, on the 15th day of each month commencing with October 1968. C made all of the required 1968 payments. Assuming that C is a cash method, calendar year taxpayer and that no other installment purchases of services or property were made, the amount to be treated as interest in 1968 is $10.50, computed as follows:

YEAR 1968

First day of	Unpaid balance outstanding
January-September	0
October	$800
November	700
December	600
Total	2,100

The sum of unpaid balances ($2,100) divided by 12 is $175; 6 percent thereof is $10.50. The carrying charges attributable to 1968 are $18.75 (*i.e.*, the total carrying charges ($50), divided by the total number of payments (8), multiplied by the number of payments made in 1968 (3)). Since the amount to be treated as interest in 1968 ($10.50) does not exceed the carrying charges attributable to 1968 ($18.75), the limitation set forth in paragraph (c) of this section is not applicable.

(ii) The result in this example would be the same even if the X University assigned the agreement to a bank or other financial institution and C made his payments directly to the bank or other financial institution.

Example 5. On September 15, 1968, D registered at Y University for the 1968–69 academic year. The tuition for such year was $1,500. In order to pay his tuition, D borrowed $1,500 from the M Corporation, a lending institution, and remitted that sum to the Y University. The loan agreement between M Corporation and D provided that D was to repay the loan, plus a service charge, in 10 equal monthly installments, on the first day of each month commencing with October 1968. The service charge consisted of interest and the cost of credit life insurance on D's life. Since section 163(b) and this section do not apply to a contract for the loan of money, D is not entitled to compute his interest deduction with respect to his loan from M Corporation under such sections. D may deduct that portion of each installment payment which constitutes interest (as distinguished from payments of principal and the charge for credit life insurance) under section 163(a) and §1.163–1, provided that the amount of such interest can be ascertained.

(e) *Effective date.* Except in the case of payments made under a contract for educational services, the rule provided in section 163(b) and this section applies to payments made during taxable years beginning after December 31, 1953, and ending after August 16, 1954, regardless of when the contract of sale was made. In the case of payments made under a contract for educational services, the rule provided in section 163(b) and this section applies to payments made during taxable years beginning after December 31, 1963, regardless of when the contract for educational services was made.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6991, 34 FR 742, Jan. 17, 1969]

§ 1.163–3 Deduction for discount on bond issued on or before May 27, 1969.

(a) *Discount upon issuance.* (1) If bonds are issued by a corporation at a discount, the net amount of such discount is deductible and should be prorated or amortized over the life of the bonds. For purposes of this section, the amortizable bond discount equals the excess of the amount payable at maturity (or, in the case of a callable bond, at the earlier call date) over the issue price of the bond (as defined in paragraph (b)(2) of §1.1232–3).

(2) In the case of a bond issued by a corporation after December 31, 1954, as part of an investment unit consisting of an obligation and an option, the issue price of the bond is determined by allocating the amount received for the investment unit to the individual elements of the unit in the manner set forth in subdivision (ii)(*a*) of §1.1232–3(b)(2). Discount with respect to bonds issued by a corporation as part of investment units consisting of obligations and options after December 31, 1954, and before Dec. 24, 1968—

(i) Increased by any amount treated as bond premium which has been included in gross income with respect to such bonds prior to Dec. 24, 1968, or

(ii) Decreased by any amount which has been deducted by the issuer as discount attributable to such bonds prior to Dec. 24, 1968, and

(iii) Decreased by any amount which has been deducted by the issuer prior to Dec. 24, 1968 upon the exercise or sale by investors of options issued in investment units with such bonds,

should be amortized, starting with the first taxable year ending on or after Dec. 24, 1968 over the remaining life of such bonds.

(b) *Examples.* The rules in paragraph (a) of this section are illustrated by the following examples:

Example 1. M Corporation, on January 1, 1960, the beginning of its taxable year issued for $95,000, 3 percent bonds, maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. M Corporation should treat $5,000 ($100,000–$95,000) as the total amount to be amortized over the life of the bonds.

Example 2. Assume the same facts as example (1), except that the bonds are convertible into common stock of M Corporation. Since the issue price of the bonds includes any amount attributable to the conversion privilege, the result is the same as in example (1).

Example 3. Assume the same facts as example (1), except that the bonds are issued as part of an investment unit consisting of an obligation and an option. Assume further that the issue price of the bonds as determined under the rules of allocation set forth in subdivision (ii)(*a*) of §1.1232–3(b)(2) is $94,000. Accordingly, M Corporation should treat $6,000 ($100,000–$94,000) as the total amount to be amortized over the life of the bonds.

Example 4. Assume in example (3), that prior to Dec. 24, 1968, M Corporation had only treated $5,000 as the bond discount to be amortized and deducted only $4,000 of this amount. Starting with the first taxable year ending on or after Dec. 24, 1968, M Corporation should amortize $2,000 ($6,000 discount, less $4,000 previously deducted) over the remaining life of the bonds.

Example 5. N Corporation, on January 1, 1956, for a consideration of $102,000, issued 20-year bonds in the face amount of $100,000, together with options to purchase stock of N Corporation. The issue price of the bonds as determined under the rules of allocation set forth in subdivision (ii)(*a*) of § 1.1232–3(b)(2) is $99,000. Until Dec. 24, 1968, N Corporation has treated as bond premium, $2,000, representing the excess of the consideration received for the bond-option investment units over the maturity value of the bonds, and has accordingly prorated and included in income $1,200 of such amount. Starting with the first taxable year beginning on or after Dec. 24, 1968, N Corporation may amortize as a deduction over the remaining life of the bonds the amount of $2,200 ($1,000 discount, plus $1,200 previously included in income).

Example 6. O Corporation, on January 1, 1956, for a consideration of $100,000, issued 20-year bonds with a $100,000 face value, together with options to purchase stock of O Corporation, which could be exercised at any time up to 5 years from the date of issue. The issue price of the bonds as determined under the rules of allocation set forth in subdivision (ii)(*a*) of § 1.1232–3(b)(2) is $98,000. O Corporation, upon the exercise of the options prior to Dec. 24, 1968, had deducted from income their fair market value at the time of exercise, which is assumed for purposes of this example to have been $3,000. Even though the bonds are considered to have been issued at a discount under paragraph (a)(1) of this section, O Corporation would have no deduction over the remaining life of the bonds, inasmuch as O Corporation, in computing the amount of such deduction, is required under paragraph (a)(2)(iii) of this section to reduce the amount which would otherwise be treated as bond discount, $2,000 ($100,000–$98,000), by the amount deducted from income upon the exercise of the options, in this case, $3,000.

(c) *Deduction upon repurchase.* (1) Except as provided in subparagraphs (2) and (3) of this paragraph, if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of discount deducted prior to repurchase, or (in the case of bonds issued subsequent to Feb. 28, 1913) minus any amount of premium returned as income prior to repurchase, the excess of the purchase price over the issue price adjusted for amortized premium or discount is a deductible expense for the taxable year.

(2) In the case of a convertible bond (except a bond which the corporation, before Sept. 5, 1968, has obligated itself to repurchase at a specified price), the deduction allowable under subparagraph (1) of this paragraph may not exceed an amount equal to 1 year's interest at the rate specified in the bond, except to the extent that the corporation can demonstrate to the satisfaction of the Commissioner or his delegate that an amount in excess of 1 year's interest does not include any amount attributable to the conversion feature.

(3) No deduction shall be allowed under subparagraph (1) of this paragraph to the extent a deduction is disallowed under subparagraph (2) of this paragraph or to the extent a deduction is disallowed by section 249 (relating to limitation on deduction of bond premium on repurchase of convertible obligation) and the regulations thereunder. See paragraph (f) of § 1.249–1 for effective date limitation on section 249.

(d) *Definition.* For purposes of this section, a debenture, note, certificate other evidence of indebtedness, issued by a corporation and bearing interest shall be given the same treatment as a bond.

(e) *Effective date.* The provisions of this section shall not apply in respect of a bond issued after May 27, 1969, unless issued pursuant to a written commitment which was binding on that date and at all times thereafter.

[T.D. 6984, 33 FR 19175, Dec. 24, 1968, as amended by T.D. 7154, 36 FR 24996, Dec. 28, 1971; T.D. 7259, 38 FR 4253, Feb. 12, 1973]

§ 1.163–4 Deduction for original issue discount on certain obligations issued after May 27, 1969.

(a) *In general.* (1) If an obligation is issued by a corporation with original issue discount, the amount of such discount is deductible as interest and shall be prorated or amortized over the life of the obligation. For purposes of this section the term ''obligation'' shall have the same meaning as in § 1.1232–1 (without regard to whether the obligation is a capital asset in the hands of the holder) and the term ''original issue discount'' shall have the same meaning as in section 1232(b)(1) (without regard to the one-fourth of 1 percent limitation in the second sentence thereof). Thus, in general, the amount of original issue discount equals the excess of the amount payable at maturity over the issue price of the bond (as defined in paragraph (b)(2) of §1.1232–3), regardless of whether that amount is less than one-fourth of 1 percent of the redemption price at maturity multiplied by the number of complete years to maturity. For the rule as to whether there is original issue discount in the case of an obligation issued in an exchange for property other than money, and the amount thereof, see paragraph (b)(2)(iii) of §1.1232–3. In any case in which original issue discount is carried over from one corporation to another corporation under section 381(c)(9) or from an obligation exchanged to an obligation received in any exchange under paragraph (b)(1)(iv) of §1.1232–3, such discount shall be carried over for purposes of this section. The amount of original issue discount carried over in an exchange of obligations under the preceding sentence shall be prorated or amortized over the life of the obligation issued in such exchange. For computation of issue price and the amount of original issue discount in the case of serial obligations, see paragraph (b)(2)(iv) of §1.1232–3.

(2) In the case of an obligation issued by a corporation as part of an investment unit (as defined in paragraph (b)(2)(ii)(*a*) of §1.1232–3) consisting of an obligation and other property, the issue price of the obligation is determined by allocating the amount received for the investment unit to the individual elements of the unit in the manner set forth in paragraph (b)(2)(ii) of §1.1232–3.

(3) *Recovery or retention of amounts previously deducted.* In any taxable year in which an amount of original issue discount which was deducted as interest under this section is retained or recovered by the taxpayer, such as, for example, by reason of a fine, penalty, forfeiture, or other withdrawal fee, such amount shall be includible in the gross income of such taxpayer for such taxable year.

(b) *Examples.* The rules in paragraph (a) of this section are illustrated by the following examples:

Example 1. N Corporation, which uses the calendar year as its taxable year, on January 1, 1970, issued for $99,000, 9 percent bonds maturing 10 years from the date of issue, with a stated redemption price at maturity of $100,000. The original issue discount on each bond (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $1,000, *i.e.*, redemption price, $100,000, minus issue price, $99,000. N shall treat $1,000 as the total amount to be amortized over the life of the bonds.

Example 2. Assume the same facts as example (1), except that the bonds are convertible into common stock of N Corporation. Since the issue price of the bonds includes any amount attributable to the conversion privilege, the result is the same as in example (1).

Example 3. Assume the same facts as example (1), except that the bonds are issued as part of an investment unit consisting of an obligation and an option. Assume further that the issue price of the bonds as determined under the rules of allocation set forth in paragraph (b)(2)(ii) of §1.1232–3 is $94,000. The original issue discount on the bond (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $6,000, *i.e.*, redemption price, $100,000, minus issue price, $94,000. N shall treat $6,000 as the total amount to be amortized over the life of the bonds.

Example 4. On January 1, 1971, a commercial bank which uses the calendar year as its taxable year, issued a certificate of deposit 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 Regulations 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 certificate is an obligation to which section 1232(a)(3)(A) applies (see paragraph (d) of §1.1232–1), and the original issue discount with respect to the certificate (as determined under section 1232(b)(1) without regard to the one-fourth-of-1-percent limitation in the second sentence thereof) is $3,382.26 (*i.e.*, redemption price, $13,382.26, minus issued price, $10,000). Y shall treat $3,382.26 as the total amount to be amortized over the life of the certificate.

(c) *Deduction upon repurchase.* (1) Except as provided in subparagraph (2) of this paragraph, if bonds are issued by a corporation and are subsequently repurchased by the corporation at a price in excess of the issue price plus any amount of original issue discount deducted prior to repurchase, or minus any amount of premium returned as income prior to repurchase, the excess of the repurchase price over the issue price adjusted for amortized premium or deducted discount is deductible as interest for the taxable year.

(2) The provisions of subparagraph (1) of this paragraph shall not apply to the extent a deduction is disallowed by section 249 (relating to limitation on deduction of bond premium or repurchase of convertible obligation) and the regulations thereunder.

(d) *Effective date.* The provisions of this section shall apply in respect of obligations issued after May 27, 1969, other than—

(1) Obligations issued pursuant to a written commitment which was binding on May 27, 1969, and at all times thereafter, and

(2) Deposits made before January 1, 1971, in the case of certificates of deposit, time deposits, bonus plans, and other deposit arrangements with banks, domestic building and loan associations, and similar financial institutions.

[36 FR 24996, Dec. 28, 1971, as amended by T.D. 7213, 37 FR 21991, Oct. 18, 1972; T.D. 7259, 38 FR 4253, Feb. 12, 1973]

§ 1.163–5 Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form.

(a)–(b) [Reserved]

(c) *Obligations issued to foreign persons after September 21, 1984*—(1) *In general.* A determination of whether an obligation satisfies each of the requirements of this paragraph shall be made on an obligation-by-obligation basis. An obligation issued directly (or through affiliated entities) in bearer form by, or guaranteed by, a United States Government-owned agency or a United States Government-sponsored enterprise, such as the Federal National Mortgage Association, the Federal Home Loan Banks, the Federal Loan Mortgage Corporation, the Farm Credit Administration, and the Student Loan Marketing Association, may not satisfy this paragraph (c). An obligation issued after September 21, 1984 is described in this paragraph if—

(i) There are arrangements reasonably designed to ensure that such obligation will be sold (or resold in connection with its original issuance) only to a person who is not a United States person or who is a United States person that is a financial institution (as defined in §1.165–12(c)(1)(v)) purchasing for its own account or for the account of a customer and that agrees to comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder, and

(ii) In the case of an obligation which is not in registered form—

(A) Interest on such obligation is payable only outside the United States and its possessions, and

(B) Unless the obligation is described in subparagraph (2)(i)(C) of this paragraph or is a temporary global security, the following statement in English either appears on the face of the obligation and on any interest coupons which may be detached therefrom or, if the obligation is evidenced by a book entry, appears in the book or record in which the book entry is made: ''Any United States person who holds this obligation will be subject to limitations under the United States income tax laws, including the limitations provided in sections 165(j) and 1287(a) of the Internal Revenue Code.'' For purposes of this paragraph, the term ''temporary global security'' means a security which is held for the benefit of the purchasers of the obligations of the issuer and interests in which are exchangeable for securities in definitive registered or bearer form prior to its stated maturity.

(2) *Rules for the application of this paragraph*—(i) *Arrangements reasonably designed to ensure sale to non-United States persons.* An obligation will be considered to satisfy paragraph (c)(1)(i) of this section if the conditions of paragraph (c)(2)(i) (A), (B), (C), or (D) of this section are met in connection with the original issuance of the obligation. An exchange of one obligation for another is considered an original issuance if and only if the exchange constitutes a disposition of property for purposes of section 1001 of the Code. However, an exchange of one obligation for another will not be considered a new issuance if the obligation received is identical in all respects to the obligation surrendered in exchange therefor, except that the obligor of the obligation received

need not be the same obligor as the obligor of the obligation surrendered. Obligations that meet the conditions of paragraph (c)(2)(i) (A), (B), (C) or (D) of this section may be issued in a single public offering. The preceding sentence does not apply to certificates of deposit issued under the conditions of paragraph (c)(2)(i)(C) of this section by a United States person or by a controlled foreign corporation within the meaning of section 957(a) that is engaged in the active conduct of a banking business within the meaning of section 954(c)(3)(B) as in effect prior to the Tax Reform Act of 1986, and the regulations thereunder. A temporary global security need not satisfy the conditions of paragraph (c)(2)(i) (A), (B) or (C) of this section, but must satisfy the applicable requirements of paragraph (c)(2)(i)(D) of this section.

(A) In connection with the original issuance of an obligation, the obligation is offered for sale or resale only outside of the United States and its possessions, is delivered only outside the United States and its possessions and is not registered under the Securities Act of 1933 because it is intended for distribution to persons who are not United States persons. An obligation will not be considered to be required to be registered under the Securities Act of 1933 if the issuer, in reliance on the written opinion of counsel received prior to the issuance thereof, determines in good faith that the obligation need not be registered under the Securities Act of 1933 for the reason that it is intended for distribution to persons who are not United States persons. Solely for purposes of this subdivision (i)(A), the term ''United States person'' has the same meaning as it has for purposes of determining whether an obligation is intended for distribution to persons under the Securities Act of 1933. Except as provided in paragraph (c)(3) of this section, this paragraph (c)(2)(i)(A) applies only to obligations issued on or before September 7, 1990.

(B) The obligation is registered under the Securities Act of 1933, is exempt from registration by reason of section 3 or section 4 of such Act, or does not qualify as a security under the Securities Act of 1933; all of the conditions set forth in paragraph (c)(2)(i)(B) (*1*), (*2*), (*3*), (*4*), and (*5*) of this section are met with respect to such obligations; and, except as provided in paragraph (c)(3) of this section, the obligation is issued on or before September 7, 1990.

(*1*) In connection with the original issuance of an obligation in bearer form, the obligation is offered for sale or resale only outside the United States and its possessions.

(*2*) The issuer does not, and each underwriter and each member of the selling group, if any, covenants that it will not, in connection with the original issuance of the obligation, offer to sell or resell the obligation in bearer form to any person inside the United States or to a United States person unless such United States person is a financial institution as defined in §1.165–12(c)(v) purchasing for its own account or for the account of a customer, which financial institution, as a condition of the purchase, agrees to provide on delivery of the obligation (or on issuance, if the obligation is not in definitive form) the certificate required under paragraph (c)(2)(i)(B)(4).

(*3*) In connection with its sale or resale during the original issuance of the obligation in bearer form, each underwriter and each member of the selling group, if any, or the issuer, if there is no underwriter or selling group, sends a confirmation to the purchaser of the bearer obligation stating that the purchaser represents that it is not a United States person or, if it is a United States person, it is a financial institution as defined in §1.165–12(c)(v) purchasing for its own account or for the account of a customer and that the financial institution will comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder. The confirmation must also state that, if the purchaser is a dealer, it will send similar confirmations to whomever purchases from it.

(*4*) In connection with the original issuance of the obligation in bearer form it is delivered in definitive form (or issued, if the obligation is not in definitive form) to the person entitled to physical delivery thereof only outside the United States and its possessions and only upon presentation of a certificate signed by such person to the issuer, underwriter, or member of the selling group, which certificate states that the obligation is not being acquired by or on behalf of a United States person, or for offer to resell or for resale to a United States person or any person inside the United States, or, if a beneficial interest in the obligation is being acquired by a United States person, that such person is a financial institution as defined in §1.165.12(c)(1)(v) or is acquiring through a financial institution and that the obligation is held by a financial institution that has agreed to comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder and that is not purchasing for offer to resell or for resale inside the United States. When a certificate is provided by a clearing organization, it must be based on statements provided to it by its member organizations. A clearing organization is an entity which is in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of a member without the necessity of physical delivery of the obligation. For purposes of paragraph (c)(2)(i)(B), the term ''delivery'' does not include the delivery of an obligation to an underwriter or member of the selling group, if any.

(*5*) The issuer, underwriter, or member of the selling group does not have actual knowledge that the certificate described in paragraph (c)(2)(i)(B)(*4*) of this section is false. The issuer, underwriter, or member of the selling group shall be deemed to have actual knowledge that the certificate described in paragraph (c)(2)(i)(B)(*4*) of this section is false if the issuer, underwriter, or member of the selling group has a United States address for the beneficial owner (other than a financial institution as defined in §1.165–12(c)(v) that represents that it will comply with the requirements of section 165(j)(3) (A), (B), or (C) and the regulations thereunder) and does not have documentary evidence as described in §1.6049–5(c)(1) that the beneficial owner is not a United States person.

(C) The obligation is issued only outside the United States and its possessions by an issuer that does not significantly engage in interstate commerce with respect to the issuance of such obligation either directly or through its agent, an underwriter, or a member of the selling group. In the case of an issuer that is a United States person, such issuer may only satisfy the test set forth in this paragraph (c)(2)(i)(C) if—

(*1*) It is engaged through a branch in the active conduct of a banking business, within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, and the regulations thereunder, outside the United States;

(*2*) The obligation is issued outside of the United States by the branch in connection with that trade or business;

(*3*) The obligation that is so issued is sold directly to the public and is not issued as a part of a larger issuance made by means of a public offering; and

(*4*) The issuer either maintains documentary evidence as described in subdivision (iii) of A–5 of §35a.9999–4T that the purchaser is not a United States person (provided that the issuer has no actual knowledge that the documentary evidence is false) or on delivery of the obligation the issuer receives a statement signed by the person entitled to physical delivery thereof and stating either that the obligation is not being acquired by or on behalf of a United States person or that, if a beneficial interest in the obligation is being acquired by a United States person, such person is a financial institution as defined in §1.165–12(c)(v) or is acquiring through a financial institution and the obligation is held by a financial institution that has agreed to comply with the requirements of 165(j)(3) (A), (B) or (C) and the regulations thereunder and that it is not purchasing for offer to resell or for resale inside the United States (provided that the issuer has no actual knowledge that the statement is false).

In addition, an issuer that is a controlled foreign corporation within the meaning of section 957 (a) that is engaged in the active conduct of a banking business outside the United States within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, and the regulations thereunder, can only satisfy the provisions of this paragraph (c)(2)(i)(C), if it meets the requirements of this paragraph (c)(2)(i)(C)(2), (3) and (4).

(D) The obligation is issued after September 7, 1990, and all of the conditions set forth in this paragraph (c)(2)(i)(D) are met with respect to such obligation.

(*1*) *Offers and sales*—(*i*) *Issuer.* The issuer does not offer or sell the obligation during the restricted period to a person who is within the United States or its possessions or to a United States person.

(*ii*) *Distributors.* (*A*) The distributor of the obligation does not offer or sell the obligation during the restricted period to a person who is within the United States or its possessions or to a United States person.

(*B*) The distributor of the obligation will be deemed to satisfy the requirements of paragraph (c)(2)(i)(D)(*1*)(*ii*)(*A*) of this section if the distributor of the obligation convenants that it will not offer or sell the obligation during the restricted period to a person who is within the United States or its possessions or to a United States person; and the distributor of the obligation has in effect, in connection with the offer and sale of the obligation during the restricted period, procedures reasonably designed to ensure that its employees or agents who are directly engaged in selling the obligation are aware that the obligation cannot be offered or sold during the restricted period to a person who is within the United States or its possessions or is a United States person.

(*iii*) *Certain rules.* For purposes of paragraph (c)(2)(i)(D)(*1*) (*i*) and (*ii*) of this section:

(*A*) An offer or sale will be considered to be made to a person who is within the United States or its possessions if the offeror or seller of the obligation has an address within the United States or its possessions for the offeree or buyer of the obligation with respect to the offer or sale.

(*B*) An offer or sale of an obligation will not be treated as made to a person within the United States or its possessions or to a United States person if the person to whom the offer or sale is made is: An exempt distributor, as defined in paragraph (c)(2)(i)(D)(*5*) of this section; An international organization as defined in section 7701(a)(18) and the regulations thereunder, or a foreign central bank as defined in section 895 and the regulations thereunder; or The foreign branch of a United States financial institution as described in paragraph (c)(2)(i)(D)(*6*)(*i*) of this section.

Paragraph (c)(2)(i)(D)(*1*)(*iii*)(*B*) regarding an exempt distributor will only apply to an offer to the United States office of an exempt distributor, and paragraph (c)(2)(i)(D)(*1*)(*iii*)(*B*) regarding an international organization or foreign central bank will only apply to an offer to an international organization or foreign central bank, if such offer is made directly and specifically to the United States office, organization or bank.

(*C*) A sale of an obligation will not be treated as made to a person within the United States or its possessions or to a United States person if the person to whom the sale is made is a person described in paragraph (c)(2)(i)(D)(*6*)(*ii*) of this section.

(*2*) *Delivery.* In connection with the sale of the obligation during the restricted period, neither the issuer nor any distributor delivers the obligation in definitive form within the United States or it possessions.

(*3*) *Certification*—(*i*) *In general.* On the earlier of the date of the first actual payment of interest by the issuer on the obligation or the date of delivery by the issuer of the obligation in definitive form, a certificate is provided to the issuer of the obligation stating that on such date:

(*A*) The obligation is owned by a person that is not a United States person:

(*B*) The obligation is owned by a United States person described in paragraph (c)(2)(i)(D)(*6*) of this section; or

(*C*) The obligation is owned by a financial institution for purposes of resale during the restricted period, and such financial institution certifies in addition that it has not acquired the obligation for purposes of resale directly or indirectly to a United States person or to a person within the United States or its possessions.

A certificate described in paragraph (c)(2)(i)(D)(*3*)(*i*) (*A*) or (*B*) of this section may not be given with respect to an obligation that is owned by a financial institution for purposes of resale during the restricted period. For purposes of paragraph (c)(2)(i)(D) (*2*) and (*3*) of this section, a temporary global security (as defined in §1.163–5 (c)(1)(ii)(B)) is not considered to be an obligation in definitive form. If the issuer does not make the obligation available for delivery in definitive form within a reasonable period of time after the end of the restricted period, then the obligation shall be treated as not satisfying the requirements of this paragraph (c)(2)(i)(D)(*3*). The certificate must be signed (or sent, as provided in paragraph (c)(2)(i)(D)(*3*)(*ii*) of this section) either by the owner of the obligation or by a financial institution or clearing organization through which the owner holds the obligation, directly or indirectly. For purposes of this paragraph (c)(2)(i)(D)(*3*), the term ''financial institution'' means a financial institution described in §1.165–12(c)(i)(v). When a certificate is provided by a clearing organization, the certificate must be based on statements provided to it by its member organizations. The requirement of this paragraph (c)(1)(D)(*3*) shall be deemed not to be satisfied with respect to an obligation if the issuer knows or has reason to know that the certificate with respect to such obligation is false. The certificate must be retained by the issuer (and statements by member organizations must be retained by the clearing organization, in the case of certificates based on such statements) for a period of four calendar years following the year in which the certificate is received.

(*ii*) *Electronic certification.* The certificate required by paragraph (c)(2)(i)(D)(*3*)(*i*) of this section (including a statement provided to a clearing organization by a member organization) may be provided electronically, but only if the person receiving such electronic certificate maintains adequate records, for the retention period described in paragraph (c)(2)(i)(D)(*3*)(*i*) of this section, establishing that such certificate was received in respect of the subject obligation, and only if there is a written agreement entered into prior to the time of certification (including the written membership rules of a clearing organization) to which the sender and recipient are subject, providing that the electronic certificate shall have the effect of a signed certificate described in paragraph (c)(2)(i)(D)(*3*)(*i*) of this section.

(*iii*) *Exception for certain obligations.* This paragraph (c)(2)(i)(D)(*3*) shall not apply, and no certificate shall be required, in the case of an obligation that is sold during the restricted period and that satisfies all of the following requirements:

(*A*) The interest and principal with respect to the obligation are denominated only in the currency of a single foreign country.

(*B*) The interest and principal with respect to the obligation are payable only within that foreign country (according to rules similar to those set forth in §1.163–5(c)(2)(v)).

(*C*) The obligation is offered and sold in accordance with practices and documentation customary in that foreign country.

(*D*) The distributor covenants to use reasonable efforts to sell the obligation within that foreign country.

(*E*) The obligation is not listed, or the subject of an application for listing, on an exchange located outside that foreign country.

(*F*) The Commissioner has designated that foreign country as a foreign country in which certification under paragraph (c)(2)(i)(D)(*3*)(*i*) of this section is not permissible.

(*G*) The issuance of the obligation is subject to guidelines or restrictions imposed by governmental, banking or securities authorities in that foreign country.

(*H*) More than 80 percent by value of the obligations included in the offering of which the obligation is a part are offered and sold to non-distributors by distributors maintaining an office located in that foreign country. Foreign currency denominated obligations that are convertible into U.S. dollar denominated obligations or that by their terms are linked to the U.S. dollar in a way which effectively converts the obligations to U.S. dollar denominated obligations do not satisfy the requirements of this paragraph (c)(2)(i)(D)(*3*)(*iii*). A foreign currency denominated obligation will not be treated as linked, by its terms, to the

U.S. dollar solely because the obligation is the subject of a swap transaction.

(*4*) *Distributor*. For purposes of this paragraph (c)(2)(i)(D), the term ''distributor'' means:

(*i*) A person that offers or sells the obligation during the restricted period pursuant to a written contract with the issuer;

(*ii*) Any person that offers or sells the obligation during the restricted period pursuant to a written contract with a person described in paragraph (c)(2)(i)(D) (*4*) (*i*); and

(*iii*) Any affiliate that acquires the obligation from another member of its affiliated group for the purpose of offering or selling the obligation during the restricted period, but only if the transferor member of the group is the issuer or a person described in paragraph (c)(2)(i)(D) (*4*)(*i*) or (*ii*) of this section. The terms ''affiliate'' and ''affiliated group'' have the same meanings as in section 1504(a) of the Code, but without regard to the exceptions contained in section 1504(b) and substituting ''50 percent'' for ''80 percent'' each time it appears.

For purposes of this paragraph (c)(2)(i)(D)(*4*), a written contract does not include a confirmation or other notice of the transaction.

(*5*) *Exempt distributor*. For purposes of this paragraph (c)(2)(i)(D), the term ''exempt distributor'' means a distributor that convenants in its contract with the issuer or with a distributor described in paragraph (c)(2)(i)(D)(*4*)(*i*) that it is buying the obligation for the purpose of resale in connection with the original issuance of the obligation, and that if it retains the obligation for its own account, it will only do so in accordance with the requirements of paragraph (c)(2)(i)(D)(*6*) of this section. In the latter case, the convenant will constitute the certificate required under paragraph (c)(2)(i)(D)(*6*). The provisions of paragraph (c)(2)(i)(D)(*7*) governing the restricted period for unsold allotments or subscriptions shall apply to any obligation retained for investment by an exempt distributor.

(*6*) *Certain United States persons*. A person is described in this paragraph (c)(2)(i)(D)(*6*) if the requirements of this paragraph are satisfied and the person is:

(*i*) The foreign branch of a United States financial institution purchasing for its own account or for resale, or

(*ii*) A United States person who acquired the obligation through the foreign branch of a United States financial institution and who, for purposes of the certification required in paragraph (c)(2)(i)(D)(*3*) of this section, holds the obligation through such financial institution on the date of certification.

For purposes of paragraph (c)(2)(i)(D)(*6*)(*ii*) of this section, a United States person will be considered to acquire and hold an obligation through the foreign branch of a United States financial institution if the United States person has an account with the United States office of a financial institution, and the transaction is executed by a foreign office of that financial institution, or by the foreign office of another financial institution acting on behalf of that financial institution. This paragraph (c)(2)(i)(D)(*6*) will apply, however, only if the United States financial institution (or the United States office of a foreign financial institution) holding the obligation provides a certificate to the issuer or distributor selling the obligation within a reasonable time stating that it agrees to comply with the requirements of section 165(j)(3)(A), (B), or (C) and the regulations thereunder. For purposes of this paragraph (c)(2)(i)(D)(*6*), the term ''financial institution'' means a financial institution as defined in §1.165–12(c)(1)(v). As an alternative to the certification required above, a financial institution may provide a blanket certificate to the issuer or distributor selling the obligation stating that the financial institution will comply with the requirements of section 165(j)(3)(A), (B) or (C) and the regulations thereunder. A blanket certificate must be received by the issuer or the distributor in the year of the issuance of the obligation or in either of the preceding two calendar years, and must be retained by the issuer or distributor for at least four years after the end of the last calendar year to which it relates.

(*7*) *Restricted period.* For purposes of this paragraph (c)(2)(i)(D), the restricted period with respect to an obligation begins on the earlier of the closing date (or the date on which the issuer receives the loan proceeds, if there is no closing with respect to the obligation), or the first date on which the obligation is offered to persons other than a distributor. The restricted period with respect to an obligation ends on the expiration of the forty day period beginning on the closing date (or the date on which the issuer receives the loan proceeds, if there is no closing with respect to the obligation). Notwithstanding the preceding sentence, any offer or sale of the obligation by the issuer or a distributor shall be deemed to be during the restricted period if the issuer or distributor holds the obligation as part of an unsold allotment or subscription.

(*8*) *Clearing organization.* For purposes of this paragraph (c)(2)(i)(D), a ''clearing organization'' is an entity which is in the business of holding obligations for member organizations and transferring obligations among such members by credit or debit to the account of a member without the necessity of physical delivery of the obligation.

(ii) *Special rules.* An obligation shall not be considered to be described in paragraph (c)(2)(i)(C) of this section if it is—

(A) Guaranteed by a United States shareholder of the issuer;

(B) Convertible into a debt or equity interest in a United States shareholder of the issuer; or

(C) Substantially identical to an obligation issued by a United States shareholder of the issuer.

For purposes of this paragraph (c)(2)(ii), the term ''United States shareholder'' is defined as it is defined in section 951 (b) and the regulations thereunder. For purposes of this paragraph (c)(2)(ii)(C), obligations are substantially identical if the face amount, interest rate, term of the issue, due dates for payments, and maturity date of each is substantially identical to the other.

(iii) *Interstate commerce.* For purposes of this paragraph, the term ''interstate commerce'' means trade or commerce in obligations or any transportation or communication relating thereto between any foreign country and the United States or its possessions.

(A) An issuer will not be considered to engage significantly in interstate commerce with respect to the issuance of an obligation if the only activities with respect to which the issuer uses the means or instrumentalities of interstate commerce are activities of a preparatory or auxiliary character that do not involve communication between a prospective purchaser and an issuer, its agent, an underwriter, or member of the selling group if either is inside the United States or its possessions. Activities of a preparatory or auxiliary character include, but are not limited to, the following activities:

(*1*) Establishment or participation in establishment of policies concerning the issuance of obligations and the allocation of funding by a United States shareholder with respect to obligations issued by a foreign corporation or by a United States office with respect to obligations issued by a foreign branch;

(*2*) Negotiation between the issuer and underwriters as to the terms and pricing of an issue;

(*3*) Transfer of funds to an office of an issuer in the United States or its possessions by a foreign branch or to a United States shareholder by a foreign corporation;

(*4*) Consultation by an issuer with accountants and lawyers or other financial advisors in the United States or its possessions regarding the issuance of an obligation;

(*5*) Document drafting and printing; and

(*6*) Provision of payment or delivery instructions to members of the selling group by an issuer's office or agent that is located in the United States or its possessions.

(B) Activities that will not be considered to be of a preparatory or auxiliary character include, but are not limited to, any of the following activities:

(*1*) Negotiation or communication between a prospective purchaser and an issuer, its agent, an underwriter, or a member of the selling group concerning the sale of an obligation if either is inside the United States or its possessions;

(*2*) Involvement of an issuer's office, its agent, an underwriter, or a member of the selling group in the United States or its possessions in the offer or sale of a particular obligation, either directly with the prospective purchaser, or through the issuer in a foreign country;

(*3*) Delivery of an obligation in the United States or its possessions; or

(*4*) Advertising or otherwise promoting an obligation in the United States or its possessions.

(C) The following examples illustrate the application of this subdivision (iii) of §1.163–5(c)(2).

Example 1. Foreign corporation A, a corporation organized in and doing business in foreign country Z, and not a controlled foreign corporation within the meaning of section 957(a) that is engaged in the conduct of a banking business within the meaning of section 954(c)(3)(B) as in effect before the Tax Reform Act of 1986, issues its debentures outside the United States. The debentures are not guaranteed by a United States shareholder of A, nor are they convertible into a debt or equity interest of a United States shareholder of A, nor are they substantially identical to an obligation issued by a United States shareholder of A. A consults its accountants and lawyers in the United States for certain securities and tax advice regarding the debt offering. The underwriting and selling group in respect to A's offering is composed entirely of foreign securities firms, some of which are foreign subsidiaries of United States securities firms. A U.S. affiliate of the foreign underwriter communicates payment and delivery instructions to the selling group. All offering circulars for the offering are mailed and delivered outside the United States and its possessions. All debentures are delivered and paid for outside the United States and its possessions. No office located in the United States or in a United States possession is involved in the sale of debentures. Interest on the debentures is payable only outside the United States and its possessions. A is not significantly engaged in interstate commerce with respect to the offering.

Example 2. B, a United States bank, does business in foreign country X through a branch located in X. The branch is a staffed and operating unit engaged in the active conduct of a banking business consisting of one or more of the activities set forth in §1.954–2(d)(2)(ii). As part of its ongoing business, the branch in X issues negotiable certificates of deposit with a maturity in excess of one year to customers upon request. The certificates of deposit are not guaranteed by a United States shareholder of B, nor are they convertible into a debt or equity interest of a United States shareholder of B, nor are they substantially identical to an obligation issued by a United States shareholder of B. Policies regarding the issuance of negotiable certificates of deposit and funding allocations for foreign branches are set in the United States at B's main office. Branch personnel decide whether to issue a negotiable certificate of deposit based on the guidelines established by the United States offices of B, but without communicating with the United States offices of B with respect to the issuance of a particular obligation. Negotiable certificates of deposits are delivered and paid for outside the United States and its possessions. Interest on the negotiable certificates of deposit is payable only outside the United States and its possessions. B maintains documentary evidence described in §1.163–5(c)(2)(i)(C)(*4*). After the issuance of negotiable certificates of deposit by the foreign branch of B, the foreign branch sends the funds to a United States branch of B for use in domestic operations. B is not significantly engaged in interstate commerce with respect to the issuance of such obligation.

Example 3. The facts in Example (2) apply except that the foreign branch of B consulted, by telephone, the main office in the United States to request approval of the issuance of the certificate of deposit at a particular rate of interest. The main office granted permission to issue the negotiable certificate of deposit to the customer by a telex sent from the main office of B to the branch in X. B is significantly engaged in interstate commerce with respect to the issuance of the obligation as a result of involvement of B's United States office in the issuance of the obligation.

Example 4. The facts in Example (2) apply with the additional fact that a customer contacted the foreign branch of B through a telex originating in the United States or its possessions. Subsequent to the telex, the foreign branch issued the negotiable certificate of deposit and recorded it on the books. B is significantly engaged in interstate commerce with respect to the issuance of the obligation as a result of its communication by telex with a customer in the United States.

(iv) *Possessions.* For purposes of this section, the term ''possessions'' includes Puerto Rico, the U.S. Virgin Islands, Guam, American Samoa, Wake Island, and Northern Mariana Islands.

(v) *Interest payable outside of the United States.* Interest will be considered payable only outside the United States and its possessions if payment of such interest can be made only upon presentation of a coupon, or upon making of any other demand for payment, outside of the United States and its possessions to the issuer or a paying agent. The fact that payment is made by a draft drawn on a United States bank account or by a wire or other electronic transfer from a United States account does not affect this result. Interest payments will be considered to be made within the United States if the payments are made by a transfer of funds into an account maintained by the payee in the United States or mailed to an address in the United States, if—

(A) The interest is paid on an obligation issued by either a United States person, a controlled foreign corporation as defined in section 957 (a), or a foreign corporation if 50 percent or more of the gross income of the foreign corporation from all sources of the 3-year period ending with the close of its taxable year preceding the original issuance of the obligation (or for such part of the period that the foreign corporation has been in existence) was effectively connected with the conduct of a trade or business within the United States; and

(B) The interest is paid to a person other than—

(*1*) A person who may satisfy the requirements of section 165 (j)(3) (A), (B), or (C) and the regulations thereunder; and

(*2*) A financial institution as a step in the clearance of funds and such interest is promptly credited to an account maintained outside the United States for such financial institution or for persons for which the financial institution has collected such interest.

Interest is considered to be paid within the United States and its possessions if a coupon is presented, or a demand for payment is otherwise made, to the issuer or a paying agent (whether a United States or foreign person) in the United States and its possessions even if the funds paid are credited to an account maintained by the payee outside the United States and its possessions. Interest will be considered payable only outside the United States and its possessions notwithstanding that such interest may become payable at the office of the issuer or its United States paying agent under the following conditions: the issuer has appointed paying agents located outside the United States and its possessions with the reasonable expectation that such paying agents will be able to pay the interest in United States dollars, and the full amount of such payment at the offices of all such paying agents is illegal or effectively precluded because of the imposition of exchange controls or other similar restrictions on the full payment or receipt of interest in United States dollars. A lawsuit brought in the United States or its possessions for payment of the obligation or interest thereon as a result of a default shall not be considered to be a demand for payment. For purposes of this subdivision (v), interest includes original issue discount as defined in section 1273(a). Therefore, an amount equal to the original issue discount as defined in section 1273(a) is payable only outside the United States and its possessions. The amount of market discount as defined in section 1278(a) does not affect the amount of interest to be considered payable only outside the United States and its possessions.

(vi) *Rules relating to obligations issued after December 31, 1982 and on or before September 21, 1984.* Whether an 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, is described in section 163(f)(2)(B) shall be determined under the rules provided in §5f.163–1(c) as in effect prior to its removal. Notwithstanding the preceding sentence, an issuer will be considered to satisfy the requirements of section 163(f)(2)(B) with respect to an obligation issued after December 31, 1982 and on or before September 21, 1984 or 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, if the issuer substantially complied with the proposed regulations provided in §1.163–5(c), which were published in the FEDERAL REGISTER on September 2, 1983 (48 FR 39953) and superseded by temporary regulations published in the FEDERAL REGISTER on August 22, 1984 (49 FR 33228).

(3) *Effective date*—(i) *In general*. These regulations apply generally to obligations issued after January 20, 1987. A taxpayer may choose to apply the rules of §1.163–5(c) with respect to an obligation issued after December 31, 1982 and on or before January 20, 1987. If this choice is made, the rules of §1.163–5(c) will apply in lieu of §1.163–5T(c) except that the legend requirement under §1.163–5(c)(l)(ii)(B) does not apply with respect to a bearer obligation evidenced exclusively by a book entry and that the certification requirement under §1.163–5T(c)(2)(B)(*4*) applies in lieu of the certification under §1.163–5(c)(2)(i)(B)(4).

(ii) *Special rules*. If an obligation is originally issued after September 7, 1990 pursuant to the exercise of a warrant or the conversion of a convertible obligation, which warrant or obligation (including conversion privilege) was issued on or before May 10, 1990, then the issuer may choose to apply either the rules of §1.163–5(c)(2)(i)(A) or §1.163–5(c)(2)(i)(B), or the rules of §1.163–5(c)(2)(i)(D). The issuer of an obligation may choose to apply either the rules of §1.163–5(c)(2)(i) (A) or (B), or the rules of §1.163–5(c)(2)(i)(D), to an obligation that is originally issued after May 10, 1990, and on or before September 7, 1990. However, any issuer choosing to apply the rules of §1.163–5(c)(2)(i)(A) must apply the definition of United States person used for such purposes on December 31, 1989, and must obtain any certificates that would have been required under applicable law on December 31, 1989.

[T.D. 8110, 51 FR 45456, Dec. 19, 1986, as amended by T.D. 8203, 53 FR 17926, May 19, 1988; T.D. 8300, 55 FR 19624, May 10, 1990; T.D. 8734, 62 FR 53416, Oct. 14, 1997]

§1.163–5T Denial of interest deduction on certain obligations issued after December 31, 1982, unless issued in registered form (temporary).

(a)–(c) [Reserved]

(d) *Pass-through certificates*. (1) A pass-through or participation certificate evidencing an interest in a pool of mortgage loans which under subpart E of subchapter J of the Code is treated as a trust of which the grantor is the owner (or similar evidence of interest in a similar pooled fund or pooled trust treated as a grantor trust) (''pass-through certificate'') is considered to be a ''registration-required obligation'' under section 163(f)(2)(A) and §1.163–5(c) if the pass-through certificate is described in section 163(f)(2)(A) and §1.163–5(c) without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in section 163(f)(2)(A) and §1.163–5(c). A pass-through certificate is considered to be described in section 163(f)(2)(B) and §1.163–5(c) if the pass-through certificate is described in section 163(f)(2)(B) and §1.163–5(c) without regard to whether any obligation held by the fund or trust to which the pass-through certificate relates is described in section 163(f)(2)(B) and §1.163–5(c).

(2) An obligation held by a fund or trust in which ownership interests are represented by pass-through certificates is considered to be in registered form under section 149(a) and the regulations thereunder or to be described in section 163(f)(2) (A) or (B), if the obligation held by the fund or trust is in registered form under section 149(a) and the regulations thereunder or is described in section 163(f)(2) (A) or (B), respectively, without regard to whether the pass-through certificates are so considered.

(3) For purposes of section 4701, a pass-through certificate is considered to be issued solely by the recipient of the proceeds from the issuance of the pass-through certificate (hereinafter the ''sponsor''). The sponsor is therefore liable for any excise tax under section 4701 that may be imposed with reference to the principal amount of the pass-through certificate.

(4) In order to implement the purpose of section 163, §1.163–5(c) and this section, the Commissioner may characterize a certificate or other evidence of interest in a fund or trust which under subpart E of subchapter J of the Code is treated as a trust of which the grantor is the owner and any obligation held by such fund or trust in accordance with the substance of the arrangement they represent and may impose the

penalties provided under sections 163(f)(1) and 4701 in the appropriate amounts and on the appropriate persons. This provision may be applied, for example, where a corporation issues obligations purportedly in registered form, contributes them to a grantor trust as its only assets, and arranges for the sale to investors of bearer certificates of interest in the trust which do not meet the requirements of section 163(f)(2)(B). If this provision is applied, the obligations held by the fund or trust will not be considered to be issued in registered form or to meet the requirements of section 163(f)(2)(B). The corporation will not be allowed a deduction for the payment of interest on the obligations held by the trust, and the excise tax under section 4701, calculated with reference to the principal amount of the obligations held by the trust will be imposed on the corporation may be collected from the corporation and its agents. This paragraph (d)(4) will not be applied so as to alter the tax consequences of transactions as to which rulings have been issued by the Internal Revenue Service prior to September 19, 1985.

(5) The rules set forth in this paragraph (d) apply solely for purposes of sections 4701, 163(f)(2)(A), 163(f)(2)(B), §1.163–5(c), and any other section that refers to this section for the definition of the term ''registration-required obligation'' (such as the regulations under sections 871(h) and 881(c)). The treatment of obligations described in this paragraph (d) for purposes of section 163(f)(2) (A) and (B) does not affect the determination of whether bearer obligations that are issued or guaranteed by the United States Government, a United States Government-owned agency, a United States Government sponsored enterprise (within the meaning of §1.163–5(c)(1)) or that are backed (as described in the Treasury Department News Release R–2835 of September 10, 1984 and Treasury Department News Release R–2847 of September 14, 1984) by obligations issued by the United States Government, a United States Government-owned agency, or a United States Government sponsored enterprise comply with the requirements of section 163(f)(2)(B) and the regulations thereunder.

(6) The provisions of paragraphs (d) (1) through (5) may be illustrated by the following example:

Commercial Bank K forms a pool of 1000 residential mortgage loans, each made to a different individual homeowner, by assigning them to Commercial Bank L, an unrelated entity serving as trustee of the pool. Commercial Bank L immediately sells in a public offering certificates of interest in the trust of a maturity of 10 years in registered form. Commercial Bank L transfers the cash proceeds of the offering to Commercial Bank K. The certificates of interest in the trust are of a type offered to the public and are not described in section 163(f)(2)(B). Pursuant to paragraph (d)(1), the certificates of interest in the pool are registration-required obligations without regard to the fact that the obligations held by the trust are not registration-required obligations.

(e) *Regular interests in REMICS.* (1) A regular interest in a REMIC, as defined in sections 860D and 860G and the regulations thereunder, is considered to be a ''registration-required obligation'' under section 163(f)(2)(A) and §1.163–5(c) if the regular interest is described in section 163(f)(2)(A) and §1.163–5(c), without regard to whether any obligation held by the REMIC to which the regular interest relates is described in section 163(f)(2)(A) and §1.163–5(c). A regular interest in a REMIC is considered to be described in section 163(f)(2)(B) and §1.163–5(c), if the regular interest is described in section 163(f)(2)(B) and §1.163(c), without regard to whether any obligation held by the REMIC to which the regular interest relates is described in section 163(f)(2)(B) and §1.163–5(c).

(2) An obligation held by a REMIC is considered to be described in section 163(f)(2) (A) or (B) if such obligation is described in section 163(f)(2) (A) or (B), respectively, without regard to whether the regular interests in the REMIC are so considered.

(3) For purposes of section 4701, a regular interest is considered to be issued solely by the recipient of the proceeds from the issuance of the regular interest (hereinafter the ''sponsor''). The sponsor is therefore liable for any excise tax under section 4701 that may be imposed with reference to the principal amount of the regular interest.

(4) In order to implement the purpose of section 163, §1.163–5(c), and this section, the Commissioner may characterize a regular interest in a REMIC and any obligation held by such REMIC in accordance with the substance of the arrangement they represent and may impose the penalties provided under sections 163(f)(1) and 4701 in the appropriate amounts and on the appropriate persons. This provision may be applied, for example, where a corporation issues an obligation that is purportedly in registered form and that will qualify as a ''qualified mortgage'' within the meaning of section 860G(a)(3) in the hands of a REMIC, contributes the obligation to a REMIC as its only asset, and arranges for the sale to investors of regular interests in the REMIC in bearer form that do not meet the requirements of section 163(f)(2)(B). If this provision is applied, the obligation held by the REMIC will not be considered to be issued in registered form or to meet the requirements of section 163(f)(2)(B). The corporation will not be allowed a deduction for the payment of interest on the obligation held by the REMIC, and the excise tax under section 4701, calculated with reference to the principal amount of the obligation held by the REMIC, will be imposed on the corporation and may be collected from the corporation and its agents.

[T.D. 8202, 53 FR 17928, May 19, 1988, as amended by T.D. 8300, 55 FR 19626, May 10, 1990]

§ 1.163–6T Reduction of deduction where section 25 credit taken (temporary).

(a) *In general.* The amount of the deduction under section 163 for interest paid or accrued during any taxable year on a certified indebtedness amount with respect to a mortgage credit certificate which has been issued under section 25 shall be reduced by the amount of the credit allowable with respect to such interest under section 25 (determined without regard to section 26).

(b) *Cross reference.* See §§1.25–1T through 1.25–8T with respect to rules relating to mortgage credit certificates.

[T.D. 8023, 50 FR 19355, May 8, 1985]

§ 1.163–7 Deduction for OID on certain debt instruments.

(a) *General rule.* Except as otherwise provided in paragraph (b) of this section, an issuer (including a transferee) determines the amount of OID that is deductible each year under section 163(e)(1) by using the constant yield method described in §1.1272–1(b). This determination, however, is made without regard to section 1272(a)(7) (relating to acquisition premium) and §1.1273–1(d) (relating to de minimis OID). An issuer is permitted a deduction under section 163(e)(1) only to the extent the issuer is primarily liable on the debt instrument. For certain limitations on the deductibility of OID, see sections 163(e) and 1275(b)(2). To determine the amount of interest (OID) that is deductible each year on a debt instrument that provides for contingent payments, see §1.1275–4.

(b) *Special rules for de minimis OID*—(1) *Stated interest.* If a debt instrument has a de minimis amount of OID (within the meaning of §1.1273–1(d)), the issuer treats all stated interest on the debt instrument as qualified stated interest. See §§1.446–2(b) and 1.461–1 for the treatment of qualified stated interest.

(2) *Deduction of de minimis OID on other than a constant yield basis.* In lieu of deducting de minimis OID under the general rule of paragraph (a) of this section, an issuer of a debt instrument with a de minimis amount of OID (other than a de minimis amount treated as qualified stated interest under paragraph (b)(1) of this section) may choose to deduct the OID at maturity, on a straight-line basis over the term of the debt instrument, or in proportion to stated interest payments. The issuer makes this choice by reporting the de minimis OID in a manner consistent with the method chosen on the issuer's timely filed Federal income tax return for the taxable year in which the debt instrument is issued.

(c) *Deduction upon repurchase.* Except to the extent disallowed by any other section of the Internal Revenue Code (e.g., section 249) or this paragraph (c), if a debt instrument is repurchased by the issuer for a price in excess of its adjusted issue price (as defined in §1.1275–1(b)), the excess (repurchase premium) is deductible as interest for the taxable year in which the repurchase occurs. If the issuer repurchases a debt instrument in a debt-for-debt exchange, the repurchase price is the issue price of the newly issued debt instrument (reduced by any unstated interest within the meaning of section 483). However, if the issue price of the newly issued debt instrument is determined under either section 1273(b)(4) or section 1274, any repurchase premium is not deductible in the year of the repurchase, but is amortized over the term of the newly issued debt instrument in the same manner as if it were OID.

(d) *Choice of accrual periods to determine whether a debt instrument is an applicable high yield discount obligation (AHYDO).* Section 163(e)(5) affects an issuer's OID deductions for certain high yield debt instruments that have significant OID. For purposes of section 163(i)(2), which defines significant OID, the issuer's choice of accrual periods to determine OID accruals is used to determine whether a debt instrument has significant OID. See §1.1275–2(e) for rules relating to the issuer's obligation to disclose certain information to holders.

(e) *Qualified reopening*—(1) *In general.* In a qualified reopening of an issue of debt instruments, if a holder pays more or less than the adjusted issue price of the original debt instruments to acquire an additional debt instrument, the issuer treats this difference as an adjustment to the issuer's interest expense for the original and additional debt instruments. As provided by paragraphs (e)(2) through (5) of this section, the adjustment is taken into account over the term of the instrument using constant yield principles.

(2) *Positive adjustment.* If the difference is positive (that is, the holder pays more than the adjusted issue price of the original debt instrument), then, with respect to the issuer but not the holder, the difference increases the aggregate adjusted issue prices of all of the debt instruments in the issue, both original and additional.

(3) *Negative adjustment.* If the difference is negative (that is, the holder pays less than the adjusted issue price of the original debt instrument), then, with respect to the issuer but not the holder, the difference reduces the aggregate adjusted issue prices of all of the debt instruments in the issue, both original and additional.

(4) *Determination of issuer's interest accruals.* As of the reopening date, the issuer must redetermine the yield of the debt instruments in the issue for purposes of applying the constant yield method described in §1.1272–1(b) to determine the issuer's accruals of interest expense over the remaining term of the debt instruments in the issue. This redetermined yield is based on the aggregate adjusted issue prices of the debt instruments in the issue (as determined under this paragraph (e)) and the remaining payment schedule of the debt instruments in the issue. If the aggregate adjusted issue prices of the debt instruments in the issue (as determined under this paragraph (e)) are less than the aggregate stated redemption price at maturity of the instruments (determined as of the reopening date) by a *de minimis* amount (within the meaning of §1.1273–1(d)), the issuer may use the rules in paragraph (b) of this section to determine the issuer's accruals of interest expense.

(5) *Effect of adjustments on issuer's adjusted issue price.* The adjustments made under this paragraph (e) are taken into account for purposes of determining the issuer's adjusted issue price under §1.1275–1(b).

(6) *Definitions.* The terms *additional debt instrument*, *original debt instrument*, *qualified reopening*, and *reopening date* have the same meanings as in §1.1275–2(k).

(f) *Effective dates.* This section (other than paragraph (e) of this section) applies to debt instruments issued on or after April 4, 1994. Taxpayers, however, may rely on this section (other than paragraph (e) of this section) for debt instruments issued after December 21, 1992, and before April 4, 1994. Paragraph (e) of this section applies to qualified reopenings where the reopening date is on or after March 13, 2001.

[T.D. 8517, 59 FR 4804, Feb. 2, 1994, as amended by T.D. 8674, 61 FR 30138, June 14, 1996; T.D. 8934, 66 FR 2815, Jan. 12, 2001]

§ 1.163–8T Allocation of interest expense among expenditures (temporary).

(a) *In general*—(1) *Application.* This section prescribes rules for allocating interest expense for purposes of applying sections 469 (the ''passive loss limitation'') and 163 (d) and (h) (the ''nonbusiness interest limitations'').

(2) *Cross-references.* This paragraph provides an overview of the manner in which interest expense is allocated for the purposes of applying the passive loss limitation and nonbusiness interest limitations and the manner in which interest expense allocated under this section is treated. See paragraph (b) of this section for definitions of certain terms, paragraph (c) for the rules for allocating debt and interest expense among expenditures, paragraphs (d) and (e) for the treatment of debt repayments and refinancings, paragraph (j) for the rules for reallocating debt upon the occurrence of certain events, paragraph (m) for the coordination of the rules in this section with other limitations on the deductibility of interest expense, and paragraph (n) of this section for effective date and transitional rules.

(3) *Manner of allocation.* In general, interest expense on a debt is allocated in the same manner as the debt to which such interest expense relates is allocated. Debt is allocated by tracing disbursements of the debt proceeds to specific expenditures. This section prescribes rules for tracing debt proceeds to specific expenditures.

(4) *Treatment of interest expenses*—(i) *General rule.* Except as otherwise provided in paragraph (m) of this section (relating to limitations on interest expense other than the passive loss and nonbusiness interest limitations), interest expense allocated under the rules of this section is treated in the following manner:

(A) Interest expense allocated to a trade or business expenditure (as defined in paragraph (b)(7) of this section) is taken into account under section 163 (h)(2)(A);

(B) Interest expense allocated to a passive activity expenditure (as defined in paragraph (b)(4) of this section) or a former passive activity expenditure (as defined in paragraph (b)(2) of this section) is taken into account for purposes of section 469 in determining the income or loss from the activity to which such expenditure relates;

(C) Interest expense allocated to an investment expenditure (as defined in paragraph (b)(3) of this section) is treated for purposes of section 163(d) as investment interest;

(D) Interest expense allocated to a personal expenditure (as defined in paragraph (b)(5) of this section) is treated for purposes of section 163(h) as personal interest; and

(E) Interest expense allocated to a portfolio expenditure (as defined in paragraph (b)(6) of this section) is treated for purposes of section 469(e)(2)(B)(ii) as interest expense described in section 469(e)(1)(A)(i)(III).

(ii) *Examples.* The following examples illustrate the application of this paragraph (a)(4):

Example 1. Taxpayer A, an individual, incurs interest expense allocated under the rules of this section to the following expenditures:

$6,000 Passive activity expenditure.
$4,000 Personal expenditure.

The $6,000 interest expense allocated to the passive activity expenditure is taken into account for purposes of section 469 in computing A's income or loss from the activity to which such interest relates. Pursuant to section 163(h), A may not deduct the $4,000 interest expense allocated to the personal expenditure (except to the extent such interest is qualified residence interest, within the meaning of section 163(h)(3)).

Example 2. (i) Corporation M, a closely held C corporation (within the meaning of section 469 (j)(1)) has $10,000 of interest expense for a taxable year. Under the rules of this section, M's interest expense is allocated to the following expenditures:

$2,000 Passive activity expenditure.
$3,000 Portfolio expenditure.
$5,000 Other expenditures.

(ii) Under section 163(d)(3)(D) and this paragraph (a)(4), the $2,000 interest expense allocated to the passive activity expenditure is taken into account in computing M's passive activity loss for the taxable year, but, pursuant to section 469(e)(1) and this paragraph (a)(4), the interest expense allocated to the portfolio expenditure and the other expenditures is not taken into account for such purposes.

(iii) Since M is a closely held C corporation, its passive activity loss is allowable under section 469(e)(2)(A) as a deduction from net active income. Under section

469(e)(2)(B) and this paragraph (a)(4), the $5,000 interest expense allocated to other expenditures is taken into account in computing M's net active income, but the interest expense allocated to the passive activity expenditure and the portfolio expenditure is not taken into account for such purposes.

(iv) Since M is a corporation, the $3,000 interest expense allocated to the portfolio expenditure is allowable without regard to section 163(d). If M were an individual, however, the interest expense allocated to the portfolio expenditure would be treated as investment interest for purposes of applying the limitation of section 163(d).

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

(1) ''Former passive activity'' means an activity described in section 469(f)(3), but only if an unused deduction or credit (within the meaning of section 469(f)(1) (A) or (B)) is allocable to the activity under section 469(b) for the taxable year.

(2) ''Former passive activity expenditure'' means an expenditure that is taken into account under section 469 in computing the income or loss from a former passive activity of the taxpayer or an expenditure (including an expenditure properly chargeable to capital account) that would be so taken into account if such expenditure were otherwise deductible.

(3) ''Investment expenditure'' means an expenditure (other than a passive activity expenditure) properly chargeable to capital account with respect to property held for investment (within the meaning of section 163(d)(5)(A)) or an expenditure in connection with the holding of such property.

(4) ''Passive activity expenditure'' means an expenditure that is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer or an expenditure (including an expenditure properly chargeable to capital account) that would be so taken into account if such expenditure were otherwise deductible. For purposes of this section, the term ''passive activity expenditure'' does not include any expenditure with respect to any low-income housing project in any taxable year in which any benefit is allowed with respect to such project under section 502 of the Tax Reform Act of 1986.

(5) ''Personal expenditure'' means an expenditure that is not a trade or business expenditure, a passive activity expenditure, or an investment expenditure.

(6) ''Portfolio expenditure'' means an investment expenditure properly chargeable to capital account with respect to property producing income of a type described in section 469(e)(1)(A) or an investment expenditure for an expense clearly and directly allocable to such income.

(7) ''Trade or business expenditure'' means an expenditure (other than a passive activity expenditure or an investment expenditure) in connection with the conduct of any trade or business other than the trade or business of performing services as an employee.

(c) *Allocation of debt and interest expense*—(1) *Allocation in accordance with use of proceeds.* Debt is allocated to expenditures in accordance with the use of the debt proceeds and, except as provided in paragraph (m) of this section, interest expense accruing on a debt during any period is allocated to expenditures in the same manner as the debt is allocated from time to time during such period. Except as provided in paragraph (m) of this section, debt proceeds and related interest expense are allocated solely by reference to the use of such proceeds, and the allocation is not affected by the use of an interest in any property to secure the repayment of such debt or interest. The following example illustrates the principles of this paragraph (c)(1):

Example. Taxpayer A, an individual, pledges corporate stock held for investment as security for a loan and uses the debt proceeds to purchase an automobile for personal use. Interest expense accruing on the debt is allocated to the personal expenditure to purchase the automobile even though the debt is secured by investment property.

(2) *Allocation period*—(i) *Allocation of debt.* Debt is allocated to an expenditure for the period beginning on the date the proceeds of the debt are used or treated as used under the rules of this section to make the expenditure and ending on the earlier of—

(A) The date the debt is repaid; or

(B) The date the debt is reallocated in accordance with the rules in paragraphs (c)(4) and (j) of this section.

(ii) *Allocation of interest expense*—(A) *In general*. Except as otherwise provided in paragraph (m) of this section, interest expense accruing on a debt for any period is allocated in the same manner as the debt is allocated from time to time, regardless of when the interest is paid.

(B) *Effect of compounding*. Accrued interest is treated as a debt until it is paid and any interest accruing on unpaid interest is allocated in the same manner as the unpaid interest is allocated. For the taxable year in which a debt is reallocated under the rules in paragraphs (c)(4) and (j) of this section, however, compound interest accruing on such debt (other than compound interest accruing on interest that accrued before the beginning of the year) may be allocated between the original expenditure and the new expenditure on a straight-line basis (*i.e.*, by allocating an equal amount of such interest expense to each day during the taxable year). In addition, a taxpayer may treat a year as consisting of 12 30-day months for purposes of allocating interest on a straight-line basis.

(C) *Accrual of interest expense*. For purposes of this paragraph (c)(2)(ii), the amount of interest expense that accrues during any period is determined by taking into account relevant provisions of the loan agreement and any applicable law such as sections 163(e), 483, and 1271 through 1275.

(iii) *Examples*. The following examples illustrate the principles of this paragraph (c)(2):

Example 1. (i) On January 1, taxpayer B, a calendar year taxpayer, borrows $1,000 at an interest rate of 11 percent, compounded semiannually. B immediately uses the debt proceeds to purchase an investment security. On July 1, B sells the investment security for $1,000 and uses the sales proceeds to make a passive activity expenditure. On December 31, B pays accrued interest on the $1,000 debt for the entire year.

(ii) Under this paragraph (c)(2) and paragraph (j) of this section, the $1,000 debt is allocated to the investment expenditure for the period from January 1 through June 30, and to the passive activity expenditure from July 1 through December 31. Interest expense accruing on the $1,000 debt is allocated in accordance with the allocation of the debt from time to time during the year even though the debt was allocated to the passive activity expenditure on the date the interest was paid. Thus, the $55 interest expense for the period from January 1 through June 30 is allocated to the investment expenditure. In addition, during the period from July 1 through December 31, the interest expense allocated to the investment expenditure is a debt, the proceeds of which are treated as used to make an investment expenditure. Accordingly, an additional $3 of interest expense for the period from July 1 through December 31 ($55 × .055) is allocated to the investment expenditure. The remaining $55 of interest expense for the period from July 1 through December 31 ($1,000 × .055) is allocated to the passive activity expenditure.

(iii) Alternatively, under the rule in paragraph (c)(2)(ii)(B) of this section, B may allocate the interest expense on a straight-line basis and may also treat the year as consisting of 12 30-day months for this purpose. In that case, $56.50 of interest expense (180/360 × $113) would be allocated to the investment expenditure and the remaining $56.50 of interest expense would be allocated to the passive activity expenditure.

Example 2. On January 1, 1988, taxpayer C borrows $10,000 at an interest rate of 11 percent, compounded annually. All interest and principal on the debt is payable in a lump sum on December 31, 1992. C immediately uses the debt proceeds to make a passive activity expenditure. C materially participates in the activity in 1990, 1991, and 1992. Therefore, under paragraphs (c)(2) (i) and (j) of this section, the debt is allocated to a passive activity expenditure from January 1, 1988, through December 31, 1989, and to a former passive activity expenditure from January 1, 1990, through December 31, 1992. In accordance with the loan agreement (and consistent with §1.1272–1(d)(1) of the proposed regulations, 51 FR 12022, April 8, 1986), interest expense accruing during any period is determined on the basis of annual compounding. Accordingly, the interest expense on the debt is allocated as follows:

Year	Amount		Expenditure
1988	$10,000 × .11	$1,100	Passive activity.
1989	11,100 × .11	1,221	Passive activity.
1990	12,321 × .11 = 1,355	....	
	1,355 × 2,321/12,321	255	Passive activity.
	1,355 × 10,000/12,321	1,100	Former passive activity.
		1,355	
1991	13,676 × .11 = 1,504	....	

Year	Amount		Expenditure
	1,504 × 2,576/13,676	283	Passive activity.
	1,504 × 11,100/13,676	1,221	Former passive activity.
		1,504	
1992	15,180 × .11 = 1,670	....	
	1,670 × 2,859/15,180	315	Passive activity.
	1,670 × 12,321/15,180	1,355	Former passive activity.
		1,670	

(3) *Allocation of debt; proceeds not disbursed to borrower*—(i) *Third-party financing.* If a lender disburses debt proceeds to a person other than the borrower in consideration for the sale or use of property, for services, or for any other purpose, the debt is treated for purposes of this section as if the borrower used an amount of the debt proceeds equal to such disbursement to make an expenditure for such property, services, or other purpose.

(ii) *Debt assumptions not involving cash disbursements.* If a taxpayer incurs or assumes a debt in consideration for the sale or use of property, for services, or for any other purpose, or takes property subject to a debt, and no debt proceeds are disbursed to the taxpayer, the debt is treated for purposes of this section as if the taxpayer used an amount of the debt proceeds equal to the balance of the debt outstanding at such time to make an expenditure for such property, services, or other purpose.

(4) *Allocation of debt; proceeds deposited in borrower's account*—(i) *Treatment of deposit.* For purposes of this section, a deposit of debt proceeds in an account is treated as an investment expenditure, and amounts held in an account (whether or not interest bearing) are treated as property held for investment. Debt allocated to an account under this paragraph (c)(4)(i) must be reallocated as required by paragraph (j) of this section whenever debt proceeds held in the account are used for another expenditure. This paragraph (c)(4) provides rules for determining when debt proceeds are expended from the account. The following example illustrates the principles of this paragraph (c)(4)(i):

Example. Taxpayer C, a calendar year taxpayer, borrows $100,000 on January 1 and immediately uses the proceeds to open a non-interest-bearing checking account. No other amounts are deposited in the account during the year, and no portion of the principal amount of the debt is repaid during the year. On April 1, C uses $20,000 of the debt proceeds held in the account for a passive activity expenditure. On September 1, C uses an additional $40,000 of the debt proceeds held in the account for a personal expenditure. Under this paragraph (c)(4)(i), from January 1 through March 31 the entire $100,000 debt is allocated to an investment expenditure for the account. From April 1 through August 31, $20,000 of the debt is allocated to the passive activity expenditure, and $80,000 of the debt is allocated to the investment expenditure for the account. From September 1 through December 31, $40,000 of the debt is allocated to the personal expenditure, $20,000 is allocated to the passive activity expenditure, and $40,000 is allocated to an investment expenditure for the account.

(ii) *Expenditures from account; general ordering rule.* Except as provided in paragraph (c)(4)(iii) (B) or (C) of this section, debt proceeds deposited in an account are treated as expended before—

(A) Any unborrowed amounts held in the account at the time such debt proceeds are deposited; and

(B) Any amounts (borrowed or unborrowed) that are deposited in the account after such debt proceeds are deposited.

The following example illustrates the application of this paragraph (c)(4)(ii):

Example. On January 10, taxpayer E opens a checking account, depositing $500 of proceeds of Debt A and $1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account:

Date	Transaction
Jan. 10	$500 proceeds of Debt A and $1,000 unborowed funds deposited.
Jan. 11	$500 proceeds of Debt B deposited.
Feb. 17	$800 personal expenditure.
Feb. 26	$700 passive activity expenditure.
June 21	$1,000 proceeds of Debt C deposited.
Nov. 24	$800 investment expenditure.

Date	Transaction
Dec. 20	$600 personal expenditure.

The $800 personal expenditure is treated as made from the $500 proceeds of Debt A and $300 of the proceeds of Debt B. The $700 passive activity expenditure is treated as made from the remaining $200 proceeds of Debt B and $500 of unborrowed funds. The $800 investment expenditure is treated as made entirely from the proceeds of Debt C. The $600 personal expenditure is treated as made from the remaining $200 proceeds of Debt C and $400 of unborrowed funds. Under paragraph (c)(4)(i) of this section, debt is allocated to an investment expenditure for periods during which debt proceeds are held in the account.

(iii) *Expenditures from account; supplemental ordering rules*—(A) *Checking or similar accounts.* Except as otherwise provided in this paragraph (c)(4)(iii), an expenditure from a checking or similar account is treated as made at the time the check is written on the account, provided the check is delivered or mailed to the payee within a reasonable period after the writing of the check. For this purpose, the taxpayer may treat checks written on the same day as written in any order. In the absence of evidence to the contrary, a check is presumed to be written on the date appearing on the check and to be delivered or mailed to the payee within a reasonable period thereafter. Evidence to the contrary may include the fact that a check does not clear within a reasonable period after the date appearing on the check.

(B) *Expenditures within 15 days after deposit of borrowed funds.* The taxpayer may treat any expenditure made from an account within 15 days after debt proceeds are deposited in such account as made from such proceeds to the extent thereof even if under paragraph (c)(4)(ii) of this section the debt proceeds would be treated as used to make one or more other expenditures. Any such expenditures and the debt proceeds from which such expenditures are treated as made are disregarded in applying paragraph (c)(4)(ii) of this section. The following examples illustrate the application of this paragraph (c)(4)(iii)(B):

Example 1. Taxpayer D incurs a $1,000 debt on June 5 and immediately deposits the proceeds in an account (''Account A''). On June 17, D transfers $2,000 from Account A to another account (''Account B''). On June 30, D writes a $1,500 check on Account B for a passive activity expenditure. In addition, numerous deposits of borrowed and unborrowed amounts and expenditures occur with respect to both accounts throughout the month of June. Notwithstanding these other transactions, D may treat $1,000 of the deposit to Account B on June 17 as an expenditure from the debt proceeds deposited in Account A on June 5. In addition, D may similarly treat $1,000 of the passive activity expenditure on June 30 as made from debt proceeds treated as deposited in Account B on June 17.

Example 2. The facts are the same as in the example in paragraph (c)(4)(ii) of this section, except that the proceeds of Debt B are deposited on February 11 rather than on January 11. Since the $700 passive activity expenditure occurs within 15 days after the proceeds of Debt B are deposited in the account, E may treat such expenditure as being made from the proceeds of Debt B to the extent thereof. If E treats the passive activity expenditure in this manner, the expenditures from the account are treated as follows: The $800 personal expenditure is treated as made from the $500 proceeds of Debt A and $300 of unborrowed funds. The $700 passive activity expenditure is treated as made from the $500 proceeds of Debt B and $200 of unborrowed funds. The remaining expenditures are treated as in the example in paragraph (c)(4)(ii) of this section.

(C) *Interest on segregated account.* In the case of an account consisting solely of the proceeds of a debt and interest earned on such account, the taxpayer may treat any expenditure from such account as made first from amounts constituting interest (rather than debt proceeds) to the extent of the balance of such interest in the account at the time of the expenditure, determined by applying the rules in this paragraph (c)(4). To the extent any expenditure is treated as made from interest under this paragraph (c)(4)(iii)(C), the expenditure is disregarded in applying paragraph (c)(4)(ii) of this section.

(iv) *Optional method for determining date of reallocation.* Solely for the purpose of determining the date on which debt allocated to an account under paragraph (c)(4)(i) of this section is reallocated, the taxpayer may treat all expenditures made during any calendar month from debt proceeds in the account as occurring on the later of the first day of such month or the date on which such debt proceeds are deposited in the account. This paragraph (c)(4)(iv) applies only if all expenditures from an account during the same calendar month are similarly treated. The following example illustrates the application of this paragraph (c)(4)(iv):

Example. On January 10, taxpayer G opens a checking account, depositing $500 of proceeds of Debt A and $1,000 of unborrowed funds. The following chart summarizes the transactions which occur during the year with respect to the account (note that these facts are the same as the facts of the example in paragraph (c)(4)(ii) of this section):

Date	Transaction
Jan. 10	$500 proceeds of Debt A and $1,000 unborrowed funds deposited.
Jan. 11	$500 proceeds of Debt B deposited.
Feb. 17	$800 personal expenditure.
Feb. 26	$700 passive activity expenditure.
June 21	$1,000 proceeds of Debt C deposited.
Nov. 24	$800 investment expenditure.
Dec. 20	$600 personal expenditure.

Assume that G chooses to apply the optional rule of this paragraph (c)(4)(iv) to all expenditures. For purposes of determining the date on which debt is allocated to the $800 personal expenditure made on February 17, the $500 treated as made from the proceeds of Debt A and the $300 treated as made from the proceeds of Debt B are treated as expenditures occurring on February 1. Accordingly, Debt A is allocated to an investment expenditure for the account from January 10 through January 31 and to the personal expenditure from February 1 through December 31, and $300 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the personal expenditure from February 1 through December 31. The remaining $200 of Debt B is allocated to an investment expenditure for the account from January 11 through January 31 and to the passive activity expenditure from February 1 through December 31. The $800 of Debt C used to make the investment expenditure on November 24 is allocated to an investment expenditure for the account from June 21 through October 31 and to an investment expenditure from November 1 through December 31. The remaining $200 of Debt C is allocated to an investment expenditure for the account from June 21 through November 30 and to a personal expenditure from December 1 through December 31.

(v) *Simultaneous deposits*—(A) *In general.* If the proceeds of two or more debts are deposited in an account simultaneously, such proceeds are treated for purposes of this paragraph (c)(4) as deposited in the order in which the debts were incurred.

(B) *Order in which debts incurred.* If two or more debts are incurred simultaneously or are treated under applicable law as incurred simultaneously, the debts are treated for purposes of this paragraph (c)(4)(v) as incurred in any order the taxpayer selects.

(C) *Borrowings on which interest accrues at different rates.* If interest does not accrue at the same fixed or variable rate on the entire amount of a borrowing, each portion of the borrowing on which interest accrues at a different fixed or variable rate is treated as a separate debt for purposes of this paragraph (c)(4)(v).

(vi) *Multiple accounts.* The rules in this paragraph (c)(4) apply separately to each account of a taxpayer.

(5) *Allocation of debt; proceeds received in cash*—(i) *Expenditure within 15 days of receiving debt proceeds.* If a taxpayer receives the proceeds of a debt in cash, the taxpayer may treat any cash expenditure made within 15 days after receiving the cash as made from such debt proceeds to the extent thereof and may treat such expenditure as made on the date the taxpayer received the cash. The following example illustrates the rule in this paragraph (c)(5)(i):

Example. Taxpayer F incurs a $1,000 debt on August 4 and receives the debt proceeds in cash. F deposits $1,500 cash in an account on August 15 and on August 27 writes a check on the account for a passive activity expenditure. In addition, F engages in numerous other cash transactions throughout the month of August, and numerous deposits of borrowed and unborrowed amounts and expenditures occur with respect to the account during the same period. Notwithstanding these other transactions, F may treat $1,000 of the deposit on August 15 as an expenditure made from the debt proceeds on August 4. In addition, under the rule in paragraph (c)(4)(v)(B) of this section, F may treat the passive activity expenditure on August 27 as made from the $1,000 debt proceeds treated as deposited in the account.

(ii) *Other expenditures.* Except as provided in paragraphs (c)(5) (i) and (iii) of this section, any debt proceeds a taxpayer (other than a corporation) receives in cash are treated as used to make personal expenditures. For purposes of this paragraph (c)(5), debt proceeds are received in cash if, for example, a withdrawal of cash from an account is treated under the rules of this section as an expenditure of debt proceeds.

(iii) *Special rules for certain taxpayers.* [Reserved]

(6) *Special rules*—(i) *Qualified residence debt.* [Reserved]

(ii) *Debt used to pay interest.* To the extent proceeds of a debt are used to pay interest, such debt is allocated in the same manner as the debt on which such interest accrued is allocated from time to time. The following example illustrates the application of this paragraph (c)(6)(ii):

Example. On January 1, taxpayer H incurs a debt of $1,000, bearing interest at an annual rate of 10 percent, compounded annually, payable at the end of each year (''Debt A''). H immediately opens a checking account, in which H deposits the proceeds of Debt A. No other amounts are deposited in the account during the year. On April 1, H writes a check for a personal expenditure in the amount of $1,000. On December 31, H borrows $100 (''Debt B'') and immediately uses the proceeds of Debt B to pay the accrued interest of $100 on Debt A. From January 1 through March 31, Debt A is allocated, under the rule in paragraph (c)(4)(i) of this section, to the investment expenditure for the account. From April 1 through December 31, Debt A is allocated to the personal expenditure. Under the rule in paragraph (c)(2)(ii) of this section, $25 of the interest on Debt A for the year is allocated to the investment expenditure, and $75 of the interest on Debt A for the year is allocated to the personal expenditure. Accordingly, for the purpose of allocating the interest on Debt B for all periods until Debt B is repaid, $25 of Debt B is allocated to the investment expenditure, and $75 of Debt B is allocated to the personal expenditure.

(iii) *Debt used to pay borrowing costs*—(A) *Borrowing costs with respect to different debt.* To the extent the proceeds of a debt (the ''ancillary debt'') are used to pay borrowing costs (other than interest) with respect to another debt (the ''primary debt''), the ancillary debt is allocated in the same manner as the primary debt is allocated from time to time. To the extent the primary debt is repaid, the ancillary debt will continue to be allocated in the same manner as the primary debt was allocated immediately before its repayment. The following example illustrates the rule in this paragraph (c)(6)(iii)(A):

Example. Taxpayer I incurs debts of $60,000 (''Debt A'') and $10,000 (''Debt B''). I immediately uses $30,000 of the proceeds of Debt A to make a trade or business expenditure, $20,000 to make a passive activity expenditure, and $10,000 to make an investment expenditure. I immediately use $3,000 of the proceeds of Debt B to pay borrowing costs (other than interest) with respect to Debt A (such as loan origination, loan commitment, abstract, and recording fees) and deposits the remaining $7,000 in an account. Under the rule in this paragraph (c)(6)(iii)(A), the $3,000 of Debt B used to pay expenses of incurring Debt A is allocated $1,500 to the trade or business expenditure ($3,000 × $30,000/$60,000), $1,000 to the passive activity expenditure ($3,000 × $20,000/$60,000), and $500 ($3,000 × $10,000/$60,000) to the investment expenditure. The manner in which the $3,000 of Debt B used to pay expenses of incurring Debt A is allocated may change if the allocation of Debt A changes, but such allocation will be unaffected by any repayment of Debt A. The remaining $7,000 of Debt B is allocated to an investment expenditure for the account until such time, if any, as this amount is used for a different expenditure.

(B) *Borrowing costs with respect to same debt.* To the extent the proceeds of a debt are used to pay borrowing costs (other than interest) with respect to such debt, such debt is allocated in the same manner as the remaining debt is allocated from time to time. The remaining debt for this purpose is the portion of the debt that is not used to pay borrowing costs (other than interst) with respect to such debt. Any repayment of the debt is treated as a repayment of the debt allocated under this paragraph (c)(6)(iii)(B) and the remaining debt is the same proportion as such amount bear to each other. The following example illustrates the application of this paragraph (c)(6)(iii)(B):

Example. (i) Taxpayer J borrows $85,000. The lender disburses $80,000 of this amount to J, retaining $5,000 for borrowing costs (other than interest) with respect to the loan. J immediately uses $40,000 of the debt proceeds to make a personal expenditure, $20,000 to make a passive activity expenditure, and $20,000 to make an investment expenditure. Under the rule in this paragraph (c)(6)(iii)(B), the $5,000 used to pay borrowing costs is allocated $2,500 ($5,000 × $40,000/$80,000) to the personal expenditure, $1,250 ($5,000 × $20,000/$80,000) to the investment expenditure. The manner in which this $5,000 is allocated may change if the allocation of the remaining $80,000 of debt is changed.

(ii) Assume that J repays $50,000 of the debt. The repayment is treated as a repayment of $2,941 ($50,000 × $5,000/$85,000) of the debt used to pay borrowing costs and a repayment of $47,059 ($50,000 × $80,000/$85,000) of the remaining debt. Under paragraph (d) of this section, J is treated as repaying the $42,500 of debt allocated to the personal expenditure ($2,500 of debt used to pay borrowing costs and $40,000 of remaining debt). In addition, assuming that under paragraph (d)(2) J chooses to treat the allocation to the passive activity expenditure as having occurred before the allocation to the investment expenditure, J is treated as repaying $7,500 of debt allocated to the passive activity expenditure ($441 of debt used to pay borrowing costs and $7,059 of remaining debt).

(iv) *Allocation of debt before actual receipt of debt proceeds.* If interest properly accrues on a debt during any period before the debt proceeds are actually received or used to make an expenditure, the debt is allocated to an investment expenditure for such period.

(7) *Antiabuse rules.* [Reserved]

(d) *Debt repayments*—(1) *General ordering rule.* If, at the time any portion of a debt is repaid, such debt is allocated to more than one expenditure, the debt is treated for purposes of this section as repaid in the following order:

(i) Amounts allocated to personal expenditures;

(ii) Amounts allocated to investment expenditures and passive activity expenditures (other than passive activity expenditures described in paragraph (d)(1)(iii) of this section);

(iii) Amounts allocated to passive activity expenditures in connection with a rental real estate activity with respect to which the taxpayer actively participates (within the meaning of section 469(i));

(iv) Amounts allocated to former passive activity expenditures; and

(v) Amounts allocated to trade or business expenditures and to expenditures described in the last sentence of paragraph (b)(4) of this section.

(2) *Supplemental ordering rules for expenditures in same class.* Amounts allocated to two or more expenditures that are described in the subdivision of paragraph (d)(1) of this section (e.g., amounts allocated to different personal expenditures) are treated as repaid in the order in which the amounts were allocated (or reallocated) to such expenditures. For purposes of this paragraph (d)(2), the taxpayer may treat allocations and reallocations that occur on the same day as occurring in any order (without regard to the order in which expenditures are treated as made under paragraph (c)(4)(iii)(A) of this section).

(3) *Continuous borrowings.* In the case of borrowings pursuant to a line of credit or similar account or arrangement that allows a taxpayer to borrow funds periodically under a single loan agreement—

(i) All borrowings on which interest accrues at the same fixed or variable rate are treated as a single debt; and

(ii) Borrowings or portions of borrowings on which interest accrues at different fixed or variable rates are treated as different debts, and such debts are treated as repaid for purposes of this paragraph (d) in the order in which such borrowings are treated as repaid under the loan agreement.

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

Example 1. Taxpayer B borrows $100,000 (''Debt A'') on July 12, immediately deposits the proceeds in an account, and uses the debt proceeds to make the following expenditures on the following dates:

August 31—$40,000 passive activity expenditure #1.

October 5—$20,000 passive activity expenditure #2.

December 24—$40,000 personal expenditure.

On January 19 of the following year, B repays $90,000 of Debt A (leaving $10,000 of Debt A outstanding). The $40,000 of Debt A allocated to the personal expenditure, the $40,000 allocated to passive activity expenditure #1, and $10,000 of the $20,000 allocated to passive activity expenditure #2 are treated as repaid.

Example 2. (i) Taxpayer A obtains a line of credit. Interest on any borrowing on the line of credit accrues at the lender's ''prime lending rate'' on the date of the borrowing plus two percentage points. The loan documents provide that borrowings on the line of credit are treated as repaid in the order the borrowings were made. A borrows $30,000 (''Borrowing #1'') on the line of credit and immediately uses $20,000 of the debt proceeds to make a personal expenditure (''personal expenditure #1'') and $10,000 to make a trade or business expenditure (''trade or business expenditure #1''). A subsequently borrows another $20,000 (''Borrowing #2'') on the line of credit and immediately uses $15,000 of the debt proceeds to make a personal expenditure (''personal expenditure #2'') and $5,000 to make a trade or business expenditure (''trade or business expenditure #2''). A then repays $40,000 of the borrowings.

(ii) If the prime lending rate plus two percentage points was the same on both the date of Borrowing #1 and the date of Borrowing #2, the borrowings are treated for purposes of this paragraph (d) as a single debt, and A is treated as having repaid $35,000 of debt allocated to personal expenditure #1 and personal expenditure #2, and $5,000 of debt allocated to trade or business expenditure #1.

(iii) If the prime lending rate plus two percentage points was different on the date of Borrowing #1 and Borrowing #2, the borrowings are treated as two debts, and, in accordance with the loan agreement, the $40,000 repaid amount is treated as a repayment of Borrowing #1 and $10,000 of Borrowing #2. Accordingly, A is treated as having repaid $20,000 of debt allocated to personal expenditure #1, $10,000 of debt allocated to trade or business expenditure #1, and $10,000 of debt allocated to personal expenditure #2.

(e) *Debt refinancings*—(1) *In general.* To the extent proceeds of any debt (the ''replacement debt'') are used to repay any portion of a debt, the replacement debt is allocated to the expenditures to which the repaid debt was allocated. The amount of replacement debt allocated to any such expenditure is equal to the amount of debt allocated to such expenditure that was repaid with proceeds of the replacement debt. To the extent proceeds of the replacement debt are used for expenditures other than repayment of a debt, the replacement debt is allocated to expenditures in accordance with the rules of this section.

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

Example. Taxpayer C borrows $100,000 (''Debt A'') on July 12, immediately deposits the debt proceeds in an account, and uses the proceeds to make the following expenditures on the following dates (note that the facts of this example are the same as the facts of example (1) in paragraph (d)(4) of this section):

August 31—$40,000 passive activity expenditure #1.

October 5—$20,000 passive activity expenditure #2.

December 24—$40,000 personal expenditure #1.

On January 19 of the following year, C borrows $120,000 (''Debt B'') and uses $90,000 of the proceeds of repay $90,000 of Debt A (leaving $10,000 of Debt A outstanding). In addition, C uses $30,000 of the proceeds of Debt B to make a personal expenditure (''personal expenditure #2''). Debt B is allocated $40,000 to personal expenditure #1, $40,000 to passive activity expenditure #1, $10,000 to passive activity expenditure #2, and $30,000 to personal expenditure #2. Under paragraph (d)(1) of this section, Debt B will be treated as repaid in the following order: (1) amounts allocated to personal expenditure #1, (2) amounts allocated to personal expenditure #2, (3) amounts allocated to passive activity expenditure #1, and (4) amounts allocated to passive activity expenditure #2.

(f) *Debt allocated to distributions by passthrough entities.* [Reserved]

(g) *Repayment of passthrough entity debt.* [Reserved]

(h) *Debt allocated to expenditures for interests in passthrough entities.* [Reserved]

(i) *Allocation of debt to loans between passthrough entities and interest holders.* [Reserved]

(j) *Reallocation of debt*—(1) *Debt allocated to capital expenditures*—(i) *Time of reallocation.* Except as provided in paragraph (j)(2) of this section, debt allocated to an expenditure properly chargeable to capital account with respect to an asset (the ''first expenditure'') is reallocated to another expenditure on the earlier of—

(A) The date on which proceeds from a disposition of such asset are used for another expenditure; or

(B) The date on which the character of the first expenditure changes (e.g., from a passive activity expenditure to an expenditure that is not a passive activity expenditure) by reason of a change in the use of the asset with respect to which the first expenditure was capitalized.

(ii) *Limitation on amount reallocated.* The amount of debt reallocated under paragraph (j)(1)(i)(A) of this section may not exceed the proceeds from the disposition of the asset. The amount of debt reallocated under paragraph (j)(1)(i)(B) of this section may not exceed the fair market value of the asset on the date of the change in use. In applying this paragraph (j)(1)(ii) with respect to a debt in any case in which two or more debts are allocable to expenditures properly chargeable to capital account with respect to the same asset, only a ratable portion (determined with respect to any such debt by dividing the amount of such debt by the aggregate amount of all such debts) of the fair market value or proceeds from the disposition of such asset shall be taken into account.

(iii) *Treatment of loans made by the taxpayer*. Except as provided in paragraph (j)(1)(iv) of this section, an expenditure to make a loan is treated as an expenditure properly chargeable to capital account with respect to an asset, and for purposes of paragraph (j)(1)(i)(A) of this section any repayment of the loan is treated as a disposition of the asset. Paragraph (j)(3) of this section applies to any repayment of a loan in installments.

(iv) *Treatment of accounts*. Debt allocated to an account under paragraph (c)(4)(i) of this section is treated as allocated to an expenditure properly chargeable to capital account with respect to an asset, and any expenditure from the account is treated as a disposition of the asset. See paragraph (c)(4) of this section for rules under which debt proceeds allocated to an account are treated as used for another expenditure.

(2) *Disposition proceeds in excess of debt*. If the proceeds from the disposition of an asset exceed the amount of debt reallocated by reason of such disposition, or two or more debts are reallocated by reason of the disposition of an asset, the proceeds of the disposition are treated as an account to which the rules in paragraph (c)(4) of this section apply.

(3) *Special rule for deferred payment sales*. If any portion of the proceeds of a disposition of an asset are received subsequent to the disposition—

(i) The portion of the proceeds to be received subsequent to the disposition is treated for periods prior to the receipt as used to make an investment expenditure; and

(ii) Debt reallocated by reason of the disposition is allocated to such investment expenditure to the extent such debt exceeds the proceeds of the disposition previously received (other than proceeds used to repay such debt).

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

Example 1. On January 1, 1988, taxpayer D sells an asset for $25,000. Immediately before the sale, the amount of debt allocated to expenditures properly chargeable to capital account with respect to the asset was $15,000. The proceeds of the disposition are treated as an account consisting of $15,000 of debt proceeds and $10,000 of unborrowed funds to which paragraph (c)(4) of this section applies. Thus, if D immediately makes a $10,000 personal expenditure from the proceeds and within 15 days deposits the remaining proceeds in an account, D may, pursuant to paragraph (c)(4)(iii)(B) of this section, treat the entire $15,000 deposited in the account as proceeds of a debt.

Example 2. The facts are the same as in example (1) except that, instead of receiving all $25,000 of the sale proceeds on January 1, 1988, D receives 5,000 on that date, $10,000 on January 1, 1989, and $10,000 on January 1, 1990. D does not use any portion of the sale proceeds to repay the debt. Between January 1, 1988, and December 31, 1988, D is treated under paragraph (j)(3) of this section as making an investment expenditure of $20,000 to which $10,000 of debt is allocated. In addition, the remaining $5,000 of debt is reallocated on January 1, 1988, in accordance with D's use of the sales proceeds received on that date. Between January 1, 1989, and December 31, 1989, D is treated as making an investment expenditure of $10,000 to which no debt is allocated. In addition, as of January 1, 1989, $10,000 of debt is reallocated in accordance with D's use of the sales proceeds received on that date.

Example 3. The facts are the same as in example (2), except that D immediately uses the $5,000 sale proceeds received on January 1, 1988, to repay $5,000 of the $15,000 debt. Between January 1, 1988, and December 31, 1988, D is treated as making an investment expenditure of $20,000 to which the remaining balance ($10,000) of the debt is reallocated. The results in 1989 are as described in example (2).

(k) *Modification of rules in the case of interest expense allocated to foreign source income*. [Reserved]

(l) [Reserved]

(m) *Coordination with other provisions*—(1) *Effect of other limitations*—(i) *In general*. All debt is allocated among expenditures pursuant to the rules in this section, without regard to any limitations on the deductibility of interest expense on such debt. The applicability of the passive loss and nonbusiness interest limitations to interest on such debt, however, may be affected by other limitations on the deductibility of interest expense.

(ii) *Disallowance provisions.* (Interest expense that is not allowable as a deduction by reason of a disallowance provision (within the meaning of paragraph (m)(7)(ii) of this section) is not taken into account for any taxable year for purposes of applying the passive loss and nonbusiness interest limitations.

(iii) *Deferral provisions.* Interest expense that is not allowable as a deduction for the taxable year in which paid or accrued by reason of a deferral provision (within the meaning of paragraph (m)(7)(iii) of this section) is allocated in the same manner as the debt giving rise to the interest expense is allocated for such taxable year. Such interest expense is taken into account for purposes of applying the passive loss and nonbusiness interest limitations for the taxable year in which such interest expense is allowable under such deferral provision.

(iv) *Capitalization provisions.* Interest expense that is capitalized pursuant to a capitalization provision (within the meaning of paragraph (m)(7)(i) of this section) is not taken into account as interest for any taxable year for purposes of applying the passive loss and nonbusiness interest limitations.

(2) *Effect on other limitations*—(i) *General rule.* Except as provided in paragraph (m)(2)(ii) of this section, any limitation on the deductibility of an item (other than the passive loss and nonbusiness interest limitations) applies without regard to the manner in which debt is allocated under this section. Thus, for example, interest expense treated under section 265(a)(2) as interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax is not deductible regardless of the expenditure to which the underlying debt is allocated under this section.

(ii) *Exception.* Capitalization provisions (within the meaning of paragraph (m)(7)(i) of this section) do not apply to interest expense allocated to any personal expenditure under the rules of this section.

(3) *Qualified residence interest.* Qualified residence interest (within the meaning of section 163(h)(3)) is allowable as a deduction without regard to the manner in which such interest expense is allocated under the rules of this section. In addition, qualified residence interest is not taken into account in determining the income or loss from any activity for purposes of section 469 or in determining the amount of investment interest for purposes of section 163(d). The following example illustrates the rule in this paragraph (m)(3):

Example. Taxpayer E, an individual, incurs a $20,000 debt secured by a residence and immediately uses the proceeds to purchase an automobile exclusively for E's personal use. Under the rules in this section, the debt and interest expense on the debt are allocated to a personal expenditure. If, however, the interest on the debt is qualified residence interest within the meaning of section 163(h)(3), the interest is not treated as personal interest for purposes of section 163(h).

(4) *Interest described in section 163(h)(2)(E).* Interest described in section 163(h)(2)(E) is allowable as a deduction without regard to the rules of this section.

(5) *Interest on deemed distributee debt.* [Reserved]

(6) *Examples.* The following examples illustrate the relationship between the passive loss and nonbusiness interest limitations and other limitations on the deductibility of interest expense:

Example 1. Debt is allocated pursuant to the rules in this section to an investment expenditure for the purchase of taxable investment securities. Pursuant to section 265(a)(2), the debt is treated as indebtedness incurred or continued to purchase or carry obligations the interest on which is wholly exempt from Federal income tax, and, accordingly, interest on the debt is disallowed. If section 265(a)(2) subsequently ceases to apply (because, for example, the taxpayer ceases to hold any tax-exempt obligations), and the debt at such time continues to be allocated to an investment expenditure, interest on the debt that accrues after such time is subject to section 163(d).

Example 2. An accrual method taxpayer incurs a debt payable to a cash method lender who is related to the taxpayer within the meaning of section 267(b). During the period in which interest on the debt is not deductible by reason of section 267(a)(2), the debt is allocated to a passive activity expenditure. Thus, interest that accrues on the debt for such period is also allocated to the passive activity expenditure. When such interest expense becomes deductible under section 267(a)(2), it will be allocated to the passive activity expenditure, regardless of how the debt is allocated at such time.

Example 3. A taxpayer incurs debt that is allocated under the rules of this section to an investment expenditure. Under section 263A(f), however, interest expense on such debt is capitalized during the production period (within the meaning of section 263A(f)(4)(B)) of property used in a passive activity of the taxpayer. The capitalized interest expense is not allocated to the investment expenditure, and depreciation deductions attributable to the capitalized interest expense are subject to the passive loss limitation as long as the property is used in a passive activity. However, interest expense on the debt for periods after the production period is allocated to the investment expenditure as long as the debt remains allocated to the investment expenditure.

(7) *Other limitations on interest expense*—(i) *Capitalization provisions.* A capitalization provision is any provision that requires or allows interest expense to be capitalized. Capitalization provisions include sections 263(g), 263A(f), and 266.

(ii) *Disallowance provisions.* A disallowance provision is any provision (other than the passive loss and nonbusiness interest limitations) that disallows a deduction for interest expense for all taxable years and is not a capitalization provision. Disallowance provisions include sections 163(f)(2), 264(a)(2), 264(a)(4), 265(a)(2), 265(b)(2), 279(a), 291(e)(1)(B)(ii), 805(b)(1), and 834(c)(5).

(iii) *Deferral provisions.* A deferral provision is any provision (other than the passive loss and nonbusiness interest limitations) that disallows a deduction for interest expense for any taxable year and is not a capitalization or disallowance provision. Deferral provisions include sections 267(a)(2), 465, 1277, and 1282.

(n) *Effective date*—(1) *In general.* This section applies to interest expense paid or accrued in taxable years beginning after December 31, 1986.

(2) *Transitional rule for certain expenditures.* For purposes of determining whether debt is allocated to expenditures made on or before August 3, 1987, paragraphs (c)(4)(iii)(B) and (c)(5)(i) of this section are applied by substituting ''90 days'' for ''15 days.''

(3) *Transitional rule for certain debt*—(i) *General rule.* Except as provided in paragraph (n)(3)(ii) of this section, any debt outstanding on December 31, 1986, that is properly attributable to a business or rental activity is treated for purposes of this section as debt allocated to expenditures properly chargeable to capital account with respect to the assets held for use or for sale to customers in such business or rental activity. Debt is properly attributable to a business or rental activity for purposes of this section (regardless of whether such debt otherwise would be allocable under this section to expenditures in connection with such activity) if the taxpayer has properly and consistently deducted interest expense (including interest subject to limitation under section 163(d) as in effect prior to the Tax Reform Act of 1986) on such debt on Schedule C, E, or F of Form 1040 in computing income or loss from such business or rental activity for taxable years beginning before January 1, 1987. For purposes of this paragraph (n)(3), amended returns filed after July 2, 1987 are disregarded in determining whether a taxpayer has consistently deducted interest expense on Schedule C, E, or F of Form 1040 in computing income or loss from a business or rental activity.

(ii) *Exceptions*—(A) *Debt financed distributions by passthrough entities.* [Reserved]

(B) *Election out.* This paragraph (n)(3) does not apply with respect to debt of a taxpayer who elects under paragraph (n)(3) (viii) of this section to allocate debt outstanding on December 31, 1986, in accordance with the provisions of this section other than this paragraph (n)(3) (*i.e.*, in accordance with the use of the debt proceeds).

(iii) *Business or rental activity.* For purposes of this paragraph (n)(3), a business or rental activity is any trade or business or rental activity of the taxpayer. For this purpose—

(A) A trade or business includes a business or profession the income and deductions of which (or, in the case of a partner or S corporation shareholder, the taxpayer's share thereof) are properly reported on Schedule C, E, or F of Form 1040; and

(B) A rental activity includes an activity of renting property the income and deductions of which (or, in the case of a partner or S corporation shareholder, the taxpayer's share thereof) are properly reported on Schedule E of Form 1040.

(iv) *Example.* The following example illustrates the circumstances in which debt is properly attributable to a business or rental activity:

Example. Taxpayer H incurred a debt in 1979 and properly deducted the interest expense on the debt on Schedule C of Form 1040 for each year from 1979 through 1986. Under this paragraph (n) (3), the debt is properly attributable to the business the results of which are reported on Schedule C.

(v) *Allocation requirement*—(A) *In general.* Debt outstanding on December 31, 1986, that is properly attributable (within the meaning of paragraph (n)(3)(i) of this section) to a business or rental activity must be allocated in a reasonable and consistent manner among the assets held for use or for sale to customers in such activity on the last day of the taxable year that includes December 31, 1986. The taxpayer shall specify the manner in which such debt is allocated by filing a statement in accordance with paragraph (n)(3)(vii) of this section. If the taxpayer does not file such a statement or fails to allocate such debt in a reasonable and consistent manner, the Commissioner shall allocate the debt.

(B) *Reasonable and consistent manner—examples of improper allocation.* For purposes of this paragraph (n)(3)(v), debt is not treated as allocated in a reasonable and consistent manner if—

(*1*) The amount of debt allocated to goodwill exceeds the basis of the goodwill; or

(*2*) The amount of debt allocated to an asset exceeds the fair market value of the asset, and the amount of debt allocated to any other asset is less than the fair market value (lesser of basis or fair market value in the case of goodwill) of such other asset.

(vi) *Coordination with other provisions.* The effect of any events occurring after the last day of the taxable year that includes December 31, 1986, shall be determined under the rules of this section, applied by treating the debt allocated to an asset under paragraph (n)(3)(v) of this section as if proceeds of such debt were used to make an expenditure properly chargeable to capital account with respect to such asset on the last day of the taxable year that includes December 31, 1986. Thus, debt that is allocated to an asset in accordance with this paragraph (n)(3) must be reallocated in accordance with paragraph (j) of this section upon the occurrence with respect to such asset of any event described in such paragraph (j). Similarly, such debt is treated as repaid in the order prescribed in paragraph (d) of this section. In addition, a replacement debt (within the meaning of paragraph (e) of this section) is allocated to an expenditure properly chargeable to capital account with respect to an asset to the extent the proceeds of such debt are used to repay the portion of a debt allocated to such asset under this paragraph (n)(3).

(vii) *Form for allocation of debt.* A taxpayer shall allocate debt for purposes of this paragraph (n)(3) by attaching to the taxpayer's return for the first taxable year beginning after December 31, 1986, a statement that is prominently identified as a transitional allocation statement under §1.163–8T(n)(3) and includes the following information:

(A) A description of the business or rental activity to which the debt is properly attributable;

(B) The amount of debt allocated;

(C) The assets among which the debt is allocated;

(D) The manner in which the debt is allocated;

(E) The amount of debt allocated to each asset; and

(F) Such other information as the Commissioner may require.

(viii) *Form for election out.* A taxpayer shall elect to allocate debt outstanding on December 31, 1986, in accordance with the provisions of this section other than this paragraph (n)(3) by attaching to the taxpayer's return (or amended return) for the first taxable year beginning after December 31, 1986, a statement to that effect, prominently identified as as election out under §1.163–8T(n)(3).

(ix) *Special rule for partnerships and S corporations.* For purposes of paragraph (n)(3)(ii)(B), (v), (vii) and (viii) of this section (relating to the allocation of debt and election out), a partnership or S corporation shall be treated as the taxpayer with respect to the debt of the partnership or S corporation.

(x) *Irrevocability.* An allocation or election filed in accordance with paragraph (n)(3) (vii) or (viii) of this section may not be revoked or modified except with the consent of the Commissioner.

[T.D. 8145, 52 FR 24999, July 2, 1987, as amended by T.D. 8145, 62 FR 40270, July 28, 1997]

§ 1.163–9T Personal interest (temporary).

(a) *In general.* No deduction under any provision of Chapter 1 of the Internal Revenue Code shall be allowed for personal interest paid or accrued during the taxable year by a taxpayer other than a corporation.

(b) *Personal interest*—(1) *Definition.* For purposes of this section, personal interest is any interest expense other than—

(i) Interest paid or accrued on indebtedness properly allocable (within the meaning of §1.163–8T) to the conduct of trade or business (other than the trade or business of performing services as an employee),

(ii) Any investment interest (within the meaning of section 163(d)(3)),

(iii) Any interest that is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(iv) Any qualified residence interest (within the meaning of section 163(h)(3) and §1.163–10T), and

(v) Any interest payable under section 6601 with respect to the unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163, 6166, or 6166A (as in effect before its repeal by the Economic Recovery Tax Act of 1981).

(2) *Interest relating to taxes*—(i) *In general.* Except as provided in paragraph (b)(2)(iii) of this section, personal interest includes interest—

(A) Paid on underpayments of individual Federal, State or local income taxes and on indebtedness used to pay such taxes (within the meaning of §1.163–8T), regardless of the source of the income generating the tax liability;

(B) Paid under section 453(e)(4)(B) (interest on deferred tax resulting from certain installment sales) and section 1291(c) (interest on deferred tax attributable to passive foreign investment companies); or

(C) Paid by a trust, S corporation, or other pass-through entity on underpayments of State or local income taxes and on indebtedness used to pay such taxes.

(ii) *Example.* A, an individual, owns stock of an S corporation. On its return for 1987, the corporation underreports its taxable income. Consequently, A underreports A's share of that income on A's tax return. In 1989, A pays the resulting deficiency plus interest to the Internal Revenue Service. The interest paid by A in 1989 on the tax deficiency is personal interest, notwithstanding the fact that the additional tax liability may have arisen out of income from a trade or business. The result would be the same if A's business had been operated as a sole proprietorship.

(iii) *Certain other taxes.* Personal interest does not include interest—

(A) Paid with respect to sales, excise and similar taxes that are incurred in connection with a trade or business or an investment activity;

(B) Paid by an S corporation with respect to an underpayment of income tax from a year in which the S corporation was a C corporation or with respect to an underpayment of the taxes imposed by sections 1374 or 1375, or similar provision of State law; or

(C) Paid by a transferee under section 6901 (tax liability resulting from transferred assets), or a similar provision of State law, with respect to a C corporation's underpayment of income tax.

(3) *Cross references.* See §1.163–8T for rules for determining the allocation of interest expense to various activities. See §1.163–10T for rules concerning qualified residence interest.

(c) *Effective date*—(1) *In general.* The provisions of this section are effective for taxable years beginning after December 31, 1986. In the case of any taxable year beginning in calendar years

1987 through 1990, the amount of personal interest that is nondeductible under this section is limited to the applicable percentage of such amount.

(2) *Applicable percentages.* The applicable percentage for taxable years beginning in 1987 through 1990 are as follows:

1987: 35 percent
1988: 60 percent
1989: 80 percent
1990: 90 percent

[T.D. 8168, 52 FR 48409, Dec. 22, 1987; 68 FR 13226, Mar. 19, 2003]

§ 1.163–10T Qualified residence interest (temporary).

(a) *Table of contents.* This paragraph (a) lists the major paragraphs that appear in this § 1.163–10T.

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(i) In general.
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(1) In general.
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(3) Treatment of interest expense of the cooperative described in section 216(a)(2).
(4) Special rule to prevent tax avoidance.
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(r) Effective date.

(b) *Treatment of qualified residence interest.* Except as provided below, qualified residence interest is deductible under section 163(a). Qualified residence interest is not subject to limitation or otherwise taken into account under section 163(d) (limitation on investment interest), section 163(h)(1) (disallowance of deduction for personal interest), section 263A (capitalization and inclusion in inventory costs of certain expenses) or section 469 (limitations on losses from passive activities). Qualified residence interest is subject to the limitation imposed by section 263(g) (certain interest in the case of straddles), section 264(a) (2) and (4) (interest paid in connection with certain insurance), section 265(a)(2) (interest relating to tax-exempt income), section 266 (carrying charges), section 267(a)(2) (interest with respect to transactions between related taxpayers) section 465 (deductions limited to amount at risk), section 1277 (deferral of interest deduction allocable to accrued market discount), and section 1282 (deferral of interest deduction allocable to accrued discount).

(c) *Determination of qualified residence interest when secured debt does not exceed adjusted purchase price*—(1) *In general.* If the sum of the average balances for the taxable year of all secured debts on a qualified residence does not exceed the adjusted purchase price (determined as of the end of the taxable year) of the qualified residence, all of the interest paid or accrued during the taxable year with respect to the secured debts is qualified residence interest. If the sum of the average balances for the taxable year of all secured debts exceeds the adjusted purchase price of the qualified residences (determined as of the end of the taxable year), the taxpayer must use either the simplified method (see paragraph (d) of this section) or the exact method (see paragraph (e) of this section) to determine the amount of interest that is qualified residence interest.

(2) *Examples.*

Example 1. T purchases a qualified residence in 1987 for $65,000. T pays $6,500 in cash and finances the remainder of the purchase with a mortgage of $58,500. In 1988, the average balance of the mortgage is $58,000. Because the average balance of the mortgage is less than the adjusted purchase price of the residence ($65,000), all of the interest paid or accrued during 1988 on the mortgage is qualified residence interest.

Example 2. The facts are the same as in example (1), except that T incurs a second mortgage on January 1, 1988, with an initial principal balance of $2,000. The average balance of the second mortgage in 1988 is $1,900. Because the sum of the average balance of the first and second mortgages ($59,900) is less than the adjusted purchase price of the residence ($65,000), all of the interest paid or accrued during 1988 on both the first and second mortgages is qualified residence interest.

Example 3. P borrows $50,000 on January 1, 1988 and secures the debt by a qualified residence. P pays the interest on the debt monthly, but makes no principal payments in 1988. There are no other debts secured by the residence during 1988. On December 31, 1988, the adjusted purchase price of the residence is $40,000. The average balance of the debt in 1988 is $50,000. Because the average balance of the debt exceeds the adjusted purchase price ($10,000), some of the interest on the debt is not qualified residence interest. The portion of the total interest that is qualified residence interest must be determined in accordance with the rules of paragraph (d) or paragraph (e) of this section.

(d) *Determination of qualified residence interest when secured debt exceeds adjusted purchase price—Simplified method*—(1) *In general.* Under the simplified method, the amount of qualified residence interest for the taxable year is equal to the total interest paid or accrued during the taxable year with respect to all secured debts multiplied by a fraction (not in excess of one), the numerator of which is the adjusted purchase price (determined as of the end of the taxable year) of the qualified residence and the denominator of which is the sum of the average balances of all secured debts.

(2) *Treatment of interest paid or accrued on secured debt that is not qualified residence interest.* Under the simplified method, the excess of the total interest paid or accrued during the taxable year with respect to all secured debts over the amount of qualified residence interest is personal interest.

(3) *Example.*

Example. R's principal residence has an adjusted purchase price on December 31, 1988, of $105,000. R has two debts secured by the residence, with the following average balances and interest payments:

Debt	Date secured	Average balance	Interest
Debt 1	June 1983	$80,000	$8,000
Debt 2	May 1987	40,000	4,800
Total	....	120,000	12,800

The amount of qualified residence interest is determined under the simplified method by multiplying the total interest ($12,800) by a fraction (expressed as a decimal amount) equal to the adjusted purchase price ($105,000) of the residence divided by the combined average balances ($120,000). For 1988, this fraction is equal to 0.875 ($105,000/$120,000). Therefore, $11,200 ($12,800 × 0.875) of the total interest is qualified residence interest. The remaining $1,600 in interest ($12,800 − $11,200) is personal interest, even if (under the rules of §1.163–8T) such remaining interest would be allocated to some other category of interest.

(e) *Determination of qualified residence interest when secured debt exceeds adjusted purchase price—Exact method*—(1) *In general.* Under the exact method, the amount of qualified residence interest for the taxable year is determined on a debt-by-debt basis by computing the applicable debt limit for each secured debt and comparing each such applicable debt limit to the average balance of the corresponding debt. If, for the taxable year, the average balance of a secured debt does not exceed the applicable debt limit for that debt, all of the interest paid or accrued during the taxable year with respect to the debt is qualified residence interest. If the average balance of the secured debt exceeds the applicable debt limit for that debt, the amount of qualified residence interest with respect to the debt is determined by multiplying the interest paid or accrued with respect to the debt by a fraction, the numerator of which is the applicable debt limit for that debt and the denominator of which is the average balance of the debt.

(2) *Determination of applicable debt limit.* For each secured debt, the applicable debt limit for the taxable year is equal to

(i) The lesser of—

(A) The fair market value of the qualified residence as of the date the debt is first secured, and

(B) The adjusted purchase price of the qualified residence as of the end of the taxable year,

(ii) Reduced by the average balance of each debt previously secured by the qualified residence.

For purposes of paragraph (e)(2)(ii) of this section, the average balance of a debt shall be treated as not exceeding the applicable debt limit of such debt. See paragraph (n)(1)(i) of this section for the rule that increases the adjusted purchase price in paragraph (e)(2)(i)(B) of this section by the amount of any qualified indebtedness (certain medical and educational debt). See paragraph (f) of this section for special rules relating to the determination of the fair market value of the qualified residence.

(3) *Example.* (i) R's principal residence has an adjusted purchase price on December 31, 1988, of $105,000. R has two debts secured by the residence. The average balances and interest payments on each debt during 1988 and fair market value of the residence on the date each debt was secured are as follows:

Debt	Date secured	Fair market value	Average balance	Interest
Debt 1	June 1983	$100,000	$80,000	$8,000
Debt 2	May 1987	140,000	40,000	4,800
Total	....	....	120,000	12,800

(ii) The amount of qualified residence interest for 1988 under the exact method is determined as follows. Because there are no debts previously secured by the residence, the applicable debt limit for Debt 1 is $100,000 (the lesser of the adjusted purchase price as of the end of the taxable year and the fair market value of the residence at the time the debt was secured). Because the average balance of Debt 1 ($80,000) does not exceed its applicable debt limit ($100,000), all of the interest paid on the debt during 1988 ($8,000) is qualified residence interest.

(iii) The applicable debt limit for Debt 2 is $25,000 ($105,000 (the lesser of $140,000 fair market value and $105,000 adjusted purchase price) reduced by $80,000 (the average balance of Debt 1)). Because the average balance of Debt 2 ($40,000) exceeds its applicable debt limit, the amount of qualified residence interest on Debt 2 is determined by multiplying the amount of interest paid on the debt during the year ($4,800) by a fraction equal to its applicable debt limit divided by its average balance ($25,000/$40,000 = 0.625). Accordingly, $3,000 ($4,800 × 0.625) of the interest paid in 1988 on Debt 2 is qualified residence interest. The character of the remaining $1,800 of interest paid on Debt 2 is determined under the rules of paragraph (e)(4) of this section.

(4) *Treatment of interest paid or accrued with respect to secured debt that is not qualified residence interest*—(i) *In general.* Under the exact method, the excess of the interest paid or accrued during the taxable year with respect to a secured debt over the amount of qualified residence interest with respect to the debt is allocated under the rules of § 1.163–8T.

(ii) *Example.* T borrows $20,000 and the entire proceeds of the debt are disbursed by the lender to T's broker to purchase securities held for investment. T secures the debt with T's principal residence. In 1990, T pays $2,000 of interest on the debt. Assume that under the rules of paragraph (e) of this section, $1,500 of the interest is qualified residence interest. The remaining $500 in interest expense would be allocated under the rules of § 1.163–8T. Section 1.163–8T generally allocates debt (and the associated interest expense) by tracing disbursements of the debt proceeds to specific expenditures. Accordingly, the $500 interest expense on the debt that is not qualified residence interest is investment interest subject to section 163(d).

(iii) *Special rule if debt is allocated to more than one expenditure.* If—

(A) The average balance of a secured debt exceeds the applicable debt limit for that debt, and

(B) Under the rules of § 1.163–8T, interest paid or accrued with respect to such debt is allocated to more than one expenditure,

the interest expense that is not qualified residence interest may be allocated among such expenditures, to the extent of such expenditures, in any manner selected by the taxpayer.

(iv) *Example.* (*i*) C borrows $60,000 secured by a qualified residence. C uses (within the meaning of § 1.163–8T) $20,000 of the proceeds in C's trade or business, $20,000 to purchase stock held for investment and $20,000 for personal purposes. In 1990, C pays $6,000 in interest on the debt and, under the rules of § 1.163–8T, $2,000 in interest is allocable to trade or business expenses, $2,000 to investment expenses and $2,000 to personal expenses. Assume that under paragraph (e) of this section, $2,500 of the interest is qualified residence interest and $3,500 of the interest is not qualified residence interest.

(*ii*) Under paragraph (e)(4)(iii) of this section, C may allocate up to $2,000 of the interest that is not qualified residence interest to any of the three categories of expenditures up to a total of $3,500 for all three categories. Therefore, for example, C may allocate $2,000 of such interest to C's trade or business and $1,500 of such interest to the purchase of stock.

(f) *Special rules*—(1) *Special rules for personal property*—(i) *In general.* If a qualified residence is personal property under State law (e.g., a boat or motorized vehicle)—

(A) For purposes of paragraphs (c)(1) and (d)(1) of this section, if the fair market value of the residence as of the date that any secured debt (outstanding during the taxable year) is first secured by the residence is less than the adjusted purchase price as of the end of the taxable year, the lowest such fair market value shall be substituted for the adjusted purchase price.

(B) For purposes of paragraphs (e)(2)(i)(A) and (f)(1)(i)(A) of this section, the fair market value of the residence as of the date the debt is first secured by the residence shall not exceed the fair market value as of any date on which the taxpayer borrows any additional amount with respect to the debt.

(ii) *Example.* D owns a recreational vehicle that is a qualified residence under paragraph (p)(4) of this section. The adjusted purchase price and fair market value of the recreational vehicle is $20,000 in 1989. In 1989, D establishes a line of credit secured by the recreational vehicle. As of June 1, 1992, the fair market value of the vehicle has decreased to $10,000. On that day, D borrows an additional amount on the debt by using the line of credit. Although under paragraphs (e)(2)(i) and (f)(1)(i)(A) of this section, fair market value is determined at the time the debt is first secured, under paragraph (f)(1)(i)(B) of this section, the fair market value is the lesser of that amount or the fair market value on the most recent date that D borrows any additional amount with respect to the line of credit. Therefore, the fair market value with respect to the debt is $10,000.

(2) *Special rule for real property*—(i) *In general.* For purposes of paragraph (e)(2)(i)(A) of this section, the fair market value of a qualified residence that is real property under State law is presumed irrebuttably to be not less than the adjusted purchase price of the residence as of the last day of the taxable year.

(ii) *Example.* (*i*) C purchases a residence on August 11, 1987, for $50,000, incurring a first mortgage. The residence is real property under State law. During 1987, C makes $10,000 in home improvements. Accordingly, the adjusted purchase price of the residence as of December 31, 1988, is $60,000. C incurs a second mortgage on May 19, 1988, as of which time the fair market value of the residence is $55,000.

(*ii*) For purposes of determining the applicable debt limit for each debt, the fair market value of the residence is generally determined as of the time the debt is first secured. Accordingly, the fair market value would be $50,000 and $55,000 with respect to the first and second mortgage, respectively. Under the special rule of paragraph (f)(2)(i) of this section, however, the fair market value with respect to both debts in 1988 is $60,000, the adjusted purchase price on December 31, 1988.

(g) *Selection of method.* For any taxable year, a taxpayer may use the simplified method (described in paragraph (d) of this section) or the exact method (described in paragraph (e) of this section) by completing the appropriate portion of Form 8598. A taxpayer with two qualified residences may use the simplified method for one residence and the exact method for the other residence.

(h) *Average balance*—(1) *Average balance defined.* For purposes of this section, the term ''average balance'' means the amount determined under this paragraph (h). A taxpayer is not required to use the same method to determine the average balance of all secured debts during a taxable year or of any particular secured debt from one year to the next.

(2) *Average balance reported by lender.* If a lender that is subject to section 6050H (returns relating to mortgage interest received in trade or business from individuals) reports the average balance of a secured debt on Form 1098, the taxpayer may use the average balance so reported.

(3) *Average balance computed on a daily basis*—(i) *In general.* The average balance may be determined by—

(A) Adding the outstanding balance of a debt on each day during the taxable year that the debt is secured by a qualified residence, and

(B) Dividing the sum by the number of days during the taxable year that the residence is a qualified residence.

(ii) *Example.* Taxpayer A incurs a debt of $10,000 on September 1, 1989, securing the debt with A's principal residence. The residence is A's principal residence during the entire taxable year. A pays current interest on the debt monthly, but makes no principal payments. The debt is, therefore, outstanding for 122 days with a balance each day of $10,000. The residence is a qualified residence for 365 days. The average balance of the debt for 1989 is $3,342 ($122 \times \$10{,}000/365$).

(4) *Average balance computed using the interest rate*—(i) *In general.* If all accrued interest on a secured debt is paid at least monthly, the average balance of the secured debt may be determined by dividing the interest paid or accrued during the taxable year while the debt is secured by a qualified residence by the annual interest rate on the debt. If the interest rate on a debt varies during the taxable year, the lowest annual interest rate that applies to the debt during the taxable year must be used for purposes of this paragraph (h)(4). If the residence securing the debt is a qualified residence for less than the entire taxable year, the average balance of any secured debt may be determined by dividing the average balance determined under the preceding sentence by the percentage of the taxable year that the debt is secured by a qualified residence.

(ii) *Points and prepaid interest.* For purposes of paragraph (h)(4)(i) of this section, the amount of interest paid during the taxable year does not include any amount paid as points and includes prepaid interest only in the year accrued.

(iii) *Examples.*

Example 1. B has a line of credit secured by a qualified residence for the entire taxable year. The interest rate on the debt is 10 percent throughout the taxable year. The principal balance on the debt changes throughout the year. B pays the accrued interest on the debt monthly. B pays $2,500 in interest on the debt during the taxable year. The average balance of the debt ($25,000) may be computed by dividing the total interest paid by the interest rate ($25,000 = $2,500/0.10).

Example 2. Assume the same facts as in example 1, except that the residence is a qualified residence, and the debt is outstanding, for only one-half of the taxable year and B pays only $1,250 in interest on the debt during the taxable year. The average balance of the debt may be computed by first dividing the total interest paid by the interest rate ($12,500 = $1,250/0.10). Second, because the residence is not a qualified residence for the entire taxable year, the average balance must be determined by dividing this amount ($12,500) by the portion of the year that the residence is qualified (0.50). The average balance is therefore $25,000 ($12,500/0.50).

(5) *Average balance computed using average of beginning and ending balances*—(i) *In general.* If—

(A) A debt requires level payments at fixed equal intervals (e.g., monthly, quarterly) no less often than semi-annually during the taxable year,

(B) The taxpayer prepays no more than one month's principal on the debt during the taxable year, and

(C) No new amounts are borrowed on the debt during the taxable year,

the average balance of the debt may be determined by adding the principal balance as of the first day of the taxable year that the debt is secured by the qualified residence and the principal balance as of the last day of the taxable year that the debt is secured by the qualified residence and dividing the sum by 2. If the debt is secured by a qualified residence for less than the entire period during the taxable year that the residence is a qualified residence, the average balance may be determined by multiplying the average balance determined under the preceding sentence by a fraction, the numerator of which is the number of days during the taxable year that the debt is secured by the qualified residence and the denominator of which is the number of days during the taxable year that the residence is a qualified residence. For purposes of this paragraph (h)(5)(i), the determination of whether payments are level shall disregard the fact that the amount of the payments may be adjusted from time to time to take into account changes in the applicable interest rate.

(ii) *Example.* C borrows $10,000 in 1988, securing the debt with a second mortgage on a principal residence. The terms of the loan require C to make equal monthly payments of principal and interest so as to amortize the entire loan balance over 20 years. The balance of the debt is $9,652 on January 1, 1990, and is $9,450 on December 31, 1990. The average balance of the debt during 1990 may be computed as follows:

Balance on first day of the year: $9,652
Balance on last day of the year: $9,450

$$\text{Average balance:} \frac{\$9{,}652+\$9{,}450}{2} = \$9{,}551$$

(6) *Highest principal balance.* The average balance of a debt may be determined by taking the highest principal balance of the debt during the taxable year.

(7) *Other methods provided by the Commissioner.* The average balance may be determined using any other method provided by the Commissioner by form, publication, revenue ruling, or revenue procedure. Such methods may include methods similar to (but with restrictions different from) those provided in paragraph (h) of this section.

(8) *Anti-abuse rule.* If, as a result of the determination of the average balance of a debt using any of the methods specified in paragraphs (h) (4), (5), or (6) of this section, there is a significant overstatement of the amount of qualified residence interest and a principal purpose of the pattern of payments and borrowing on the debt is to cause the amount of such qualified residence interest to be overstated, the district director may redetermine the average balance using the method specified under paragraph (h)(3) of this section.

(i) [Reserved]

(j) *Determination of interest paid or accrued during the taxable year*—(1) *In general.* For purposes of determining the amount of qualified residence interest with respect to a secured debt, the amount of interest paid or accrued during the taxable year includes only interest paid or accrued while the debt is secured by a qualified residence.

(2) *Special rules for cash-basis taxpayers*—(i) *Points deductible in year paid under section 461(g)(2).* If points described in section 461(g)(2) (certain points paid in respect of debt incurred in connection with the purchase or improvement of a principal residence) are paid with respect to a debt, the amount of such points is qualified residence interest.

(ii) *Points and other prepaid interest described in section 461(g)(1).* The amount of points or other prepaid interest charged to capital account under section 461(g)(1) (prepaid interest) that is qualified residence interest shall be determined under the rules of paragraphs (c) through (e) of this section in the same manner as any other interest paid with respect to the debt in the taxable year to which such payments are allocable under section 461(g)(1).

(3) *Examples.*

Example 1. T designates a vacation home as a qualified residence as of October 1, 1987. The home is encumbered by a mortgage during the entire taxable year. For purposes of determining the amount of qualified residence interest for 1987, T may take into account the interest paid or accrued on the secured debt from October 1, 1987, through December 31, 1987.

Example 2. R purchases a principal residence on June 17, 1987. As part of the purchase price, R obtains a conventional 30-year mortgage, secured by the residence. At closing, R pays 2½ points on the mortgage and interest on the mortgage for the period June 17, 1987 through June 30, 1987. The points are actually paid by R and are not merely withheld from the loan proceeds. R incurs no additional secured debt during 1987. Assuming that the points satisfy the requirements of section 461(g) (2), the entire amount of points and the interest paid at closing are qualified residence interest.

Example 3. (*i*) On July 1, 1987, W borrows $120,000 to purchase a residence to use as a vacation home. W secures the debt with the residence. W pays 2 points, or $2,400. The debt has a term of 10 years and requires monthly payments of principal and interest. W is permitted to amortize the points at the rate of $20 per month over 120 months. W elects to treat the residence as a second residence. W has no other debt secured by the residence. The average balance of the debt in each taxable year is less than the adjusted purchase price of the residence. W sells the residence on June 30, 1990, and pays off the remaining balance of the debt.

(*ii*) W is entitled to treat the following amounts of the points as interest paid on a debt secured by a qualified residence—

1987	$120 = $20 × 6 months;
1988	$240 = $20 × 12 months;
1989	$120 = $20 × 6 months.
Total	$480

All of the interest paid on the debt, including the allocable points, is qualified residence interest. Upon repaying the debt, the remaining $1,920 ($2,400 − $480) in unamortized points is treated as interest paid in 1990 and, because the average balance of the secured debt in 1990 is less than the adjusted purchase price, is also qualified residence interest.

(k) *Determination of adjusted purchase price and fair market value*—(1) *Adjusted purchase price*—(i) *In general.* For purposes of this section, the adjusted purchase price of a qualified residence is equal to the taxpayer's basis in the residence as initially determined under section 1012 or other applicable sections of the Internal Revenue Code, increased by the cost of any improvements to the residence that have been added to the taxpayer's basis in the residence under section 1016(a)(1). Any other adjustments to basis, including those required under section 1033(b) (involuntary conversions), and 1034(e) (rollover of gain or sale of principal residence) are disregarded in determining the taxpayer's adjusted purchase price. If, for example, a taxpayer's second residence is rented for a portion of the year and its basis is reduced by depreciation allowed in connection with the rental use of the property, the amount of the taxpayer's adjusted purchase price in the residence is not reduced. See paragraph (m) of this section for a rule that treats the sum of the grandfathered amounts of all secured debts as the adjusted purchase price of the residence.

(ii) *Adjusted purchase price of a qualified residence acquired incident to divorce.* [Reserved]

(iii) *Examples.*

Example 1. X purchases a residence for $120,000. X's basis, as determined under section 1012, is the cost of the property, or $120,000. Accordingly, the adjusted purchase price of the residence is initially $120,000.

Example 2. Y owns a principal residence that has a basis of $30,000. Y sells the residence for $100,000 and purchases a new principal residence for $120,000. Under section 1034, Y does not recognize gain on the sale of the former residence. Under section 1034(e), Y's basis in the new residence is reduced by the amount of gain not recognized. Therefore, under section 1034(e), Y's basis in the new residence is $50,000 ($120,000 − $70,000). For purposes of section 163(h), however, the adjusted purchase price of the residence is not adjusted under section 1034(e). Therefore, the adjusted purchase price of the residence is initially $120,000.

Example 3. Z acquires a residence by gift. The donor's basis in the residence was $30,000. Z's basis in the residence, determined under section 1015, is $30,000. Accordingly, the adjusted purchase price of the residence is initially $30,000.

(2) *Fair market value*—(i) *In general.* For purposes of this section, the fair market value of a qualified residence on any date is the fair market value of the taxpayer's interest in the residence on such date. In addition, the fair market value determined under this paragraph (k)(2)(i) shall be determined by taking into account the cost of improvements to the residence reasonably expected to be made with the proceeds of the debt.

(ii) *Example.* In 1988, the adjusted purchase price of P's second residence is $65,000 and the fair market value of the residence is $70,000. At that time, P incurs an additional debt of $10,000, the proceeds of which P reasonably expects to use to add two bedrooms to the residence. Because the fair market value is determined by taking into account the cost of improvements to the residence that are reasonably expected to be made with the proceeds of the debt, the fair market value of the residence with respect to the debt incurred in 1988 is $80,000 ($70,000 + $10,000).

(3) *Allocation of adjusted purchase price and fair market value.* If a property includes both a qualified residence and other property, the adjusted purchase

price and the fair market value of such property must be allocated between the qualified residence and the other property. See paragraph (p)(4) of this section for rules governing such an allocation.

(l) [Reserved]

(m) *Grandfathered amount*—(1) *Substitution for adjusted purchase price.* If, for the taxable year, the sum of the grandfathered amounts, if any, of all secured debts exceeds the adjusted purchase price of the qualified residence, such sum may be treated as the adjusted purchase price of the residence under paragraphs (c), (d) and (e) of this section.

(2) *Determination of grandfathered amount*—(i) *In general.* For any taxable year, the grandfathered amount of any secured debt that was incurred on or before August 16, 1986, and was secured by the residence continuously from August 16, 1986, through the end of the taxable year, is the average balance of the debt for the taxable year. A secured debt that was not incurred and secured on or before August 16, 1986, has no grandfathered amount.

(ii) *Special rule for lines of credit and certain other debt.* If, with respect to a debt described in paragraph (m)(2)(i) of this section, a taxpayer has borrowed any additional amounts after August 16, 1986, the grandfathered amount of such debt is equal to the lesser of—

(A) The average balance of the debt for the taxable year, or

(B) The principal balance of the debt as of August 16, 1986, reduced (but not below zero) by all principal payments after August 16, 1986, and before the first day of the current taxable year.

For purposes of this paragraph (m)(2)(ii), a taxpayer shall not be considered to have borrowed any additional amount with respect to a debt merely because accrued interest is added to the principal balance of the debt, so long as such accrued interest is paid by the taxpayer no less often than quarterly.

(iii) *Fair market value limitation.* The grandfathered amount of any debt for any taxable year may not exceed the fair market value of the residence on August 16, 1986, reduced by the principal balance on that day of all previously secured debt.

(iv) *Examples.*

Example 1. As of August 16, 1986, T has one debt secured by T's principal residence. The debt is a conventional self-amortizing mortgage and, on August 16, 1986, it has an outstanding principal balance of $75,000. In 1987, the average balance of the mortgage is $73,000. The adjusted purchase price of the residence as of the end of 1987 is $50,000. Because the mortgage was incurred and secured on or before August 16, 1986 and T has not borrowed any additional amounts with respect to the mortgage, the grandfathered amount is the average balance, $73,000. Because the grandfathered amount exceeds the adjusted purchase price ($50,000), T may treat the grandfathered amount as the adjusted purchase price in determining the amount of qualified residence interest.

Example 2. (i) The facts are the same as in example (1), except that in May 1986, T also obtains a home equity line of credit that, on August 16, 1986, has a principal balance of $40,000. In November 1986, T borrows an additional $10,000 on the home equity line, increasing the balance to $50,000. In December 1986, T repays $5,000 of principal on the home equity line. The average balance of the home equity line in 1987 is $45,000.

(ii) Because T has borrowed additional amounts on the line of credit after August 16, 1986, the grandfathered amount for that debt must be determined under the rules of paragraph (m)(2)(ii) of this section. Accordingly, the grandfathered amount for the line of credit is equal to the lesser of $45,000, the average balance of the debt in 1987, and $35,000, the principal balance on August 16, 1986, reduced by all principal payments between August 17, 1986, and December 31, 1986 ($40,000–$5,000). The sum of the grandfathered amounts with respect to the residence is $108,000 ($73,000 + $35,000). Because the sum of the grandfathered amounts exceeds the adjusted purchase price ($50,000), T may treat the sum as the adjusted purchase price in determining the qualified residence interest for 1987.

(3) *Refinancing of grandfathered debt*—(i) *In general.* A debt incurred and secured on or before August 16, 1986, is refinanced if some or all of the outstanding balance of such a debt (the ''original debt'') is repaid out of the proceeds of a second debt secured by the same qualified residence (the ''replacement debt''). In the case of a refinancing, the replacement debt is treated as a debt incurred and secured on or before August 16, 1986, and the grandfathered amount of such debt is the

amount (but not less than zero) determined pursuant to paragraph (m)(3)(ii) of this section.

(ii) *Determination of grandfathered amount*—(A) *Exact refinancing.* If—

(*1*) The entire proceeds of a replacement debt are used to refinance one or more original debts, and

(*2*) The taxpayer has not borrowed any additional amounts after August 16, 1986, with respect to the original debt or debts,

the grandfathered amount of the replacement debt is the average balance of the replacement debt. For purposes of the preceding sentence, the fact that proceeds of a replacement debt are used to pay costs of obtaining the replacement debt (including points or other closing costs) shall be disregarded in determining whether the entire proceeds of the replacement debt have been used to refinance one or more original debts.

(B) *Refinancing other than exact refinancings*—(*1*) *Year of refinancing.* In the taxable year in which an original debt is refinanced, the grandfathered amount of the original and replacement debts is equal to the lesser of—

(*i*) The sum of the average balances of the original debt and the replacement debt, and

(*ii*) The principal balance of the original debt as of August 16, 1986, reduced by all principal payments on the original debt after August 16, 1986, and before the first day of the current taxable year.

(*2*) *In subsequent years.* In any taxable year after the taxable year in which an original debt is refinanced, the grandfathered amount of the replacement debt is equal to the least of—

(*i*) The average balance of the replacement debt for the taxable year,

(*ii*) The amount of the replacement debt used to repay the principal balance of the original debt, reduced by all principal payments on the replacement debt after the date of the refinancing and before the first day of the current taxable year, or

(*iii*) The principal balance of the original debt on August 16, 1986, reduced by all principal payments on the original debt after August 16, 1986, and before the date of the refinancing, and further reduced by all principal payments on the replacement debt after the date of the refinancing and before the first day of the current taxable year.

(C) *Example.* (*i*) *Facts.* On August 16, 1986, T has a single debt secured by a principal residence with a balance of $150,000. On July 1, 1988, T refinances the debt, which still has a principal balance of $150,000, with a new secured debt. The principal balance of the replacement debt throughout 1988 and 1989 is $150,000. The adjusted purchase price of the residence is $100,000 throughout 1987, 1988 and 1989. The average balance of the original debt was $150,000 in 1987 and $75,000 in 1988. The average balance of the replacement debt is $75,000 in 1988 and $150,000 in 1989.

(*ii*) *Grandfathered amount in 1987.* The original debt was incurred and secured on or before August 16, 1986 and T has not borrowed any additional amounts with respect to the debt. Therefore, its grandfathered amount in 1987 is its average balance ($150,000). This amount is treated as the adjusted purchase price for 1987 and all of the interest paid on the debt is qualified residence interest.

(*iii*) *Grandfathered amount in 1988.* Because the replacement debt was used to refinance a debt incurred and secured on or before August 16, 1986, the replacement debt is treated as a grandfathered debt. Because all of the proceeds of the replacement debt were used in the refinancing and because no amounts have been borrowed after August 16, 1986, on the original debt, the grandfathered amount for the original debt is its average balance ($75,000) and the grandfathered amount for the replacement debt is its average balance ($75,000). Since the sum of the grandfathered amounts ($150,000) exceeds the adjusted purchase price of the residence, the sum of the grandfathered amounts may be substituted for the adjusted purchase price for 1988 and all of the interest paid on the debt is qualified residence interest.

(*iv*) *Grandfathered amount in 1989.* The grandfathered amount for the placement debt is its average balance ($150,000). This amount is treated as the adjusted purchase price for 1989 and all of the interest paid on the mortgage is qualified residence interest.

(4) *Limitation on term of grandfathered debt*—(i) *In general.* An original debt or replacement debt shall not have any grandfathered amount in any taxable year that begins after the date, as determined on August 16, 1986, that the original debt was required to be repaid in full (the "maturity date"). If a replacement debt is used to refinance more than one original debt, the maturity date is determined by reference to the original debt that, as of August 16, 1986, had the latest maturity date.

(ii) *Special rule for nonamortizing debt.* If an original debt was actually incurred and secured on or before August 16, 1986, and if as of such date the terms of such debt did not require the amortization of its principal over its original term, the maturity date of the replacement debt is the earlier of the maturity date of the replacement debt or the date 30 years after the date the original debt is first refinanced.

(iii) *Example.* C incurs a debt on May 10, 1986, the final payment of which is due May 1, 2006. C incurs a second debt on August 11, 1990, with a term of 20 years and uses the proceeds of the second debt to refinance the first debt. Because, under paragraph (m)(4)(i) of this section, a replacement debt will not have any grandfathered amount in any taxable year that begins after the maturity date of the original debt (May 1, 2006), the second debt has no grandfathered amount in any taxable year after 2006.

(n) *Qualified indebtedness (secured debt used for medical and educational purposes)*—(1) *In general*—(i) *Treatment of qualified indebtedness.* The amount of any qualified indebtedness resulting from a secured debt may be added to the adjusted purchase price under paragraph (e)(2)(i)(B) of this section to determine the applicable debt limit for that secured debt and any other debt subsequently secured by the qualified residence.

(ii) *Determination of amount of qualified indebtedness.* If, as of the end of the taxable year (or the last day in the taxable year that the debt is secured), at least 90 percent of the proceeds of a secured debt are used (within the meaning of paragraph (n)(2) of this section) to pay for qualified medical and educational expenses (within the meaning of paragraphs (n)(3) and (n)(4) of this section), the amount of qualified indebtedness resulting from that debt for the taxable year is equal to the average balance of such debt for the taxable year.

(iii) *Determination of amount of qualified indebtedness for mixed-use debt.* If, as of the end of the taxable year (or the last day in the taxable year that the debt is secured), more than ten percent of the proceeds of a secured debt are used to pay for expenses other than qualified medical and educational expenses, the amount of qualified indebtedness resulting from that debt for the taxable year shall equal the lesser of—

(A) The average balance of the debt, or

(B) The amount of the proceeds of the debt used to pay for qualified medical and educational expenses through the end of the taxable year, reduced by any principal payments on the debt before the first day of the current taxable year.

(iv) *Example.* (*i*) C incurs a $10,000 debt on April 20, 1987, which is secured on that date by C's principal residence. C immediately uses (within the meaning of paragraph (n)(2) of this section) $4,000 of the proceeds of the debt to pay for a qualified medical expense. C makes no principal payments on the debt during 1987. During 1988 and 1989, C makes principal payments of $1,000 per year. The average balance of the debt during 1988 is $9,500 and the average balance during 1989 is $8,500.

(*ii*) Under paragraph (n)(1)(iii) of this section, C determines the amount of qualified indebtedness for 1988 as follows:

Average balance		$9,500
Amount of debt used to pay for qualified medical expenses	$4,000	
Less payments of principal before 1988	$0	
Net qualified expenses		$4,000

The amount of qualified indebtedness for 1988 is, therefore, $4,000 (lesser of $9,500 average balance or $4,000 net qualified expenses). This amount may be added to the adjusted purchase price of C's principal residence under paragraph (e)(2)(i)(B) of this section for purposes of computing the applicable debt limit for this debt and any other debt subsequently secured by the principal residence.

(*iii*) C determines the amount of qualified indebtedness for 1989 as follows:

Average balance		$8,500
Amount of debt used to pay for qualified medical expenses	$4,000	
Less payments of principal before 1988	$1,000	
Net qualified expenses		$3,000

The amount of qualified indebtedness for 1989 is, therefore, $3,000 (lesser of $8,500 average balance or $3,000 net qualified expenses).

(v) *Prevention of double counting in year of refinancing*—(A) *In general.* A debt used to pay for qualified medical or educational expenses is refinanced if some or all of the outstanding balance of the debt (the ''original debt'') is repaid out of the proceeds of a second debt (the ''replacement debt''). If, in the year of a refinancing, the combined qualified indebtedness of the original debt and the replacement debt exceeds the combined qualified expenses of such debts, the amount of qualified indebtedness for each such debt shall be determined by multiplying the amount of qualified indebtedness for each such debt by a fraction, the numerator of which is the combined qualified expenses and the denominator of which is the combined qualified indebtedness.

(B) *Definitions.* For purposes of paragraph (n)(1)(v)(A) of this section—

(*1*) The term ''combined qualified indebtedness'' means the sum of the qualified indebtedness (determined without regard to paragraph (n)(1)(v) of this section) for the original debt and the replacement debt.

(*2*) The term ''combined qualified expenses'' means the amount of the proceeds of the original debt used to pay for qualified medical and educational expenses through the end of the current taxable year, reduced by any principal payments on the debt before the first day of the current taxable year, and increased by the amount, if any, of the proceeds of the replacement debt used to pay such expenses through the end of the current taxable year other than as part of the refinancing.

(C) *Example.* (*i*) On August 11, 1987, C incurs a $8,000 debt secured by a principal residence. C uses (within the meaning of paragraph (n)(2)(i) of this section) $5,000 of the proceeds of the debt to pay for qualified educational expenses. C makes no principal payments on the debt. On July 1, 1988, C incurs a new debt in the amount of $8,000 secured by C's principal residence and uses all of the proceeds of the new debt to repay the original debt. Under paragraph (n)(2)(ii) of this section $5,000 of the new debt is treated as being used to pay for qualified educational expenses. C makes no principal payments (other than the refinancing) during 1987 or 1988 on either debt and pays all accrued interest monthly. The average balance of each debt in 1988 is $4,000.

(*ii*) Under paragraph (n)(1)(iii) of this section, the amount of qualified indebtedness for 1988 with respect to the original debt is $4,000 (the lesser of its average balance ($4,000) and the amount of the debt used to pay for qualified medical and educational expenses ($5,000)). Similarly, the amount of qualified indebtedness for 1988 with respect to the replacement debt is also $4,000. Both debts, however, are subject in 1988 to the limitation in paragraph (n)(1)(v)(A) of this section. The combined qualified indebtedness, determined without regard to the limitation, is $8,000 ($4,000 of qualified indebtedness from each debt). The combined qualified expenses are $5,000 ($5,000 from the original debt and $0 from the replacement debt). The amount of qualified indebtedness from each debt must, therefore, be reduced by a fraction, the numerator of which is $5,000 (the combined qualified expenses) and the denominator of which is $8,000 (the combined qualified indebtedness). After application of the limitation, the amount of qualified indebtedness for the original debt is $2,500 ($4,000 × × 5/8). Similarly, the amount of qualified indebtedness for the replacement debt is $2,500. Note that the total qualified indebtedness for both the original and the replacement debt is $5,000 ($2,500 + $2,500). Therefore, C is entitled to the same amount of qualified indebtedness as C would have been entitled to if C had not refinanced the debt.

(vi) *Special rule for principal payments in excess of qualified expenses.* For purposes of paragraph (n)(1)(iii)(B), (n)(1)(v)(B)(*2*) and (n)(2)(ii) of this section, a principal payment is taken into account only to the extent that the payment, when added to all prior payments, does not exceed the amount used on or before the date of the payment to pay for qualified medical and educational expenses.

(2) *Debt used to pay for qualified medical or educational expenses*—(i) *In general.* For purposes of this section, the proceeds of a debt are used to pay for qualified medical or educational expenses to the extent that—

(A) The taxpayer pays qualified medical or educational expenses within 90 days before or after the date that amounts are actually borrowed with respect to the debt, the proceeds of the debt are not directly allocable to another expense under §1.163–8T(c)(3) (allocation of debt; proceeds not disbursed to borrower) and the proceeds of any other debt are not allocable to the medical or educational expenses under §1.163–8T(c)(3), or

(B) The proceeds of the debt are otherwise allocated to such expenditures under §1.163–8T.

(ii) *Special rule for refinancings.* For purposes of this section, the proceeds of a debt are used to pay for qualified medical and educational expenses to the extent that the proceeds of the debt are allocated under §1.163–8T to the repayment of another debt (the ''original debt''), but only to the extent of the amount of the original debt used to pay for qualified medical and educational expenses, reduced by any principal payments on such debt up to the time of the refinancing.

(iii) *Other special rules.* The following special rules apply for purposes of this section.

(A) Proceeds of a debt are used to pay for qualified medical or educational expenses as of the later of the taxable year in which such proceeds are borrowed or the taxable year in which such expenses are paid.

(B) The amount of debt which may be treated as being used to pay for qualified medical or educational expenses may not exceed the amount of such expenses.

(C) Proceeds of a debt may not be treated as being used to pay for qualified medical or educational expenses to the extent that:

(*1*) The proceeds have been repaid as of the time the expense is paid;

(*2*) The proceeds are actually borrowed before August 17, 1986; or

(*3*) The medical or educational expenses are paid before August 17, 1986.

(iv) *Examples*—

Example 1. A pays a $5,000 qualified educational expense from a checking account that A maintains at Bank 1 on November 9, 1987. On January 1, 1988, A incurs a $20,000 debt that is secured by A's residence and places the proceeds of the debt in a savings account that A also maintains at Bank 1. A pays another $5,000 qualified educations expense on March 15 from a checking account that A maintains at Bank 2. Under paragraph (n)(2) of this section, the debt proceeds are used to pay for both educational expenses, regardless of other deposits to, or expenditures from, the accounts, because both expenditures are made within 90 days before or after the debt was incurred.

Example 2. B pays a $5,000 qualified educational expense from a checking account on November 1, 1987. On November 30, 1987, B incurs a debt secured by B's residence, and the lender disburses the debt proceeds directly to a person who sells B a new car. Although the educational expense is paid within 90 days of the date the debt is incurred, the proceeds of the debt are not used to pay for the educational expense because the proceeds are directly allocable to the purchase of the new car under §1.163–8T(c)(3).

Example 3. On November 1, 1987, C borrows $5,000 from C's college. The proceeds of this debt are not disbursed to C, but rather are used to pay tuition fees for C's attendance at the college. On November 30, 1987, C incurs a second debt and secures the debt by C's residence. Although the $5,000 educational expense is paid within 90 days before the second debt is incurred, the proceeds of the second debt are not used to pay for the educational expense, because the proceeds of the first debt are directly allocable to the educational expense under §1.163–8T(c)(3).

Example 4. On January 1, 1988, D incurs a $20,000 debt secured by a qualified residence. D places the proceeds of the debt in a separate account (*i.e.,* the proceeds of the debt are the only deposit in the account). D makes payments of $5,000 each for qualified educational expenses on September 1, 1988, September 1, 1989, September 1, 1990, and September 1, 1991. Because the debt proceeds are allocated to educational expenses as of the date the expenses are paid, under the rules of §1.163–8T(c)(4), the following amounts of the debt proceeds are used to pay for qualified educational expenses as of the end of each year:

1988: $5,000
1989: $10,000
1990: $15,000
1991: $20,000

Example 5. During 1987 E incurs a $10,000 debt secured by a principal residence. E uses (within the meaning of paragraph (n)(2)(i) of this section) all of the proceeds of the debt to pay for qualified educational expenses. On August 20, 1988, at which time the balance of the debt is $9,500, E incurs a new debt in the amount of $9,500 secured by E's principal residence and uses all of the proceeds of the new debt to repay the original debt. Under paragraph (n)(2)(ii) of this section, all of the proceeds of the new debt are used to pay for qualified educational expenses.

(3) *Qualified medical expenses.* Qualified medical expenses are amounts that are paid for medical care (within the meaning of section 213(d)(1) (A) and (B)) for the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer (within the meaning of section 152), and that are not compensated for by insurance or otherwise.

(4) *Qualified educational expenses.* Qualified educational expenses are amounts that are paid for tuition, fees, books, supplies and equipment required for enrollment, attendance or courses of instruction at an educational organization described in section 170(b)(1)(A)(ii) and for any reasonable living expenses while away from home while in attendance at such an institution, for the taxpayer, the taxpayer's spouse or a dependent of the taxpayer (within the meaning of section 152) and that are not reimbursed by scholarship or otherwise.

(o) *Secured debt*—(1) *In general.* For purposes of this section, the term ''secured debt'' means a debt that is on the security of any instrument (such as a mortgage, deed of trust, or land contract)—

(i) That makes the interest of the debtor in the qualified residence specific security for the payment of the debt,

(ii) Under which, in the event of default, the residence could be subjected to the satisfaction of the debt with the same priority as a mortgage or deed of trust in the jurisdiction in which the property is situated, and

(iii) That is recorded, where permitted, or is otherwise perfected in accordance with applicable State law.

A debt will not be considered to be secured by a qualified residence if it is secured solely by virtue of a lien upon the general assets of the taxpayer or by a security interest, such as a mechanic's lien or judgment lien, that attaches to the property without the consent of the debtor.

(2) *Special rule for debt in certain States.* Debt will not fail to be treated as secured solely because, under an applicable State or local homestead law or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

(3) *Times at which debt is treated as secured.* For purposes of this section, a debt is treated as secured as of the date on which each of the requirements of paragraph (o)(1) of this section are satisfied, regardless of when amounts are actually borrowed with respect to the debt. For purposes of this paragraph (o)(3), if the instrument is recorded within a commercially reasonable time after the security interest is granted, the instrument will be treated as recorded on the date that the security interest was granted.

(4) *Partially secured debt*—(i) *In general.* If the security interest is limited to a prescribed maximum amount or portion of the residence, and the average balance of the debt exceeds such amount or the value of such portion, such excess shall not be treated as secured debt for purposes of this section.

(ii) *Example.* T borrows $80,000 on January 1, 1991. T secures the debt with a principal residence. The security in the residence for the debt, however, is limited to $20,000. T pays $8,000 in interest on the debt in 1991 and the average balance of the debt in that year is $80,000. Because the average balance of the debt exceeds the maximum amount of the security interest, such excess is not treated as secured debt. Therefore, for purposes of applying the limitation on qualified residence interest, the average balance of the secured debt is $20,000 (the maximum amount of the security interest) and the interest paid or accrued on the secured debt is $2,000 (the total interest paid on the debt multiplied by the ratio of the average balance of the secured debt ($20,000) and the average balance of the total debt ($80,000)).

(5) *Election to treat debt as not secured by a qualified residence*—(i) *In general.* For purposes of this section, a taxpayer may elect to treat any debt that is secured by a qualified residence as not secured by the qualified residence. An election made under this paragraph shall be effective for the taxable year for which the election is made and for all subsequent taxable years unless revoked with the consent of the Commissioner.

(ii) *Example.* T owns a principal residence with a fair market value of $75,000 and an adjusted purchase price of $40,000. In 1988, debt A, the proceeds of which were used to purchase the residence, has an average balance of $15,000. The proceeds of debt B, which is secured by a second mortgage on the property, are allocable to T's trade or business under §1.163–8T and has an average balance of $25,000. In 1988, T incurs debt C, which is also secured by T's principal residence and which has an average balance in 1988 of $5,000. In the absence of an election to treat debt B as unsecured, the applicable debt limit for debt C in 1988 under paragraph (e) of this section would be zero dollars ($40,000−$15,000−$25,000) and none of the interest paid on debt C would be qualified residence interest. If, however, T makes or has previously made an election pursuant to paragraph (o)(5)(i) of this section to treat debt B as not secured by the residence, the applicable debt limit for debt C would be $25,000 ($40,000−$15,000), and all of the interest paid on debt C during the taxable year would be qualified residence interest. Since the proceeds of debt B are allocable to T's trade or business under §1.163–8T, interest on debt B may be deductible under other sections of the Internal Revenue Code.

(iii) *Allocation of debt secured by two qualified residences.* [Reserved]

(p) *Definition of qualified residence*—(1) *In general.* The term ''qualified residence'' means the taxpayer's principal residence (as defined in paragraph (p)(2) of this section), or the taxpayer's second residence (as defined in paragraph (p)(3) of this section).

(2) *Principal residence.* The term ''principal residence'' means the taxpayer's principal residence within the meaning of section 1034. For purposes of this section, a taxpayer cannot have more than one principal residence at any one time.

(3) *Second residence*—(i) *In general.* The term ''second residence'' means—

(A) A residence within the meaning of paragraph (p)(3)(ii) of this section,

(B) That the taxpayer uses as a residence within the meaning of paragraph (p)(3)(iii) of this section, and

(C) That the taxpayer elects to treat as a second residence pursuant to paragraph (p)(3)(iv) of this section.

A taxpayer cannot have more than one second residence at any time.

(ii) *Definition of residence.* Whether property is a residence shall be determined based on all the facts and circumstances, including the good faith of the taxpayer. A residence generally includes a house, condominium, mobile home, boat, or house trailer, that contains sleeping space and toilet and cooking facilities. A residence does not include personal property, such as furniture or a television, that, in accordance with the applicable local law, is not a fixture.

(iii) *Use as a residence.* If a residence is rented at any time during the taxable year, it is considered to be used as a residence only if the taxpayer uses it during the taxable year as a residence within the meaning of section 280A(d). If a residence is not rented at any time during the taxable year, it shall be considered to be used as a residence. For purposes of the preceding sentence, a residence will be deemed to be rented during any period that the taxpayer holds the residence out for rental or resale or repairs or renovates the residence with the intention of holding it out for rental or resale.

(iv) *Election of second residence.* A taxpayer may elect a different residence (other than the taxpayer's principal residence) to be the taxpayer's second residence for each taxable year. A taxpayer may not elect different residences as second residences at different times of the same taxable year except as provided below—

(A) If the taxpayer acquires a new residence during the taxable year, the taxpayer may elect the new residence as a taxpayer's second residence as of the date acquired;

(B) If property that was the taxpayer's principal residence during the taxable year ceases to qualify as the taxpayer's principal residence, the taxpayer may elect that property as the taxpayer's second residence as of the date that the property ceases to be the taxpayer's principal residence; or

(C) If property that was the taxpayer's second residence is sold during the taxable year or becomes the taxpayer's principal residence, the taxpayer may elect a new second residence as of such day.

(4) *Allocations between residence and other property*—(i) *In general.* For purposes of this section, the adjusted purchase price and fair market value of property must be allocated between the portion of the property that is a qualified residence and the portion that is not a qualified residence. Neither the average balance of the secured debt nor the interest paid or accrued on secured debt is so allocated. Property that is not used for residential purposes does not qualify as a residence. For example, if a portion of the property is used as an office in the taxpayer's trade or business, that portion of the property does not qualify as a residence.

(ii) *Special rule for rental of residence.* If a taxpayer rents a portion of his or her principal or second residence to another person (a ''tenant''), such portion may be treated as used by the taxpayer for residential purposes if, but only if—

(A) Such rented portion is used by the tenant primarily for residential purposes,

(B) The rented portion is not a self-contained residential unit containing separate sleeping space and toilet and cooking facilities, and

(C) The total number of tenants renting (directly or by sublease) the same or different portions of the residence at any time during the taxable year does not exceed two. For this purpose, if two persons (and the dependents, as defined by section 152, of either of them) share the same sleeping quarters, they shall be treated as a single tenant.

(iii) *Examples.*

Example 1. D, a dentist, uses a room in D's principal residence as an office which qualifies under section 280A(c)(1)(B) as a portion of the dwelling unit used exclusively on a regular basis as a place of business for meeting with patients in the normal course of D's trade or business. D's adjusted purchase price of the property is $65,000; $10,000 of which is allocable under paragraph (o)(4)(i) of this section to the room used as an office. For purposes of this section, D's residence does not include the room used as an office. The adjusted purchase price of the residence is, accordingly, $55,000. Similarly, the fair market value of D's residence must be allocated between the office and the remainder of the property.

Example 2. J rents out the basement of property that is otherwise used as J's principal residence. The basement is a self-contained residential unit, with sleeping space and toilet and cooking facilities. The adjusted purchase price of the property is $100,000; $15,000 of which is allocable under paragraph (o)(4)(i) of this section to the basement. For purposes of this section, J's residence does not include the basement and the adjusted purchase price of the residence is $85,000. Similarly, the fair market value of the residence must be allocated between the basement unit and the remainder of the property.

(5) *Residence under construction*—(i) *In general.* A taxpayer may treat a residence under construction as a qualified residence for a period of up to 24 months, but only if the residence becomes a qualified residence, without regard to this paragraph (p)(5)(i), as of the time that the residence is ready for occupancy.

(ii) *Example.* X owns a residential lot suitable for the construction of a vacation home. On April 20, 1987, X obtains a mortgage secured by the lot and any property to be constructed on the lot. On August 9, 1987, X begins construction of a residence on the lot. The residence is ready for occupancy on November 9, 1989. The residence is used as a residence within the meaning of paragraph (p)(3)(iii) of this section during 1989 and X elects to treat the residence as his second residence for the period November 9, 1989, through December 31, 1989. Since the residence under construction is a qualified residence as of the first day that the residence is ready for occupancy (November 9, 1987), X may treat the residence as his second residence under paragraph (p)(5)(i) of this section for up to 24 months of the period during which the residence is under construction, commencing on or after the date that construction is begun (August 9, 1987). If X treats the residence under construction as X's second residence beginning on August 9, 1987, the residence under construction would cease to qualify as a qualified residence under paragraph (p)(5)(i) on August 8, 1989. The residence's status as a qualified residence for future periods would be determined without regard to paragraph (p)(5)(i) of this section.

(6) *Special rule for time-sharing arrangements.* Property that is otherwise a qualified residence will not fail to qualify as such solely because the taxpayer's interest in or right to use the property is restricted by an arrangement whereby two or more persons with interests in the property agree to exercise control over the property for different periods during the taxable year. For purposes of determining the use of a residence under paragraph (p)(3)(iii) of this section, a taxpayer will not be considered to have used or rented a residence during any period that the taxpayer does not have the right to use the property or to receive any benefits from the rental of the property.

(q) *Special rules for tenant-stockholders in cooperative housing corporations*—(1) *In general.* For purposes of this section, a residence includes stock in a cooperative housing corporation owned by a tenant-stockholder if the house or apartment which the tenant-stockholder is entitled to occupy by virtue of owning such stock is a residence within the meaning of paragraph (p)(3)(ii) of this section.

(2) *Special rule where stock may not be used to secure debt.* For purposes of this section, if stock described in paragraph (q)(1) of this section may not be used to secure debt because of restrictions under local or State law or because of restrictions in the cooperative agreement (other than restrictions the principal purpose of which is to permit the tenant-stockholder to treat unsecured debt as secured debt under this paragraph (q)(2)), debt may be treated as secured by such stock to the extent that the proceeds of the debt are allocated to the purchase of the stock under the rules of §1.163–8T. For purposes of this paragraph (q)(2), proceeds of debt incurred prior to January 1, 1987, may be treated as allocated to the purchase of such stock to the extent that the tenant-stockholder has properly and consistently deducted interest expense on such debt as home mortgage interest attributable to such stock on Schedule A of Form 1040 in determining his taxable income for taxable years beginning before January 1, 1987. For purposes of this paragraph (q)(2), amended returns filed after December 22, 1987, are disregarded.

(3) *Treatment of interest expense of the cooperative described in section 216(a)(2).* For purposes of section 163(h) and §1.163–9T (disallowance of deduction for personal interest) and section 163(d) (limitation on investment interest), any amount allowable as a deduction to a tenant-stockholder under section 216(a)(2) shall be treated as interest paid or accrued by the tenant-stockholder. If a tenant-stockholder's stock in a cooperative housing corporation is a qualified residence of the tenant-shareholder, any amount allowable as a deduction to the tenant-stockholder under section 216(a)(2) is qualified residence interest.

(4) *Special rule to prevent tax avoidance.* If the amount treated as qualified residence interest under this section exceeds the amount which would be so treated if the tenant-stockholder were treated as directly owning his proportionate share of the assets and liabilities of the cooperative and one of the principal purposes of the cooperative arrangement is to permit the tenant-stockholder to increase the amount of qualified residence interest, the district director may determine that such excess is not qualified residence interest.

(5) *Other definitions.* For purposes of this section, the terms ''tenant-stockholder,'' ''cooperative housing corporation'' and ''proportionate share'' shall have the meaning given by section 216 and the regulations thereunder.

(r) *Effective date.* The provisions of this section are effective for taxable years beginning after December 31, 1986.

[T.D. 8168, 52 FR 48410, Dec. 22, 1987]

§ 1.163–11 Allocation of certain prepaid qualified mortgage insurance premiums.

(a) *Allocation*—(1) *In general.* As provided in section 163(h)(3)(E), premiums paid or accrued for qualified mortgage insurance during the taxable year in connection with acquisition indebtedness with respect to a qualified residence (as defined in section 163(h)(4)(A)) of the taxpayer shall be treated as qualified residence interest (as defined in section 163(h)(3)(A)). If an individual taxpayer pays such a premium that is properly allocable to a mortgage the payment of which extends to periods beyond the close of the taxable year in which the premium is paid, the taxpayer must allocate the premium to determine the amount treated as qualified residence interest for each taxable year. The premium must be allocated ratably over the shorter of—

(i) The stated term of the mortgage; or

(ii) A period of 84 months, beginning with the month in which the insurance was obtained.

(2) *Limitation.* If a mortgage is satisfied before the end of its stated term, no deduction as qualified residence interest shall be allowed for any amount of the premium that is allocable to periods after the mortgage is satisfied.

(b) *Scope.* The allocation requirement in paragraph (a) of this section applies only to mortgage insurance provided by the Federal Housing Administration or private mortgage insurance (as defined by section 2 of the Homeowners Protection Act of 1998 (12 U.S.C. 4901) as in effect on December 20, 2006). It does not apply to mortgage insurance provided by the Department of Veterans Affairs or the Rural Housing Service. Paragraph (a) of this section applies whether the qualified mortgage insurance premiums are paid in cash or are financed, without regard to source.

(c) *Limitation on the treatment of mortgage insurance premiums as interest.* This section applies to prepaid qualified mortgage insurance premiums described in paragraph (a) of this section that are paid or accrued on or after January 1, 2011, and during periods to which section 163(h)(3)(E) is applicable. This section does not apply to any amount of prepaid qualified mortgage insurance premiums that are allocable to any periods to which section 163(h)(3)(E) is not applicable.

(d) *Effective/applicability date.* This section is applicable on and after January 1, 2011. For regulations applicable before January 1, 2011, see § 1.163–11T in effect prior to January 1, 2011 (§ 1.163–11T as contained in 26 CFR part 1 edition revised as of April 1, 2011).

[T.D. 9588, 77 FR 26699, May 7, 2012]

§ 1.163–12 Deduction of original issue discount on instrument held by related foreign person.

(a) *General rules*—(1) *Deferral of deduction.* Except as provided in paragraph (b) of this section, section 163(e)(3) requires a taxpayer to use the cash method of accounting with respect to the deduction of original issue discount owed to a related foreign person. A deduction for an otherwise deductible portion of original issue discount with respect to a debt instrument will not be allowable as a deduction to the issuer until paid if, at the close of the issuer's taxable year in which such amount would otherwise be deductible, the person holding the debt instrument is a related foreign person. For purposes of this section, a related foreign person is any person that is not a United States person within the meaning of section 7701(a)(30), and that is related (within the meaning of section 267(b)) to the issuer at the close of the taxable year in which the amount incurred by the taxpayer would otherwise be deductible. Section 267(f) defines ''controlled group'' for purposes of section 267(b) without regard to the limitations of section 1563(b). An amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441 or section 1442 (including an amount taken into account pursuant to section 871(a)(1)(C), section 881(a)(3), or section 884(f)). The rules of this paragraph (a) apply even if the original issue discount is not subject to United States tax, or is subject to a reduced rate of tax, pursuant to a provision of the Internal Revenue Code or a treaty obligation of the United States. For purposes of this section, original issue discount is an amount described in section 1273, whether from sources inside or outside the United States.

(2) *Change in method of accounting.* A taxpayer that uses a method of accounting other than that required by the rules of this section must change its method of accounting to conform its method to the rules of this section. The taxpayer's change in method must be made pursuant to the rules of section 446(e), the regulations thereunder, and any applicable administrative procedures prescribed by the Commissioner. Because the rules of this section prescribe a method of accounting, these rules apply in the determination of a taxpayer's earnings and profits pursuant to § 1.312–6(a).

(b) *Exceptions and special rules*—(1) *Effectively connected income.* The provisions of section 267(a)(2) and the regulations thereunder, and not the provisions of paragraph (a) of this section, apply to an amount of original issue discount that is income of the related foreign person that is effectively connected with the conduct of a United States trade or business of such related foreign person. An amount described in this paragraph (b)(1) thus is allowable as a deduction as of the day on which the amount is includible in the gross income of the related foreign person as effectively connected income under sections 872(a)(2) or 882(b) (or, if later, as of the day on which the deduction would be so allowable but for section 267(a)(2)). However, this paragraph (b)(1) does not apply if the related foreign person is exempt from United States income tax on the amount owed, or is subject to a reduced rate of tax, pursuant to a treaty obligation of the United States (such as under an article relating to the taxation of business profits).

(2) *Certain obligations issued by natural persons.* This section does not apply to any debt instrument described in section 163(e)(4) (relating to obligations issued by natural persons before March 2, 1984, and to loans between natural persons).

(3) *Amounts owed to a foreign personal holding company, controlled foreign corporation, or passive foreign investment company*—(i) *Foreign personal holding companies.* If an amount to which paragraph (a) of this section otherwise applies is owed to a related foreign person that is a foreign personal holding company within the meaning of section 552, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the foreign personal holding company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the foreign personal holding company computes its taxable income and earnings and profits for purposes of sections 551 through 558. See section 551(c) and the regulations thereunder for the reporting requirements of the foreign personal holding company provisions (sections 551 through 558).

(ii) *Controlled foreign corporations.* If an amount to which paragraph (a) of this section otherwise applies is owed to a related foreign person that is a controlled foreign corporation within the meaning of section 957, then the amount is allowable as a deduction as of the day on which the amount is includible in the income of the controlled foreign corporation. The day on which the amount is includible in income is determined with reference to the method of accounting under which the controlled foreign corporation computes its taxable income and earnings and profits for purposes of sections 951 through 964. See section 6038 and the regulations thereunder for the reporting requirements of the controlled foreign corporation provisions (sections 951 through 964).

(iii) *Passive foreign investment companies.* If an amount to which paragraph (a) of this section otherwise applies is owed to a related foreign person that is a passive foreign investment company within the meaning of section 1296, then the amount is allowable as a deduction as of the day on which amount is includible in the income of the passive foreign investment company. The day on which the amount is includible in income is determined with reference to the method of accounting under which the earnings and profits of the passive foreign investment company are computed for purposes of sections 1291 through 1297. See sections 1291 through 1297 and the regulations thereunder for the reporting requirements of the passive foreign investment company provisions. This exception shall apply, however, only if the person that owes the amount at issue has made and has in effect an election pursuant to section 1295 with respect to the passive foreign investment company to which the amount at issue is owed.

(c) *Application of section 267.* Except as limited in paragraph (b)(1) of this section, the provisions of section 267 and the regulations thereunder shall apply to any amount of original issue discount to which the provisions of this section do not apply.

(d) *Effective date.* The rules of this section are effective with respect to all original issue discount on debt instruments issued after June 9, 1984.

[T.D. 8465, 58 FR 236, Jan. 5, 1993; 58 FR 8098, Feb. 11, 1993]

§ 1.163–13 Treatment of bond issuance premium.

(a) *General rule.* If a debt instrument is issued with bond issuance premium, this section limits the amount of the issuer's interest deduction otherwise allowable under section 163(a). In general, the issuer determines its interest deduction by offsetting the interest allocable to an accrual period with the bond issuance premium allocable to that period. Bond issuance premium is allocable to an accrual period based on a constant yield. The use of a constant yield to amortize bond issuance premium is intended to generally conform the treatment of debt instruments having bond issuance premium with those having original issue discount. Unless otherwise provided, the terms used in this section have the same meaning as those terms in section 163(e), sections 1271 through 1275, and the corresponding regulations. Moreover, unless otherwise provided, the provisions of this section apply in a manner consistent with those of section 163(e), sections 1271 through 1275, and the corresponding regulations. In addition, the anti-abuse rule in § 1.1275–2(g) applies for purposes of this section. For rules dealing with the treatment of bond premium by a holder, see §§ 1.171–1 through 1.171–5.

(b) *Exceptions.* This section does not apply to—

(1) A debt instrument described in section 1272(a)(6)(C) (regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments, or pools of debt instruments, with payments subject to acceleration); or

(2) A debt instrument to which § 1.1275–4 applies (relating to certain debt instruments that provide for contingent payments).

(c) *Bond issuance premium.* Bond issuance premium is the excess, if any, of the issue price of a debt instrument over its stated redemption price at maturity. For purposes of this section, the issue price of a convertible bond (as defined in § 1.171–1(e)(1)(iii)(C)) does not include an amount equal to the value of the conversion option (as determined under § 1.171–1(e)(1)(iii)(A)).

(d) *Offsetting qualified stated interest with bond issuance premium*—(1) *In general.* An issuer amortizes bond issuance premium by offsetting the qualified stated interest allocable to an accrual period with the bond issuance premium allocable to the accrual period. This offset occurs when the issuer takes the qualified stated interest into account under its regular method of accounting.

(2) *Qualified stated interest allocable to an accrual period.* See § 1.446–2(b) to determine the accrual period to which qualified stated interest is allocable and to determine the accrual of qualified stated interest within an accrual period.

(3) *Bond issuance premium allocable to an accrual period.* The bond issuance premium allocable to an accrual period is determined under this paragraph (d)(3). Within an accrual period, the bond issuance premium allocable to the period accrues ratably.

(i) *Step one: Determine the debt instrument's yield to maturity.* The yield to maturity of a debt instrument is determined under the rules of § 1.1272–1(b)(1)(i).

(ii) *Step two: Determine the accrual periods.* The accrual periods are determined under the rules of § 1.1272–1(b)(1)(ii).

(iii) *Step three: Determine the bond issuance premium allocable to the accrual* *period*. The bond issuance premium allocable to an accrual period is the excess of the qualified stated interest allocable to the accrual period over the product of the adjusted issue price at the beginning of the accrual period and the yield. In performing this calculation, the yield must be stated appropriately taking into account the length of the particular accrual period. Principles similar to those in §1.1272–1(b)(4) apply in determining the bond issuance premium allocable to an accrual period.

(4) *Bond issuance premium in excess of qualified stated interest*—(i) *Ordinary income*. If the bond issuance premium allocable to an accrual period exceeds the qualified stated interest allocable to the accrual period, the excess is treated as ordinary income by the issuer for the accrual period. 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 accrual periods exceed the total amount treated by the issuer as ordinary income on the debt instrument in prior accrual periods.

(ii) *Carryforward*. If the bond issuance premium allocable to an accrual period exceeds the sum of the qualified stated interest allocable to the accrual period and the amount treated as ordinary income for the accrual period under paragraph (d)(4)(i) of this section, the excess is carried forward to the next accrual period and is treated as bond issuance premium allocable to that period. If a carryforward exists on the date the debt instrument is retired, the carryforward is treated as ordinary income on that date.

(e) *Special rules*—(1) *Variable rate debt instruments*. An issuer determines bond issuance premium on a variable rate debt instrument by reference to the stated redemption price at maturity of the equivalent fixed rate debt instrument constructed for the variable rate debt instrument. The issuer also allocates any bond issuance premium among the accrual periods by reference to the equivalent fixed rate debt instrument. The issuer constructs the equivalent fixed rate debt instrument, as of the issue date, by using the principles of §1.1275–5(e).

(2) *Inflation-indexed debt instruments*. An issuer determines bond issuance premium on an inflation-indexed debt instrument by assuming that there will be no inflation or deflation over the term of the instrument. The issuer also allocates any bond issuance premium among the accrual periods by assuming that there will be no inflation or deflation over the term of the instrument. The bond issuance premium allocable to an accrual period offsets qualified stated interest allocable to the period. Notwithstanding paragraph (d)(4) of this section, if the bond issuance premium allocable to an accrual period exceeds the qualified stated interest allocable to the period, the excess is treated as a deflation adjustment under §1.1275–7(f)(1)(ii). See §1.1275–7 for other rules relating to inflation-indexed debt instruments.

(3) *Certain debt instruments subject to contingencies*—(i) *In general*. Except as provided in paragraph (e)(3)(ii) of this section, the rules of §1.1272–1(c) apply to determine a debt instrument's payment schedule for purposes of this section. For example, an issuer uses the payment schedule determined under §1.1272–1(c) to determine the amount, if any, of bond issuance premium on the debt instrument, the yield and maturity of the debt instrument, and the allocation of bond issuance premium to an accrual period.

(ii) *Mandatory sinking fund provision*. Notwithstanding paragraph (e)(3)(i) of this section, if a debt instrument is subject to a mandatory sinking fund provision described in §1.1272–1(c)(3), the issuer must determine the payment schedule by assuming that a pro rata portion of the debt instrument will be called under the sinking fund provision.

(4) *Remote and incidental contingencies*. For purposes of determining the amount of bond issuance premium and allocating bond issuance premium among accrual periods, if a bond provides for a contingency that is remote or incidental (within the meaning of §1.1275–2(h)), the issuer takes the contingency into account under the rules for remote and incidental contingencies in §1.1275–2(h).

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

Example. (i) *Facts.* On February 1, 1999, X issues for $110,000 a debt instrument maturing on February 1, 2006, with a stated principal amount of $100,000, payable at maturity. The debt instrument provides for unconditional payments of interest of $10,000, payable on February 1 of each year. X uses the calendar year as its taxable year, X uses the cash receipts and disbursements method of accounting, and X decides to use annual accrual periods ending on February 1 of each year. X's calculations assume a 30-day month and 360-day year.

(ii) *Amount of bond issuance premium.* The issue price of the debt instrument is $110,000. Because the interest payments on the debt instrument are qualified stated interest, the stated redemption price at maturity of the debt instrument is $100,000. Therefore, the amount of bond issuance premium is $10,000 ($110,000 − $100,000).

(iii) *Bond issuance premium allocable to the first accrual period.* Based on the payment schedule and the issue price of the debt instrument, the yield of the debt instrument is 8.07 percent, compounded annually. (Although, for purposes of simplicity, the yield as stated is rounded to two decimal places, the computations do not reflect this rounding convention.) The bond issuance premium allocable to the accrual period ending on February 1, 2000, is the excess of the qualified stated interest allocable to the period ($10,000) over the product of the adjusted issue price at the beginning of the period ($110,000) and the yield (8.07 percent, compounded annually). Therefore, the bond issuance premium allocable to the accrual period is $1,118.17 ($10,000 − $8,881.83).

(iv) *Premium used to offset interest.* Although X makes an interest payment of $10,000 on February 1, 2000, X only deducts interest of $8,881.83, the qualified stated interest allocable to the period ($10,000) offset with the bond issuance premium allocable to the period ($1,118.17).

(g) *Effective date.* This section applies to debt instruments issued on or after March 2, 1998.

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

(2) *Automatic consent.* The Commissioner grants consent for an issuer to change its method of accounting for bond issuance premium on debt instruments issued on or after March 2, 1998. Because this change is made on a cutoff basis, no items of income or deduction are omitted or duplicated and, therefore, no adjustment under section 481 is allowed. The consent granted by this paragraph (h)(2) applies provided—

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

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

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

[T.D. 8746, 62 FR 68176, Dec. 31, 1997, as amended by T.D. 8838, 64 FR 48547, Sept. 7, 1999]

§ 1.163–15 Debt proceeds distributed from any taxpayer account or from cash.

(a) *In general.* Regardless of paragraphs (c)(4) and (5) of § 1.163–8T, in the case of debt proceeds deposited in an account, a taxpayer that is applying § 1.163–8T or § 1.163–14 may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are deposited in any account of the taxpayer as made from such proceeds to the extent thereof. Similarly, in the case of debt proceeds received in cash, a taxpayer that is applying § 1.163–8T or § 1.163–14 may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are received in cash as made from such proceeds to the extent thereof. For purposes of this section, terms used have the same meaning as in § 1.163–8T(c)(4) and (5).

(b) *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 to 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 in this section to that taxable year and each subsequent taxable year.

[T.D. 9943, 86 FR 5521, Jan. 19, 2021]

§ 1.163(d)–1 Time and manner for making elections under the Omnibus Budget Reconciliation Act of 1993 and the Jobs and Growth Tax Relief Reconciliation Act of 2003.

(a) *Description*. Section 163(d)(4)(B)(iii), as added by section 13206(d) of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 467), allows an electing taxpayer to take all or a portion of certain net capital gain attributable to dispositions of property held for investment into account as investment income. Section 163(d)(4)(B), as amended by section 302(b) of the Jobs and Growth Tax Relief Reconciliation Act of 2003 (Pub. L. 108–27, 117 Stat. 762), allows an electing taxpayer to take all or a portion of qualified dividend income, as defined in section 1(h)(11)(B), into account as investment income. As a consequence, the net capital gain and qualified dividend income taken into account as investment income under these elections are not eligible to be taxed at the capital gains rates. An election may be made for net capital gain recognized by noncorporate taxpayers during any taxable year beginning after December 31, 1992. An election may be made for qualified dividend income received by noncorporate taxpayers during any taxable year beginning after December 31, 2002, but before January 1, 2009.

(b) *Time and manner for making the elections*. The elections for net capital gain and qualified dividend income must be made on or before the due date (including extensions) of the income tax return for the taxable year in which the net capital gain is recognized or the qualified dividend income is received. The elections are to be made on Form 4952, ''Investment Interest Expense Deduction,'' in accordance with the form and its instructions.

(c) *Revocability of elections*. The elections described in this section are revocable with the consent of the Commissioner.

(d) *Effective date*. The rules set forth in this section regarding the net capital gain election apply beginning December 12, 1996. The rules set forth in this section regarding the qualified dividend income election apply to any taxable year beginning after December 31, 2002, but before January 1, 2009.

[T.D. 9191, 70 FR 13100, Mar. 18, 2005]

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[T.D. 9905, 85 FR 56760, Sept, 14, 2020, as amended by T.D. 9943, 86 FR 5522, Jan. 19, 2021]

§ 1.163(j)–1 Definitions.

§1.163(j)–1 Definitions.

(a) *In general*. The definitions provided in this section apply for purposes of the section 163(j) regulations. For purposes of the rules set forth in §§1.163(j)–2 through 1.163(j)–11, additional definitions for certain terms are provided in those sections.

(b) *Definitions*—(1) *Adjusted taxable income*. The term *adjusted taxable income* (ATI) means the tentative taxable income of the taxpayer for the taxable year, with the adjustments in this paragraph (b)(1).

(i) *Additions*. The amounts of the following items that were included in the computation of the taxpayer's tentative taxable income (if any) are added to tentative taxable income to determine ATI—

(A) Any business interest expense, other than disallowed business interest expense carryforwards;

(B) Any net operating loss deduction under section 172;

(C) Any deduction under section 199A;

(D) Subject to paragraph (b)(1)(iii) of this section, for taxable years beginning before January 1, 2022, any depreciation under section 167, section 168, or section 168 of the Internal Revenue Code (Code) of 1954 (former section 168);

(E) Subject to paragraph (b)(1)(iii) of this section, for taxable years beginning before January 1, 2022, any amortization of intangibles (for example, under section 167 or 197) and other amortized expenditures (for example, under section 174(b), 195(b)(1)(B), 248, or 1245(a)(2)(C));

(F) Subject to paragraph (b)(1)(iii) of this section, for taxable years beginning before January 1, 2022, any depletion under section 611;

(G) Any deduction for a capital loss carryback or carryover; and

(H) Any deduction or loss that is not properly allocable to a non-excepted trade or business (for rules governing the allocation of items to an excepted trade or business, see §§ 1.163(j)–1(b)(44) and 1.163(j)–10).

(ii) *Subtractions.* The amounts of the following items (if any) are subtracted from the taxpayer's tentative taxable income to determine ATI —

(A) Any business interest income that was included in the computation of the taxpayer's tentative taxable income;

(B) Any floor plan financing interest expense for the taxable year that was included in the computation of the taxpayer's tentative taxable income;

(C) With respect to the sale or other disposition of property, the greater of the allowed or allowable depreciation, amortization, or depletion of the property, as provided under section 1016(a)(2), for the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group) for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property;

(D) With respect to the sale or other disposition of stock of a member of a consolidated group by another member, the investment adjustments under § 1.1502–32 with respect to such stock that are attributable to deductions described in paragraph (b)(1)(ii)(C) of this section;

(E) With respect to the sale or other disposition of an interest in a partnership, the taxpayer's distributive share of deductions described in paragraph (b)(1)(ii)(C) of this section with respect to property held by the partnership at the time of such sale or other disposition to the extent such deductions were allowable under section 704(d);

(F) Any income or gain that is not properly allocable to a non-excepted trade or business (for rules governing the allocation of items to an excepted trade or business, see §§ 1.163(j)–1(b)(44) and 1.163(j)–10)) and that was included in the computation of the taxpayer's tentative taxable income; and

(G) An amount equal to the sum of any specified deemed inclusions that were included in the computation of the taxpayer's tentative taxable income, reduced by the portion of the deduction allowed under section 250(a) by reason of the specified deemed inclusions. For this purpose, a *specified deemed inclusion* is the inclusion of an amount by a United States shareholder (as defined in section 951(b)) in gross income under section 78, 951(a), or 951A(a) with respect to an applicable CFC (as defined in § 1.163(j)–1(b)(2)) that is properly allocable to a non-excepted trade or business. Furthermore, a specified deemed inclusion includes any amounts included in a domestic partnership's gross income under section 951(a) or 951A(a) with respect to an applicable CFC to the extent such amounts are attributable to investment income of the partnership and are allocated to a domestic C corporation that is a direct (or indirect partner) and treated as properly allocable to a non-excepted trade or business of the domestic C corporation under §§ 1.163(j)–4(b)(3) and 1.163(j)–10. To determine the amount of a specified deemed inclusion described in this paragraph (b)(1)(ii)(G), the portion of a United States shareholder's inclusion under section 951A(a) treated as being with respect to an applicable CFC is determined under section 951A(f)(2) and § 1.951A–6(b)(2).

(iii) *Depreciation, amortization, or depletion capitalized under section 263A.* For purposes of paragraph (b)(1)(i) of this section, amounts of depreciation, amortization, or depletion that are capitalized under section 263A during the taxable year are deemed to be included in the computation of the taxpayer's tentative taxable income for such taxable year, regardless of the period in which the capitalized amount is recovered. See *Example 3* in § 1.163(j)–2(h)(3).

(iv) *Application of § 1.163(j)–1(b)(1)(ii)(C), (D), and (E)*—(A) *Sale or other disposition*—(*1*) *In general.* For purposes of paragraphs (b)(1)(ii)(C), (D), and (E) and paragraphs (b)(1)(iv)(B) and (E) of this section, except as otherwise provided in this paragraph (b)(1)(iv)(A), the term *sale or other disposition* does not include a transfer of an asset to an acquiring corporation in a transaction to which section 381(a) applies.

(*2*) *Intercompany transactions.* For purposes of paragraphs (b)(1)(ii)(C) and (D) and paragraphs (b)(1)(iv)(B) and (b)(1)(iv)(E)(*1*) and (*2*) of this section, the term *sale or other disposition* excludes all intercompany transactions, within the meaning of §1.1502–13(b)(1)(i), to the extent necessary to achieve single-entity taxation of the consolidated group.

(*3*) *Deconsolidations.* Notwithstanding any other rule in this paragraph (b)(1)(iv)(A), any transaction in which a member (S) leaves a consolidated group (selling group), including a section 381(a) transaction described in paragraph (b)(1)(iv)(A)(*1*) of this section, is treated as a taxable disposition of all S stock held by any member of the selling group for purposes of paragraphs (b)(1)(ii)(C) and (D) and paragraphs (b)(1)(iv)(B) and (b)(1)(iv)(E)(*1*) and (*2*) of this section, unless the transaction is described in §1.1502–13(j)(5)(i). Following S's deconsolidation, any subsequent sales or dispositions of S stock by the selling group do not trigger further adjustments under paragraphs (b)(1)(ii)(C) and (D) and paragraphs (b)(1)(iv)(B) and (b)(1)(iv)(E)(*1*) and (*2*) of this section. If a transaction is described in §1.1502–13(j)(5)(i), the transaction is not treated as a sale or other disposition for purposes of paragraphs (b)(1)(ii)(C) and (D) and paragraphs (b)(1)(iv)(B) and (b)(1)(iv)(E)(*1*) and (*2*) of this section. See also the successor rules in paragraph (b)(1)(iv)(C) of this section.

(*4*) *Nonrecognition transactions.* The disposition of property, member stock (other than in a deconsolidation described in paragraph (b)(1)(iv)(A)(*3*) of this section), or partnership interests in a nonrecognition transaction, other than a section 381(a) transaction described in paragraph (b)(1)(iv)(A)(*1*) of this section, is treated as a taxable disposition of the property, member stock, or partnership interest disposed of for purposes of paragraph (b)(1)(iv)(E)(*1*)(*i*), (b)(1)(iv)(E)(*2*)(*i*), and (b)(1)(iv)(E)(*3*)(*i*) of this section, respectively. For example, if a taxpayer transfers property to a wholly owned, non-consolidated subsidiary, the transfer of the property is treated as a taxable disposition for purposes of paragraph (b)(1)(iv)(E)(*1*)(*i*) of this section notwithstanding the application of section 351.

(B) *Deductions by members of a consolidated group*—(*1*) *In general.* If paragraph (b)(1)(ii)(C), (D), or (E) of this section applies to adjust the tentative taxable income of a consolidated group, and if the consolidated group does not use the alternative computation method in paragraph (b)(1)(iv)(E) of this section, the amount of the adjustment under paragraph (b)(1)(ii)(C) of this section equals the greater of the allowed or allowable depreciation, amortization, or depletion of the property, as provided under section 1016(a)(2), for the consolidated group for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property.

(*2*) *Application of the alternative computation method.* If paragraph (b)(1)(ii)(C), paragraph (b)(1)(ii)(D), or paragraph (b)(1)(ii)(E) of this section applies to adjust the tentative taxable income of a consolidated group, and if the consolidated group uses the alternative computation method in paragraph (b)(1)(iv)(E) of this section, the amount of the adjustment computed under paragraph (b)(1)(iv)(E)(*1*)(*i*), paragraph (b)(1)(iv)(E)(*2*)(*i*), or paragraph (b)(1)(iv)(E)(*3*)(*i*) of this section must take into account the net gain that would be taken into account by the consolidated group, including from intercompany transactions, determined by treating the sale or other disposition as a taxable transaction (see paragraphs (b)(1)(iv)(A)(*3*) and (*4*) of this section regarding deconsolidations and certain nonrecognition transactions, respectively).

(C) *Successor rules*—(*1*) *Successor assets.* This paragraph (b)(1)(iv)(C)(*1*) applies if deductions described in paragraph (b)(1)(ii)(C) of this section are allowed or allowable to a consolidated group member (S) and either the depreciable property or S's stock is subsequently transferred to another member (S1) in an intercompany transaction in which the transferor receives S1 stock. If this paragraph (b)(1)(iv)(C)(*1*) applies, and if the transferor's basis in the S1 stock received in the intercompany transaction is determined, in whole or in part, by reference to its basis in the depreciable property or the S stock, the S1 stock received in the intercompany transaction is treated as a successor asset for purposes of paragraph (b)(1)(ii)(D) and (b)(1)(iv)(E)(*2*) of this section. Thus, except as otherwise provided in paragraph (b)(1)(iv)(D) of this section, the subsequent disposition of either the S1 stock or the S stock (or both) may require the application of the adjustment rules of paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(*2*) of this section.

(*2*) *Successor entities.* The acquiring corporation in a section 381(a) transaction to which the exception in paragraph (b)(1)(iv)(A)(*1*) of this section applies is treated as a successor to the distributor or transferor corporation for purposes of paragraphs (b)(1)(ii)(C) through (E) and (b)(1)(iv)(B) and (E) of this section. Therefore, for example, in applying paragraphs (b)(1)(ii)(C) through (E) and (b)(1)(iv)(B) and (E) of this section, the acquiring corporation is treated as succeeding to the allowed or allowable items of the distributor or transferor corporation. Similarly, the surviving group in a transaction described in §1.1502–13(j)(5)(i) to which the exception in paragraph (b)(1)(iv)(A)(*3*) of this section applies is treated as a successor to the terminating group for purposes of paragraphs (b)(1)(ii)(C) through (E) and (b)(1)(iv)(B) and (E) of this section.

(D) *Anti-duplication rule*—(*1*) *In general.* The aggregate of the subtractions from tentative taxable income of a consolidated group under paragraphs (b)(1)(ii)(C) through (E) or paragraphs (b)(1)(iv)(E)(*1*) through (*3*) of this section with respect to an item of property (including with regard to dispositions of successor assets described in paragraph (b)(1)(iv)(C)(*1*) of this section) cannot exceed the aggregate amount of the consolidated group members' deductions described in paragraph (b)(1)(ii)(C) of this section with respect to such item of property. In addition, once an item of property is no longer held by any member of a consolidated group (whether or not an adjustment to the tentative taxable income of the group is made under paragraph (b)(1)(ii)(C) of this section with respect to the direct or indirect disposition of that property), no further adjustment to the group's tentative taxable income is made under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(*2*) of this section in relation to the same property with respect to any subsequent stock disposition.

(*2*) *Adjustments following deconsolidation.* If a corporation (S) leaves a consolidated group (Group 1) in a transaction that requires an adjustment under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(*2*) of this section, no further adjustment is required under paragraph (b)(1)(ii)(C) or (E) or paragraph (b)(1)(iv)(E) of this section in a separate return year (as defined in §1.1502–1(e)) of S with respect to depreciation, amortization, or depletion deductions allowed or allowable to Group 1. See paragraph (b)(1)(iv)(A) of this section for special rules regarding the meaning of the term ''sale or other disposition'' for purposes of the adjustments required under paragraphs (b)(1)(ii)(C) through (E) and paragraphs (b)(1)(iv)(B) and (E) of this section. For example, assume that S deconsolidates from Group 1 in a transaction not described in §1.1502–13(j)(5)(i) after holding property for which depreciation, amortization, or depletion deductions were allowed or allowable in Group 1. On the deconsolidation, S and Group 1 would adjust tentative taxable income with regard to that property. See paragraphs (b)(1)(iv)(A)(*3*), (b)(1)(ii)(D), and (b)(1)(iv)(E)(*2*) of this section. If, following the deconsolidation, S sells the property referred to in the previous sentence, no subtraction from tentative taxable income is made under paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(*1*) of this section during S's separate return year with regard to the amounts included in Group 1. See paragraphs (b)(1)(iv)(A)(*3*), (b)(1)(ii)(D), and (b)(1)(iv)(E)(*2*) of this section.

(E) *Alternative computation method.* If paragraph (b)(1)(ii)(C), (D), or (E) of this section applies to adjust the tentative taxable income of a taxpayer, the taxpayer may compute the amount of the adjustments required by such paragraph using the formulas in paragraph (b)(1)(iv)(E)(*1*), (*2*), and (*3*) of this section, respectively, provided that the taxpayer applies such formulas to all dispositions for which an adjustment is required under paragraph (b)(1)(ii)(C), (D), or (E) of this section. For special rules regarding the treatment of deconsolidating transactions and nonrecognition transactions, see paragraph (b)(1)(iv)(A)(*3*) and (*4*) of this section, respectively. For special rules regarding the application of the formulas in paragraph (b)(1)(iv)(E)(*1*), (*2*), and (*3*) of this section by consolidated groups, see paragraph (b)(1)(iv)(B)(*2*) of this section.

(*1*) *Alternative computation method for property dispositions.* With respect to the sale or other disposition of property, the lesser of:

(*i*) Any gain recognized on the sale or other disposition of such property by the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group); and

(*ii*) The greater of the allowed or allowable depreciation, amortization, or depletion of the property, as provided under section 1016(a)(2), for the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group) for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property.

(*2*) *Alternative computation method for dispositions of member stock.* With respect to the sale or other disposition by a member of a consolidated group of stock of another member for whom depreciation, amortization, or depletion was allowed or allowable with regard to an item of property (or stock of any successor to that member), the lesser of:

(*i*) Any gain recognized on the sale or other disposition of such stock; and

(*ii*) The investment adjustments under §1.1502–32 with respect to such stock that are attributable to deductions described in paragraph (b)(1)(ii)(C) of this section. The investment adjustments referred to in this paragraph (b)(1)(iv)(E)(*2*)(*ii*) include investment adjustments replicated in stock of members that are successor entities.

(*3*) *Alternative computation method for dispositions of partnership interests.* With respect to the sale or other disposition of an interest in a partnership, the lesser of:

(*i*) Any gain recognized on the sale or other disposition of such interest; and

(*ii*) The taxpayer's (or, if the taxpayer is a consolidated group, the consolidated group's) distributive share of deductions described in paragraph (b)(1)(ii)(C) of this section with respect to property held by the partnership at the time of such sale or other disposition to the extent such deductions were allowable under section 704(d).

(F) *Cap on negative adjustments*—(*1*) *In general.* A subtraction from (or negative adjustment to) tentative taxable income that is required under paragraph (b)(1)(ii)(C), (D), or (E) or paragraph (b)(1)(iv)(B) or (E) of this section is reduced to the extent the taxpayer establishes that the positive adjustments to tentative taxable income under paragraphs (b)(1)(i)(D) through (F) of this section in a prior taxable year did not result in an increase in the amount allowed as a deduction for business interest expense for such year. The extent to which the positive adjustments under paragraphs (b)(1)(i)(D) through (F) of this section resulted in an increase in the amount allowed as a deduction for business interest expense in a prior taxable year (such amount of positive adjustments, the *negative adjustment cap*) is determined after taking into account all other adjustments to tentative taxable income under paragraph (b)(1)(i) and (ii) of this section for that year, as established through books and records. The amount of the negative adjustment cap for a prior taxable year is reduced in future taxable years to the extent of negative adjustments under paragraphs (b)(1)(ii)(C) through (E) and paragraphs (b)(1)(iv)(B) and (E) of this section with respect to the prior taxable year.

(*2*) *Example.* A is a calendar-year individual taxpayer engaged in a trade or business that is neither an excepted trade or business nor eligible for the small business exemption. A has no disallowed business interest expense carryforwards. In 2021, A has $100x of business interest expense, no business interest income or floor plan financing interest expense, and $400x of tentative taxable income. After taking into account the adjustments to tentative taxable income under paragraph (b)(1)(i) and (ii) of this section other than positive adjustments under paragraphs (b)(1)(i)(D) through (F) of this section, A has tentative taxable income of $450x. A increases its tentative taxable income by $30x (from $450x to $480x) under paragraph (b)(1)(i)(D) of this section to reflect $30x of depreciation deductions with respect to Asset Y in 2021. Thus, for 2021, A would have a section 163(j) limitation of $135x ($450x × 30 percent) without regard to adjustments under paragraphs (b)(1)(i)(D) through (F) of this section. After the application of paragraph (b)(1)(i)(D) of this section, A has a section 163(j) limitation of $144x ($480x × 30 percent). In 2022, A sells Asset Y at a gain of $50x. Under paragraph (b)(1)(iv)(F)(*1*) of this section, A is not required to reduce its tentative taxable income in 2022 under paragraph (b)(1)(ii)(C) through (E) or paragraph (b)(1)(iv)(E) of this section. As established by A, the $30x addition to tentative taxable income under paragraph (b)(1)(i)(D) of this section resulted in no increase in the amount allowed as a deduction for business interest expense in 2021.

(G) *Treatment of depreciation, amortization, or depletion capitalized under section 263A.* Paragraphs (b)(1)(ii)(C) through (E) of this section and this paragraph (b)(1)(iv) apply with respect to the sale or other disposition of property to which paragraph (b)(1)(iii) of this section applies. For example, if a taxpayer with depreciable machinery capitalizes the depreciation into inventory under section 263A, paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E) of this section (and, if the taxpayer is a consolidated group, paragraph (b)(1)(iv)(B) of this section) applies upon the disposition of the machinery, subject to the cap in paragraph (b)(1)(iv)(F) of this section. Similarly, the successor asset rules in paragraph (b)(1)(iv)(C)(*1*) of this section would apply if the depreciable machinery subsequently were transferred to another member (S1) in an intercompany transaction in which the transferor received S1 stock.

(v) *Other adjustments.* ATI is computed with the other adjustments provided in §§1.163(j)–2 through 1.163(j)–11.

(vi) *Additional rules relating to adjusted taxable income in other sections.* (A) For rules governing the ATI of C corporations, see §§1.163(j)–4(b)(2) and (3) and 1.163(j)–10(a)(2)(ii).

(B) For rules governing the ATI of RICs and REITs, see §1.163(j)–4(b)(4).

(C) For rules governing the ATI of tax-exempt corporations, see §1.163(j)–4(b)(5).

(D) For rules governing the ATI of consolidated groups, see §1.163(j)–4(d)(2)(iv) and (v).

(E) For rules governing the ATI of partnerships, see §1.163(j)–6(d).

(F) For rules governing the ATI of partners, see §§1.163(j)–6(e) and 1.163(j)–6(m)(1) and (2).

(G) For rules governing partnership basis adjustments affecting ATI, see §1.163(j)–6(h)(2).

(H) For rules governing the ATI of S corporations, see §1.163(j)–6(l)(3).

(I) For rules governing the ATI of S corporation shareholders, see §1.163(j)–6(l)(4).

(J) For rules governing the ATI of certain beneficiaries of trusts and estates, see §1.163(j)–2(f).

(vii) *ATI cannot be less than zero.* If the ATI of a taxpayer would be less than zero, the ATI of the taxpayer is zero.

(viii) *Examples.* The examples in this paragraph (b)(1)(viii) illustrate the application of paragraphs (b)(1)(ii), (iii), and (iv) of this section. Unless otherwise indicated, A, B, P, S, and T are calendar-year domestic C corporations; P is the parent of a consolidated group of which S and T are members; the exemption for certain small businesses in §1.163(j)–2(d) does not apply; no entity is engaged in an excepted trade or business; no entity has business interest income or floor plan financing interest expense; and all amounts of interest expense are deductible except for the potential application of section 163(j).

(A) *Example 1*—(*1*) *Facts.* In 2021, A purchases a depreciable asset (Asset X) for $30x and fully depreciates Asset X under section 168(k). For the 2021 taxable year, A establishes that its ATI before adding back depreciation deductions with respect to Asset X under paragraph (b)(1)(i)(D) of this section is $130x, and that its ATI after adding back depreciation deductions with respect to Asset X under paragraph (b)(1)(i)(D) of this section is $160x. A incurs $45x of business interest expense in 2021. In 2024, A sells Asset X to an unrelated third party for $25x.

(*2*) *Analysis.* A's section 163(j) limitation for 2021 is $48x ($160x × 30 percent). Thus, all $45x of A's business interest expense incurred in 2021 is deductible in that year. Under paragraph (b)(1)(ii)(C) of this section, A must subtract $30x from its tentative taxable income in computing its ATI for its 2024 taxable year. Alternatively, under paragraph (b)(1)(iv)(E)(*1*) of this section, A must subtract $25x (the lesser of $30x or $25x ($25x − $0x)) from its tentative taxable income in computing its ATI for its 2024 taxable year. However, the negative adjustments under paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(*1*) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Under that paragraph, A's negative adjustment under either paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(*1*) of this section is capped at $20x, or $150x (the amount of ATI that A needed in order to deduct all $45x of business interest expense in 2021) minus $130x (the amount of A's tentative taxable income in 2021 before adding back any amounts under paragraph (b)(1)(i)(D) through (F) of this section). As established by A, the additional $10x ($30x − $20x) of depreciation deductions that were added back to tentative taxable income in 2021 under paragraph (b)(1)(i)(D) of this section did not increase A's business interest expense deduction for that year.

(*3*) *Transfer of assets in a nonrecognition transaction to which section 381 applies.* The facts are the same as in paragraph (b)(1)(viii)(A)(*1*) of this section, except that, rather than sell Asset X to an unrelated third party in 2024, A merges with and into an unrelated third party in 2024 in a transaction described in section 368(a)(1)(A) in which no gain is recognized. As provided in paragraph (b)(1)(iv)(A)(*1*) of this section, the merger transaction is not treated as a ''sale or other disposition'' for purposes of paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(*1*) of this section. Thus, no adjustment to tentative taxable income is required in 2024 under paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(*1*) of this section.

(*4*) *Transfer of assets in a nonrecognition transaction to which section 351 applies.* The facts are the same as in paragraph (b)(1)(viii)(A)(*1*) of this section, except that, rather than sell Asset X to an unrelated third party in 2024, A transfers Asset X to B (A's wholly owned subsidiary) in 2024 in a transaction to which section 351 applies. The section 351 transaction is treated as a ''sale or other disposition'' for purposes of paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(*1*) of this section, and it is treated as a taxable disposition for purposes of paragraph (b)(1)(iv)(E)(*1*) of this section. See paragraph (b)(1)(iv)(A)(*1*) and (*4*) of this section. However, the negative adjustments under paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(*1*) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Thus, A must subtract $20x from its tentative taxable income in computing its ATI for its 2024 taxable year.

(B) *Example 2*—(*1*) *Facts.* In 2021, S purchases a depreciable asset (Asset Y) for $30x and fully depreciates Asset Y under section 168(k). P reduces its basis in its S stock by $30x under §1.1502–32 to reflect S's depreciation deductions with respect to Asset Y. For the 2021 taxable year, the P group establishes that its ATI before adding back S's depreciation deductions with respect to Asset Y under paragraph (b)(1)(i)(D) of this section is $130x, and that its ATI after adding back S's depreciation deductions with respect to Asset Y under paragraph (b)(1)(i)(D) of this section is $160x. The P group incurs $45x of business interest expense in 2021. In 2024, P sells all of its S stock to an unrelated third party at a gain of $25x.

(*2*) *Analysis.* The P group's section 163(j) limitation for 2021 is $48x ($160x × 30 percent). Thus, all $45x of the P group's business interest expense incurred in 2021 is deductible in that year. Under paragraph (b)(1)(ii)(D) of this section, the P group must subtract $30x from its tentative taxable income in computing its ATI for its 2024 taxable year. Alternatively, under paragraph (b)(1)(iv)(E)(*2*) of this section, the P group must subtract $25x (the lesser of $30x or $25x) from its tentative taxable income in computing its ATI for its 2024 taxable year. However, the negative adjustments under paragraphs (b)(1)(ii)(D) and (b)(1)(iv)(E)(*2*) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Under that paragraph, the P group's negative adjustment under either paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(*2*) of this section is capped at $20x, or $150x (the amount of ATI the P group needed in order to deduct all $45x of business interest expense in 2021) minus $130x (the amount of the P group's tentative taxable income in 2021 before adding back any amounts under paragraph (b)(1)(i)(D) through (F) of this section). As established by the P group, the additional $10x ($30x − $20x) of depreciation deductions that were added back to tentative taxable income in 2021 under paragraph (b)(1)(i)(D) of this section did not increase the P group's business interest expense deduction for that year.

(*3*) *Disposition of less than all member stock.* The facts are the same as in paragraph (b)(1)(viii)(B)(*1*) of this section, except that, in 2024, P sells half of its S stock to an unrelated third party. The results are the same as in paragraph (b)(1)(viii)(B)(*2*) of this section. See paragraph (b)(1)(iv)(A)(*3*) of this section. Thus, the P group must subtract $20x from its tentative taxable income in computing its ATI for its 2024 taxable year. No further adjustment under paragraphs (b)(1)(ii)(C) and (D) or paragraphs (b)(1)(iv)(E)(*1*) and (*2*) of this section is required if P subsequently sells its remaining S stock or if S subsequently disposes of Asset Y. See paragraphs (b)(1)(iv)(A)(*3*) and (b)(1)(iv)(D) of this section.

(*4*) *Intercompany transfer; disposition of successor assets*—(*i*) *Adjustments in 2024.* The facts are the same as in paragraph (b)(1)(viii)(B)(*1*) of this section, except that, rather than sell all of its S stock to an unrelated third party in 2024, P transfers all of its S stock to T in 2024 in a transaction to which section 351 applies and, in 2025, P sells all of its T stock to an unrelated third party at a gain of $40x. As provided in paragraph (b)(1)(iv)(A)(*2*) of this section, P's intercompany transfer of its S stock to T is not a ''sale or other disposition'' for purposes of paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(*2*) of this section. Thus, no adjustment to tentative taxable income is required in 2024 under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(*2*) of this section.

(*ii*) *Adjustments in 2025.* Pursuant to paragraph (b)(1)(iv)(C)(*1*) of this section, P's stock in T is treated as a successor asset for purposes of paragraph (b)(1)(ii)(D) and (b)(1)(iv)(E)(*2*) of this section. Moreover, P's sale of its T stock causes both T and S to deconsolidate. Thus, under paragraph (b)(1)(iv)(A)(*3*) of this section, the transaction is treated as a taxable disposition of all of the T stock and all of the S stock held by all members of the P group. Under the anti-duplication rule in paragraph (b)(1)(iv)(D) of this section, the total amount of gain recognized for purposes of paragraph (b)(1)(iv)(E)(*2*)(*i*) of this section is $40x, the greater of the gain on the disposition of the T stock ($40x) or on the disposition of the S stock ($25x). However, the negative adjustments under paragraph (b)(1)(iv)(E)(*2*) of this section are subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Thus, the P group must subtract $20x from its tentative taxable income in computing its ATI for its 2025 taxable year.

(*5*) *Alternative computation and non-deconsolidating disposition of member stock.* The facts are the same as in paragraph (b)(1)(viii)(B)(*1*) of this section, except that, in 2024, P sells just ten percent of its S stock to an unrelated third party at a gain of $2.5x. Under paragraph (b)(1)(iv)(E)(*2*) of this section, the lesser of P's gain recognized on the sale of the S stock ($2.5x) and the investment adjustments under §1.1502–32 with respect to the S stock P sold ($3x) is $2.5x, an amount less than the $20x limitation under paragraph (b)(1)(iv)(F) of this section. Thus, the P group must subtract $2.5x from its tentative taxable income in computing its ATI for its 2024 taxable year.

(*6*) *Non-deconsolidating disposition of member stock followed by asset disposition.* The facts are the same as in paragraph (b)(1)(viii)(B)(*5*) of this section, except that, in 2025, S sells Asset Y to an unrelated third party for a gain of

$20x. Under paragraph (b)(1)(iv)(E)(*1*) of this section, the amount of the adjustment in 2025 is the lesser of two amounts. The first amount is the amount of S's gain recognized on the sale of Asset Y ($20x). See paragraph (b)(1)(iv)(E)(*1*)(*i*) of this section. The second amount is the amount of depreciation with respect to Asset Y (see paragraph (b)(1)(iv)(E)(*1*)(*ii*) of this section), reduced by the amount of depreciation previously taken into account in the computation under paragraph (b)(1)(iv)(E)(*2*)(*ii*) of this section ($30x − $3x, or $27x). See paragraph (b)(1)(iv)(D)(*1*) of this section. Thus, the amount of the adjustment under paragraphs (b)(1)(iv)(D) and (b)(1)(iv)(E)(*1*) of this section is $20x. In turn, this amount is subject to the negative adjustment cap under paragraph (b)(1)(iv)(F), which, after accounting for the negative adjustment on the earlier sale of S stock in 2024, is $17.5x ($20x − $2.5x). Accordingly, the P group must subtract $17.5x from its tentative taxable income in computing its ATI for its 2025 taxable year.

(C) *Example 3*—(*1*) *Facts*. The facts are the same as in paragraph (b)(1)(viii)(B)(*1*) of this section, except that, in 2024, S sells Asset Y to an unrelated third party for $25x and, in 2025, P sells all of its S stock to an unrelated third party at a gain of $25x.

(*2*) *Analysis*. The results are the same as in paragraph (b)(1)(viii)(B)(*2*) of this section. Thus, the P group must subtract $20x from its tentative taxable income in computing its ATI for its 2024 taxable year. P's sale of all of its S stock in 2025 is a ''sale or other disposition'' for purposes of paragraph (b)(1)(ii)(D) and (b)(1)(iv)(E)(*2*) of this section. However, pursuant to paragraph (b)(1)(iv)(D)(*1*) of this section, no further adjustment to the P group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(*2*) of this section.

(*3*) *Disposition of S stock prior to S's asset disposition*. The facts are the same as in paragraph (b)(1)(viii)(C)(*1*) of this section, except that, in 2024, P sells all of its S stock to an unrelated third party at a gain of $25x and, in 2025, S sells Asset Y to an unrelated third party for $25x. The results are the same as in paragraph (b)(1)(viii)(B)(*2*) of this section. Thus, the P group must subtract $20x from its tentative taxable income in computing its ATI for its 2024 taxable year. Pursuant to paragraph (b)(1)(iv)(D)(*2*) of this section, no adjustment to the acquiring group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(*1*) of this section.

(*4*) *Deconsolidation of S in nonrecognition transaction*. The facts are the same as in paragraph (b)(1)(viii)(C)(*3*) of this section, except that, rather than sell all of its S stock to an unrelated third party, P causes S to merge with and into an unrelated third party in a transaction described in section 368(a)(1)(A). As provided in paragraph (b)(1)(iv)(A)(*3*) of this section, the merger transaction is treated as a taxable disposition of all of P's stock in S for purposes of paragraphs (b)(1)(ii)(D) and (b)(1)(iv)(E)(*2*) of this section because S leaves the P group. Thus, the results are the same as in paragraph (b)(1)(viii)(C)(*3*) of this section.

(D) *Example 4*—(*1*) *Facts*. P wholly owns T, which wholly owns S. In 2021, S purchases a depreciable asset (Asset Z) for $30x and fully depreciates Asset Z under section 168(k). T reduces its basis in its S stock, and P reduces its basis in its T stock, by $30x under §1.1502–32 to reflect S's depreciation deductions with respect to Asset Z. For the 2021 taxable year, the P group establishes that its ATI before adding back S's depreciation deductions with respect to Asset Z under paragraph (b)(1)(i)(D) of this section is $130x, and that its ATI after adding back S's depreciation deductions with respect to Asset Z under paragraph (b)(1)(i)(D) of this section is $160x. The P group incurs $45x of business interest expense in 2021. In 2024, T sells all of its S stock to an unrelated third party at a gain of $25x. In 2025, P sells all of its T stock to an unrelated third party at a gain of $40x.

(*2*) *Analysis*. The results are the same as in paragraph (b)(1)(viii)(B)(*2*) of this section. Thus, the P group must subtract $20x from its tentative taxable income in computing its ATI for its 2024 taxable year. Pursuant to paragraph (b)(1)(iv)(D)(*1*) of this section, no negative adjustment to the P group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(*2*) of this section.

(*3*) *Disposition of T stock in 2024*. The facts are the same as in paragraph (b)(1)(viii)(D)(*1*) of this section, except that, in 2024, P sells all of its T stock to another consolidated group at a gain of $40x and, in 2025, T sells all of its S stock to an unrelated party at a gain of $25x. Whereas the transaction described in paragraph (b)(1)(viii)(B)(*4*) of this section is treated as a taxable disposition of both the T stock and the S stock, only the actual disposition of the T stock in the transaction described in this paragraph (b)(1)(viii)(D)(*3*) is treated as a taxable disposition for purposes of paragraphs (b)(1)(ii)(D) and (b)(1)(iv)(E)(*2*) of this section. See paragraph (b)(1)(iv)(A)(*3*) of this section. However, the results are the same as in paragraph (b)(1)(viii)(B)(*2*) and (b)(1)(viii)(B)(*4*) of this section because of the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Thus, the P group must subtract $20x from its tentative taxable income in computing its ATI for its 2024 taxable year. Pursuant to paragraph (b)(1)(iv)(D) of this section, no negative adjustment to the acquiring group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(*2*) of this section.

(E) *Example 5*—(*1*) *Facts*. In 2021, A purchases Assets X and Y for $30x and $80x, respectively, and fully depreciates each asset under section 168(k). For the 2021 taxable year, A establishes that its ATI before adding back depreciation deductions with respect to Assets X and Y under paragraph (b)(1)(i)(D) of this section is $150x, and that its ATI after adding back depreciation deductions with respect to Assets X and Y under paragraph (b)(1)(i)(D) of this section is $260x. A incurs $75x of business interest expense in 2021. In 2024, A sells Assets X and Y to an unrelated third party for $40x and $90x, respectively.

(*2*) *Analysis*. A's section 163(j) limitation for 2021 is $78x ($\$260x \times 30$ percent). Thus, all $75x of A's business interest expense incurred in 2021 is deductible in that year. Under paragraph (b)(1)(ii)(C) of this section, A must subtract $110x ($30x + $80x) from its tentative taxable income in computing its ATI for its 2024 taxable year. Alternatively, under paragraph (b)(1)(iv)(E)(*1*) of this section, A must subtract $30x with respect to Asset X (the lesser of $30x or $40x ($\$40x - \$0x$)), and $80x with respect to Asset Y (the lesser of $80x or $90x ($\$90x - \$0x$)), from its tentative taxable income in computing its ATI for its 2024 taxable year. However, the negative adjustments under paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(*1*) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Under that paragraph, A's negative adjustment in 2024 under either paragraph (b)(1)(ii)(C) ($110x) or paragraph (b)(1)(iv)(E)(*1*) (also $110x) of this section is limited to $100x. This amount equals $250x (the amount of ATI that A needed in order to deduct all $75x of business interest expense in 2021) minus $150x (the amount of A's tentative taxable income in 2021 before adding back any amounts under paragraph (b)(1)(i)(D) through (F) of this section). As established by A, the additional $10x ($\$110x - \$100x$) of depreciation deductions that were added back to tentative taxable income in 2021 under paragraph (b)(1)(i)(D) of this section did not increase A's business interest expense deduction for that year.

(*3*) *Sale of assets in different taxable years*. The facts are the same as in paragraph (b)(1)(viii)(E)(*1*) of this section, except that A sells Asset Y to an unrelated third party for $90x in 2025. Under paragraph (b)(1)(ii)(C) of this section, A must subtract $30x from its tentative taxable income in computing its ATI for its 2024 taxable year. Alternatively, under paragraph (b)(1)(iv)(E)(*1*) of this section, A must subtract $30x (the lesser of $30x or $40x ($\$40x - \$0x$)) from its tentative taxable income in computing its ATI for its 2024 taxable year. Because A's negative adjustment cap for its 2021 taxable year is $100x (see paragraph (b)(1)(viii)(E)(*2*) of this section), A's negative adjustment in 2024 of $30x is not reduced under paragraph (b)(1)(iv)(F) of this section. In 2025, A must subtract $80x from its tentative taxable income under paragraph (b)(1)(ii)(C) of this section in computing its ATI. Alternatively, under paragraph (b)(1)(iv)(E)(*1*) of this section, A must subtract $80x (the lesser of $80x or $90x ($90x − $0x)) from its tentative taxable income in computing its ATI for its 2025 taxable year. However, the negative adjustments under paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(*1*) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Moreover, A's negative adjustment cap for its 2021 taxable year is reduced from $100x to $70x to reflect A's $30x negative adjustment in 2024. See paragraph (b)(1)(iv)(F) of this section. Thus, A's negative adjustment for 2025 under either paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(*1*) of this section is reduced from $80x to $70x. As established by A, the additional $10x ($110x − $100x) of depreciation deductions that were added back to tentative taxable income in 2021 under paragraph (b)(1)(i)(D) of this section did not increase A's business interest expense deduction for that year.

(2) *Applicable CFC*. The term *applicable CFC* means a foreign corporation described in section 957, but only if the foreign corporation has at least one United States shareholder that owns, within the meaning of section 958(a), stock of the foreign corporation.

(3) *Business interest expense*—(i) *In general*. The term *business interest expense* means interest expense that is properly allocable to a non-excepted trade or business or that is floor plan financing interest expense. Business interest expense also includes disallowed business interest expense carryforwards (as defined in paragraph (b)(11) of this section). However, business interest expense does not include amounts of interest expense carried forward to the taxable year from a prior taxable year due to the application of section 465 or section 469, which apply after the application of section 163(j). For the treatment of investment interest, see section 163(d); and for the treatment of personal interest, see section 163(h).

(ii) *Special rules*. For special rules for defining business interest expense in certain circumstances, see §§ 1.163(j)–3(b)(2) (regarding disallowed interest expense), 1.163(j)–4(b) (regarding C corporations) and 1.163(j)–4(d)(2)(iii) (regarding consolidated groups), 1.163(j)–1(b)(9) (regarding current-year business interest expense), and 1.163(j)–6(c) (regarding partnerships and S corporations).

(4) *Business interest income*—(i) *In general*. The term *business interest income* means interest income includible in the gross income of a taxpayer for the taxable year which is properly allocable to a non-excepted trade or business. For the treatment of investment income, see section 163(d).

(ii) *Special rules*. For special rules defining business interest income in certain circumstances, see §§ 1.163(j)–4(b) (regarding C corporations), 1.163(j)–4(d)(2)(iii) (regarding consolidated groups), and 1.163(j)–6(c) (regarding partnerships and S corporations).

(5) *C corporation*. The term *C corporation* has the meaning provided in section 1361(a)(2).

(6) *Cleared swap*. The term *cleared swap* means a swap that is cleared by a derivatives clearing organization, as such term is defined in section 1a of the Commodity Exchange Act (7 U.S.C. 1a), or by a clearing agency, as such term is defined in section 3 of the Securities Exchange Act of 1934 (15 U.S.C. 78c), that is registered as a derivatives clearing organization under the Commodity Exchange Act or as a clearing agency under the Securities Exchange Act of 1934, respectively, if the derivatives clearing organization or clearing agency requires the parties to the swap to post and collect margin or collateral.

(7) *Consolidated group*. The term *consolidated group* has the meaning provided in § 1.1502–1(h).

(8) *Consolidated return year*. The term *consolidated return year* has the meaning provided in § 1.1502–1(d).

(9) *Current-year business interest expense*. The term *current-year business interest expense* means business interest expense that would be deductible in the current taxable year without regard to section 163(j) and that is not a disallowed business interest expense carryforward from a prior taxable year.

(10) *Disallowed business interest expense.* The term *disallowed business interest expense* means the amount of business interest expense for a taxable year in excess of the amount allowed as a deduction for the taxable year under section 163(j)(1) and § 1.163(j)–2(b). For purposes of section 163(j) and the regulations in this part under section 163(j) of the Internal Revenue Code (Code) disallowed business interest expense is treated as ''paid or accrued'' in the taxable year in which the expense is deductible for Federal income tax purposes (without regard to section 163(j)) or in the taxable year in which a deduction for the business interest expense is permitted under section 163(j), as the context may require.

(11) *Disallowed business interest expense carryforward.* The term *disallowed business interest expense carryforward* means any business interest expense described in § 1.163(j)–2(c).

(12) *Disallowed disqualified interest.* The term *disallowed disqualified interest* means interest expense, including carryforwards, for which a deduction was disallowed under old section 163(j) (as defined in paragraph (b)(27) of this section) in the taxpayer's last taxable year beginning before January 1, 2018, and that was carried forward pursuant to old section 163(j).

(13) *Electing farming business.* The term *electing farming business* means a trade or business that makes an election as provided in § 1.163(j)–9 or other published guidance and that is—

(i) A farming business, as defined in section 263A(e)(4) or § 1.263A–4(a)(4);

(ii) Any trade or business of a specified agricultural or horticultural cooperative, as defined in section 199A(g)(4); or

(iii) Specifically designated by the Secretary in guidance published in the FEDERAL REGISTER or the Internal Revenue Bulletin (see § 601.601(d) of this chapter) as a farming business for purposes of section 163(j).

(14) *Electing real property trade or business.* The term *electing real property trade or business* means a trade or business that makes an election as provided in § 1.163(j)–9 or other published guidance and that is—

(i) A real property trade or business described in section 469(c)(7)(C) and § 1.469–9(b)(2); or

(ii) A REIT that qualifies for the safe harbor described in § 1.163(j)–9(h); or

(iii) A trade or business specifically designated by the Secretary in guidance published in the FEDERAL REGISTER or the Internal Revenue Bulletin (see § 601.601(d) of this chapter) as a real property trade or business for purposes of section 163(j).

(15) *Excepted regulated utility trade or business*—(i) *In general.* The term *excepted regulated utility trade or business* means:

(A) *Automatically excepted regulated utility trades or businesses.* A trade or business—

(*1*) That furnishes or sells—

(*i*) Electrical energy, water, or sewage disposal services;

(*ii*) Gas or steam through a local distribution system; or

(*iii*) Transportation of gas or steam by pipeline; but only

(*2*) To the extent that the rates for the furnishing or sale of the items in paragraph (b)(15)(i)(A)(*1*) of this section—

(*i*) Have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof and are determined on a cost of service and rate of return basis; or

(*ii*) Have been established or approved by the governing or ratemaking body of an electric cooperative; or

(B) *Electing regulated utility trades or businesses.* A trade or business that makes a valid election under paragraph (b)(15)(iii) of this section; or

(C) *Designated excepted regulated utility trades or businesses.* A trade or business that is specifically designated by the Secretary in guidance published in the FEDERAL REGISTER or the Internal Revenue Bulletin as an excepted regulated utility trade or business (see § 601.601(d) of this chapter) for section 163(j) purposes.

(ii) *Depreciation and excepted and nonexcepted utility trades or businesses.*

(A) *Depreciation.* Taxpayers engaged in an excepted trade or business described in paragraph (b)(15)(i) of this section cannot claim the additional first-year depreciation deduction under section 168(k) for any property that is primarily used in the excepted regulated utility trade or business.

(B) *Allocation of items.* If a taxpayer is engaged in one or more excepted trades or businesses, as described in paragraph (b)(15)(i) of this section, and one or more non-excepted trades or businesses, the taxpayer must allocate items between the excepted and non-excepted utility trades or businesses. See §§ 1.163(j)–1(b)(44) and 1.163(j)–10(c)(3)(iii)(C). Some trades or businesses with de minimis furnishing or sales of items described in paragraph (b)(15)(i)(A)(*1*) of this section that are not sold pursuant to rates that are determined on a cost of service and rate of return basis or established or approved by the governing or ratemaking body of an electric cooperative, and are not subject to an election in paragraph (b)(15)(iii), are treated as excepted trades or businesses. See § 1.163(j)–10(c)(3)(iii)(C)(*3*). For look-through rules applicable to certain CFCs that furnish or sell items described in paragraph (b)(15)(i)(A)(*1*) of this section that are not sold pursuant to rates that are determined on a cost of service and rate of return basis or established or approved by the governing or ratemaking body of an electric cooperative as described in paragraph (b)(15)(i)(A)(*2*) of this section, see § 1.163(j)–10(c)(5)(ii)(C).

(iii) *Election to be an excepted regulated utility trade or business.* (A) *In general.* A trade or business that is not an excepted regulated utility trade or business described in paragraph (b)(15)(i)(A) or (C) of this section and that furnishes or sells items described in paragraph (b)(15)(i)(A)(*1*) of this section is eligible to make an election to be an excepted regulated utility trade or business to the extent that the rates for furnishing or selling the items described in paragraph (b)(15)(i)(A)(*1*) of this section have been established or approved by a regulatory body described in paragraph (b)(15)(i)(A)(*2*)(i) of this section.

(B) *Scope and effect of election*—(*1*) *In general.* An election under paragraph (b)(15)(iii) of this section is made with respect to each eligible trade or business of the taxpayer and applies only to the trade or business for which the election is made. An election under paragraph (b)(15)(iii) of this section applies to the taxable year in which the election is made and to all subsequent taxable years.

(*2*) *Irrevocability.* An election under paragraph (b)(15)(iii) of this section is irrevocable.

(C) *Time and manner of making election*—(*1*) *In general.* Subject to paragraph (b)(15)(iii)(C)(*5*) of this section, a taxpayer makes an election under paragraph (b)(15)(iii) by attaching an election statement to the taxpayer's timely filed original Federal income tax return, including extensions. A taxpayer may make elections for multiple trades or businesses on a single election statement.

(*2*) *Election statement contents.* The election statement should be titled ''Section 1.163(j)–1(b)(15)(iii) Election'' and must contain the following information for each trade or business:

(*i*) The taxpayer's name;

(*ii*) The taxpayer's address;

(*iii*) The taxpayer's social security number (SSN) or employer identification number (EIN);

(*iv*) A description of the taxpayer's electing trade or business sufficient to demonstrate qualification for an election under this section, including the principal business activity code; and

(*v*) A statement that the taxpayer is making an election under section 1.163(j)–1(b)(15)(iii).

(*3*) *Consolidated group's or partnership's trade or business.* The rules in § 1.163(j)–9(d)(3) and (4) apply with respect to an election under paragraph (b)(15)(iii) of this section for a consolidated group's or partnership's trade or business.

(*4*) *Termination of election.* The rules in § 1.163(j)–9(e) apply to determine when an election under paragraph (b)(15)(iii) of this section terminates.

(*5*) *Additional guidance.* The rules and procedures regarding the time and manner of making an election under paragraph (b)(15)(iii) of this section and the election statement contents in paragraph (b)(15)(iii)(C)(*2*) of this section may be modified through other guidance (see §§ 601.601(d) and 601.602 of this chapter). Additional situations in which an election may terminate under paragraph (b)(15)(iii)(C)(*4*) of this section may be provided through guidance published in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(16) *Excess business interest expense.* For any partnership, the term *excess business interest expense* means the amount of disallowed business interest expense of the partnership for a taxable year under section § 1.163(j)–2(b). With respect to a partner, see § 1.163(j)–6(g) and (h).

(17) *Excess taxable income.* With respect to any partnership or S corporation, the term *excess taxable income* means the amount which bears the same ratio to the partnership's ATI as—

(i) The excess (if any) of—

(A) The amount determined for the partnership or S corporation under section 163(j)(1)(B); over

(B) The amount (if any) by which the business interest expense of the partnership, reduced by the floor plan financing interest expense, exceeds the business interest income of the partnership or S corporation; bears to

(ii) The amount determined for the partnership or S corporation under section 163(j)(1)(B).

(18) *Floor plan financing indebtedness.* The term floor plan financing indebtedness means indebtedness—

(i) Used to finance the acquisition of motor vehicles held for sale or lease; and

(ii) Secured by the motor vehicles so acquired.

(19) *Floor plan financing interest expense.* The term *floor plan financing interest expense* means interest paid or accrued on floor plan financing indebtedness. For purposes of the section 163(j) regulations, all floor plan financing interest expense is treated as business interest expense. See paragraph (b)(3) of this section.

(20) *Group.* The term *group* has the meaning provided in § 1.1502–1(a).

(21) *Intercompany transaction.* The term *intercompany transaction* has the meaning provided in § 1.1502–13(b)(1)(i).

(22) *Interest.* The term *interest* means any amount described in paragraph (b)(22)(i), (ii), (iii), or (iv) of this section.

(i) *In general.* Interest is an amount paid, received, or accrued as compensation for the use or forbearance of money under the terms of an instrument or contractual arrangement, including a series of transactions, that is treated as a debt instrument for purposes of section 1275(a) and § 1.1275–1(d), and not treated as stock under § 1.385–3, or an amount that is treated as interest under other provisions of the Code or the Income Tax Regulations. Thus, interest includes, but is not limited to, the following:

(A) Original issue discount (OID), as adjusted by the holder for any acquisition premium or amortizable bond premium;

(B) Qualified stated interest, as adjusted by the holder for any amortizable bond premium or by the issuer for any bond issuance premium;

(C) Acquisition discount;

(D) Amounts treated as taxable OID under section 1286 (relating to stripped bonds and stripped coupons);

(E) Accrued market discount on a market discount bond to the extent includible in income by the holder under either section 1276(a) or 1278(b);

(F) OID includible in income by a holder that has made an election under § 1.1272–3 to treat all interest on a debt instrument as OID;

(G) OID on a synthetic debt instrument arising from an integrated transaction under § 1.1275–6;

(H) Repurchase premium to the extent deductible by the issuer under § 1.163–7(c) (determined without regard to section 163(j));

(I) Deferred payments treated as interest under section 483;

(J) Amounts treated as interest under a section 467 rental agreement;

(K) Amounts treated as interest under section 988;

(L) Forgone interest under section 7872;

(M) De minimis OID taken into account by the issuer;

(N) Amounts paid or received in connection with a sale-repurchase agreement treated as indebtedness under Federal tax principles; however, in the case of a sale-repurchase agreement relating to tax-exempt bonds, the amount is not tax-exempt interest;

(O) Redeemable ground rent treated as interest under section 163(c); and

(P) Amounts treated as interest under section 636.

(ii) *Swaps with significant nonperiodic payments*—(A) *In general*. Except as provided in paragraphs (b)(22)(ii)(B) and (C) of this section, a swap with significant nonperiodic payments is treated as two separate transactions consisting of an on-market, level payment swap and a loan. The loan must be accounted for by the parties to the contract independently of the swap. The time value component associated with the loan, determined in accordance with §1.446–3(f)(2)(iii)(A), is recognized as interest expense to the payor and interest income to the recipient.

(B) *Exception for cleared swaps*. Paragraph (b)(22)(ii)(A) of this section does not apply to a cleared swap (as defined in paragraph (b)(6) of this section).

(C) *Exception for non-cleared swaps subject to margin or collateral requirements*. Paragraph (b)(22)(ii)(A) of this section does not apply to a non-cleared swap that requires the parties to meet the margin or collateral requirements of a federal regulator or that provides for margin or collateral requirements that are substantially similar to a cleared swap or a non-cleared swap subject to the margin or collateral requirements of a federal regulator. For purposes of this paragraph (b)(22)(ii)(C), the term *federal regulator* means the Securities and Exchange Commission (SEC), the Commodity Futures Trading Commission (CFTC), or a prudential regulator, as defined in section 1a(39) of the Commodity Exchange Act (7 U.S.C. 1a), as amended by section 721 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Public Law 111–203, 124 Stat. 1376, Title VII.

(iii) *Other amounts treated as interest*—(A) *Treatment of premium*—(*1*) *Issuer*. If a debt instrument is issued at a premium within the meaning of §1.163–13, any ordinary income under §1.163–13(d)(4) is treated as interest income of the issuer.

(*2*) *Holder*. If a taxable debt instrument is acquired at a premium within the meaning of §1.171–1 and the holder elects to amortize the premium, any amount deductible as a bond premium deduction under section 171(a)(1) and §1.171–2(a)(4)(i)(A) or (C) is treated as interest expense of the holder.

(B) *Treatment of ordinary income or loss on certain debt instruments*. If an issuer of a contingent payment debt instrument subject to §1.1275–4(b), a nonfunctional currency contingent payment debt instrument subject to §1.988–6, or an inflation-indexed debt instrument subject to §1.1275–7 recognizes ordinary income on the debt instrument in accordance with the rules in §1.1275–4(b), §1.988–6(b)(2), or §1.1275–7(f), whichever is applicable, the ordinary income is treated as interest income of the issuer. If a holder of a contingent payment debt instrument subject to §1.1275–4(b), a nonfunctional currency contingent payment debt instrument subject to §1.988–6, or an inflation-indexed debt instrument subject to §1.1275–7 recognizes an ordinary loss on the debt instrument in accordance with the rules in §1.1275–4(b), §1.988–6(b)(2), or §1.1275–7(f), whichever is applicable, the ordinary loss is treated as interest expense of the holder.

(C) *Substitute interest payments*. A substitute interest payment described in §1.861–2(a)(7) is treated as interest expense to the payor only if the payment relates to a sale-repurchase agreement or a securities lending transaction that is not entered into by the payor in the ordinary course of the payor's business. A substitute interest payment described in §1.861–2(a)(7) is treated as interest income to the recipient only if the payment relates to a sale-repurchase agreement or a securities lending transaction that is not entered into by the recipient in the ordinary course of the recipient's business; however, in the case of a sale-repurchase agreement or a securities lending transaction relating to tax-exempt bonds, the recipient of a substitute payment does not receive tax-exempt interest income. This paragraph (b)(22)(iii)(C) does not apply to an amount described in paragraph (b)(22)(i)(N) of this section.

(D) *Section 1258 gain*. Any gain treated as ordinary gain under section 1258 is treated as interest income.

(E) *Factoring income.* The excess of the amount that a taxpayer collects on a factored receivable (or realizes upon the sale or other disposition of the factored receivable) over the amount paid for the factored receivable by the taxpayer is treated as interest income. For purposes of this paragraph (b)(22)(iii)(E), the term *factored receivable* includes any account receivable or other evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition of property or the performance of services by any person, if such account receivable or evidence of indebtedness is acquired by a person other than the person who disposed of the property or provided the services that gave rise to the account receivable or evidence of indebtedness. This paragraph (b)(22)(iii)(E) does not apply to an amount described in paragraph (b)(22)(i)(C) or (E) of this section.

(F) *Section 163(j) interest dividends*—(*1*) *In general.* Except as otherwise provided in this paragraph (b)(22)(iii)(F), a section 163(j) interest dividend is treated as interest income.

(*2*) *Limitation on amount treated as interest income.* A shareholder may not treat any part of a section 163(j) interest dividend as interest income to the extent the amount of the section 163(j) interest dividend exceeds the excess of the amount of the entire dividend that includes the section 163(j) interest dividend over the sum of the conduit amounts other than interest-related dividends under section 871(k)(1)(C) and section 163(j) interest dividends that affect the shareholder's treatment of that dividend.

(*3*) *Conduit amounts.* For purposes of paragraph (b)(22)(iii)(F)(*2*) of this section, the term *conduit amounts* means, with respect to any category of income (including tax-exempt interest) earned by a RIC for a taxable year, the amounts identified by the RIC (generally in a designation or written report) in connection with dividends of the RIC for that taxable year that are subject to a limit determined by reference to that category of income. For example, a RIC's conduit amount with respect to its net capital gain is the amount of the RIC's capital gain dividends under section 852(b)(3)(C).

(*4*) *Holding period.* Except as provided in paragraph (b)(22)(iii)(F)(*5*) of this section, no dividend is treated as interest income under paragraph (b)(22)(iii)(F)(*1*) of this section if the dividend is received with respect to a share of RIC stock—

(*i*) That is held by the shareholder for 180 days or less (taking into account the principles of section 246(c)(3) and (4)) during the 361-day period beginning on the date which is 180 days before the date on which the share becomes ex-dividend with respect to such dividend; or

(*ii*) To the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(*5*) *Exception to holding period requirement for money market funds and certain regularly declared dividends.* Paragraph (b)(22)(iii)(F)(*4*)(*i*) of this section does not apply to dividends distributed by any RIC regulated as a money market fund under 17 CFR 270.2a–7 (Rule 2a–7 under the 1940 Act) or to regular dividends paid by a RIC that declares section 163(j) interest dividends on a daily basis in an amount equal to at least 90 percent of its excess section 163(j) interest income, as defined in paragraph (b)(35)(iv)(E) of this section, and distributes such dividends on a monthly or more frequent basis.

(iv) *Anti-avoidance rules*—(A) *Principal purpose to reduce interest expense*—(*1*) *Treatment as interest expense.* Any expense or loss economically equivalent to interest is treated as interest expense if a principal purpose of structuring the transaction(s) is to reduce an amount incurred by the taxpayer that otherwise would have been described in paragraph (b)(22)(i), (ii), or (iii) of this section. For this purpose, the fact that the taxpayer has a business purpose for obtaining the use of funds does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense. In addition, the fact that the taxpayer has obtained funds at a lower pre-tax cost based on the structure of the transaction(s) does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of reducing the taxpayer's interest expense. For purposes of this paragraph (b)(22)(iv)(A)(*1*), any expense or loss is economically equivalent to interest to the extent that the expense or loss is—

(*i*) Deductible by the taxpayer;

(*ii*) Incurred by the taxpayer in a transaction or series of integrated or related transactions in which the taxpayer secures the use of funds for a period of time;

(*iii*) Substantially incurred in consideration of the time value of money; and

(*iv*) Not described in paragraph (b)(22)(i), (ii), or (iii) of this section.

(*2*) *Corresponding treatment of amounts as interest income.* If a taxpayer knows that an expense or loss is treated by the payor as interest expense under paragraph (b)(22)(iv)(A)(*1*) of this section, the taxpayer provides the use of funds for a period of time in the transaction(s) subject to paragraph (b)(22)(iv)(A)(*1*) of this section, the taxpayer earns income or gain with respect to the transaction(s), and such income or gain is substantially earned in consideration of the time value of money provided by the taxpayer, such income or gain is treated as interest income to the extent of the expense or loss treated by the payor as interest expense under paragraph (b)(22)(iv)(A)(*1*) of this section.

(B) *Interest income artificially increased.* Notwithstanding paragraphs (b)(22)(i) through (iii) of this section, any income realized by a taxpayer in a transaction or series of integrated or related transactions is not treated as interest income of the taxpayer if and to the extent that a principal purpose for structuring the transaction(s) is to artificially increase the taxpayer's business interest income. For this purpose, the fact that the taxpayer has a business purpose for holding interest generating assets does not affect the determination of whether the manner in which the taxpayer structures the transaction(s) is with a principal purpose of artificially increasing the taxpayer's business interest income.

(C) *Principal purpose.* Whether a transaction or a series of integrated or related transactions is entered into with a principal purpose described in paragraph (b)(22)(iv)(A) or (B) of this section depends on all the facts and circumstances related to the transaction(s), except for those facts described in paragraph (b)(22)(iv)(A) or (B) of this section. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). Factors to be taken into account in determining whether one of the taxpayer's principal purposes for entering into the transaction(s) include the taxpayer's normal borrowing rate in the taxpayer's functional currency, whether the taxpayer would enter into the transaction(s) in the ordinary course of the taxpayer's trade or business, whether the parties to the transaction(s) are related persons (within the meaning of section 267(b) or section 707(b)), whether there is a significant and bona fide business purpose for the structure of the transaction(s), whether the transactions are transitory, for example, due to a circular flow of cash or other property, and the substance of the transaction(s).

(D) *Coordination with anti-avoidance rule in §1.163(j)–2(j).* The anti-avoidance rules in paragraphs (b)(22)(iv)(A) through (C) of this section, rather than the anti-avoidance rules in §1.163(j)–2(j), apply to determine whether an item is treated as interest expense or interest income.

(v) *Examples.* The examples in this paragraph (b)(22)(v) illustrate the application of paragraph (b)(22)(iv) of this section. Unless otherwise indicated, A, B, C, D, and Bank are domestic C corporations that are publicly traded; the exemption for certain small businesses in §1.163(j)–2(d) does not apply; A is not engaged in an excepted trade or business; and all amounts of interest expense are deductible except for the potential application of section 163(j).

(A) *Example 1*—(*1*) *Facts.* A is engaged in a manufacturing business and uses the calendar year as its annual accounting period. A's functional currency is the U.S. dollar and A conducts virtually all of its business in the U.S. dollar. A has no connection to Japan or the Japanese yen in the ordinary course of business. A projects that it will have business interest expense of $100x on an existing loan obligation with a stated principal amount of $2,000x (Loan 1) and no business interest income in its taxable year ending December 31, 2021. In early 2021, A enters into the following transactions, which A would not have entered into in the ordinary course of A's trade or business:

(*i*) A enters into a loan obligation in which A borrows Japanese yen from Bank in an amount equivalent to $2,000x with an interest rate of 1 percent (Loan 2) (at the time of the loan, the U.S. dollar equivalent interest rate on a loan of $2,000x is 5 percent);

(*ii*) A enters into a foreign currency swap transaction (FX Swap) with Bank with a notional principal amount of $2,000x under which A receives Japanese yen at 1 percent multiplied by the amount of Japanese yen borrowed from Bank (which for 2021 equals $20x) and pays U.S. dollars at 5 percent multiplied by a notional amount of $2,000x ($100x per year);

(*iii*) The FX Swap is not integrated with Loan 2 under § 1.988–5; and

(*iv*) A enters into a spot transaction with Bank to convert the proceeds of Loan 2 into $2,000x U.S. dollars and A uses the U.S. dollars to repay Loan 1.

(*2*) *Analysis*. A principal purpose of A entering into the transactions with Bank was to try to reduce the amount incurred by A that otherwise would be interest expense; in effect, A sought to alter A's cost of borrowing by converting a substantial portion of its interest expense deductions on Loan 1 into section 165 deductions on the FX Swap ($100x interest expense related to Loan 1 compared to $20x interest expense related to Loan 2 and $80x section 165 deduction). A's functional currency is the U.S. dollar and A conducts virtually all of its business in the U.S. dollar. A has no connection to Japan or the Japanese yen and would not have entered into the transactions in the ordinary course of A's trade or business. The section 165 deductions related to the FX Swap were incurred by A in a series of transactions in which A secured the use of funds for a period of time and were substantially incurred in consideration of the time value of money. As a result, under paragraph (b)(22)(iv)(A)(*1*) of this section, for purposes of section 163(j), the $80x paid by A to Bank on the FX Swap is treated by A as interest expense.

(B) *Example 2*—(*1*) *Facts*. A is engaged in a manufacturing business and uses the calendar year as its annual accounting period. A does not use gold in its manufacturing business. In 2021, A expects to borrow $1,000x for six months. In January 2021, A borrows from B two ounces of gold at a time when the spot price for gold is $500x per ounce. A agrees to return the two ounces of gold in six months. A sells the two ounces of gold to C for $1,000x. A then enters into a contract with D to purchase two ounces of gold six months in the future for $1,013x. In exchange for the use of $1,000x in cash for six months, A has sustained a loss of $13x in connection with these related transactions. A would not have entered into the gold transactions in the ordinary course of A's trade or business.

(*2*) *Analysis*. In a series of related transactions, A has obtained the use of $1,000x for six months and created a loss of $13x substantially incurred in consideration of the time value of money. A would not have entered into the gold transactions in the ordinary course of A's trade or business. A entered into the transactions with a principal purpose of structuring the transactions to reduce its interest expense (in effect, A sought to convert what otherwise would be interest expense into a loss through the transactions). As a result, under paragraph (b)(22)(iv)(A)(*1*) of this section, for purposes of section 163(j), the loss of $13x is treated by A as interest expense.

(C) *Example 3*—(*1*) *Facts*. A is engaged in a manufacturing business and uses the calendar year as its annual accounting period. A's functional currency is the U.S. dollar and A conducts virtually all of its business in the U.S. dollar. A has no connection to Argentina or the Argentine peso as part of its ordinary course of business. As of January 1, 2021, A expects to have adjusted taxable income (as defined in paragraph (b)(1) of this section) of $200x in the taxable year ending December 31, 2021. A also projects that it will have business interest expense of $70x on an existing loan in 2021. A has cash equivalents of $100x on which A expects to earn $5x of business interest income. In early 2021, A enters into the following transactions, which A would not have entered into in the ordinary course of A's trade or business:

(*i*) A enters into a spot transaction with Bank to convert the $100x of cash equivalents into an amount in Argentine pesos equivalent to $100x and A uses the Argentine pesos to purchase an Argentine peso note (Note) issued by a subsidiary of Bank for the Argentine peso equivalent of $100x; the Note pays interest at a 10 percent rate; and

(*ii*) A enters into a foreign currency swap transaction (FX Swap) with Bank with a notional principal amount of $100x under which A pays Argentine pesos at 10 percent multiplied by the amount of Argentine peso principal amount on the Note (which for 2021 equals $10x) and receives U.S. dollars at 5 percent multiplied by a notional amount of $100x ($5x per year).

(*2*) *Analysis.* A principal purpose of A entering into the transactions was to increase the amount of business interest income received by A; in effect, A increased its business interest income by separately accounting for its net deduction of $5x per year on the FX Swap. A's functional currency is the U.S. dollar and A conducts virtually all of its business in the U.S. dollar. A has no connection to Argentina or the Argentine peso and would not have entered into the transactions in the ordinary course of A's trade or business. The FX Swap was incurred by A as a part of a transaction that A entered into with a principal purpose of artificially increasing its business interest income. As a result, under paragraph (b)(22)(iv)(B) of this section, for purposes of section 163(j), the $10x business interest income earned on the Note by A is reduced by $5x (the net $5x paid by A on the FX Swap).

(D) *Example 4*—(*1*) *Facts.* A is wholly owned by FC, a foreign corporation organized in foreign country X. A uses the calendar year for its annual accounting period. FC has a better credit rating than A. A needs to borrow $2,000x in the taxable year ending December 31, 2021, to fund its business operations. A also projects that, if it borrows $2,000x on January 1, 2021, and pays a market rate of interest, it will have business interest expense of $100x in its taxable year ending December 31, 2021. In early 2021, A enters into the following transactions:

(*i*) A enters into a loan obligation in which A borrows $2,000x from Bank with an interest rate of 3 percent (Loan 1);

(*ii*) FC and Bank enter into a guarantee arrangement (Guarantee) under which FC agrees to guarantee Bank that Bank will be timely paid all of the amounts due on Loan 1; and

(*iii*) A enters into a guarantee fee agreement with FC (Guarantee Fee Agreement) under which A agrees to pay FC $40x in return for FC entering into the Guarantee, which was not an agreement that A would have entered into in the ordinary course of A's trade or business.

(*2*) *Analysis.* A principal purpose of A entering into the transactions was to reduce the amount incurred by A that otherwise would be interest expense; in effect, A sought to convert a substantial portion of its interest expense deductions on Loan 1 into section 162 deductions on the Guarantee Fee Agreement ($100x interest expense had A borrowed without the Guarantee compared to $60x interest expense related to Loan 1 and $40x section 162 deduction). A would not have entered into the Guarantee Fee Agreement in the ordinary course of A's trade or business. The $40x section 162 deductions related to the Guarantee Fee Agreement were incurred by A in a series of transactions in which A secured the use of funds for a period of time and were substantially incurred in consideration of the time value of money. As a result, under paragraph (b)(22)(iv)(A)(*1*) of this section, for purposes of section 163(j), the $40x paid by A to FC on the Guarantee Fee Agreement is treated by A as interest expense.

(E) *Example 5*—(*1*) *Facts.* A, B, and C are equal partners in ABC partnership. ABC is considering acquiring an additional loan from a third-party lender to expand its business operations. However, ABC already has significant debt and interest expense. For the purpose of reducing the amount of additional interest expense ABC would have otherwise incurred by borrowing, A agrees to make an additional contribution to ABC for use in its business operations in exchange for a guaranteed payment for the use of capital under section 707(c).

(*2*) *Analysis.* The guaranteed payment is deductible by ABC, incurred by ABC in a transaction in which ABC secures the use of funds for a period of time, substantially incurred in consideration of the time value of money, and not described in paragraph (b)(22)(i), (ii), or (iii) of this section. As a result, the guaranteed payment to A is economically equivalent to the interest that ABC would have incurred on an additional loan from a third-party lender. A principal purpose of A making a contribution in exchange for a guaranteed payment for the use of capital was to reduce the amount incurred by ABC that otherwise would be interest expense. As a result, under paragraph (b)(22)(iv)(A)(*1*) of this section, for purposes of section 163(j), such guaranteed payment is treated as interest expense of ABC for purposes of section 163(j). In addition, under paragraph (b)(22)(iv)(A)(*2*) of this section, if A knows that the guaranteed payment is treated as interest expense of ABC, because A provides the use of funds for a period of time in a transaction subject to paragraph (b)(22)(iv)(A)(*1*) of this section, A earns income or gain with respect to the transaction, and such income or gain is substantially earned in consideration of the time value of money provided by A, the guaranteed payment is treated as interest income of A for purposes of section 163(j).

(23) *Interest expense.* The term *interest expense* means interest that is paid or accrued, or treated as paid or accrued, for the taxable year.

(24) *Interest income.* The term *interest income* means interest that is included in gross income for the taxable year.

(25) *Member.* The term *member* has the meaning provided in §1.1502–1(b).

(26) *Motor vehicle.* The term *motor vehicle* means a motor vehicle as defined in section 163(j)(9)(C).

(27) *Old section 163(j).* The term *old section 163(j)* means section 163(j) immediately prior to its amendment by Public Law 115–97, 131 Stat. 2054 (2017).

(28) *Ownership change.* The term *ownership change* has the meaning provided in section 382 and the regulations in this part under section 382 of the Code.

(29) *Ownership date.* The term *ownership date* has the meaning provided in section 382 and the regulations in this part under section 382 of the Code.

(30) *Real estate investment trust.* The term *real estate investment trust* (REIT) has the meaning provided in section 856.

(31) *Real property.* The term *real property* includes—

(i) Real property as defined in §1.469–9(b)(2); and

(ii) Any direct or indirect right, including a license or other contractual right, to share in the appreciation in value of, or the gross or net proceeds or profits generated by, an interest in real property, including net proceeds or profits associated with tolls, rents or other similar fees.

(32) *Regulated investment company.* The term *regulated investment company* (RIC) has the meaning provided in section 851.

(33) *Relevant foreign corporation.* The term *relevant foreign corporation* means any foreign corporation whose classification is relevant under §301.7701–3(d)(1) for a taxable year, other than solely pursuant to section 881 or 882.

(34) *S corporation.* The term *S corporation* has the meaning provided in section 1361(a)(1).

(35) *Section 163(j) interest dividend.* The term *section 163(j) interest dividend* means a dividend paid by a RIC for a taxable year for which section 852(b) applies to the RIC, to the extent described in paragraph (b)(35)(i) or (ii) of this section, as applicable.

(i) *In general.* Except as provided in paragraph (b)(35)(ii) of this section, a section 163(j) interest dividend is any dividend, or part of a dividend, that is reported by the RIC as a section 163(j) interest dividend in written statements furnished to its shareholders.

(ii) *Reduction in the case of excess reported amounts.* If the aggregate reported amount with respect to the RIC for the taxable year exceeds the excess section 163(j) interest income of the RIC for such taxable year, the section 163(j) interest dividend is—

(A) The reported section 163(j) interest dividend amount; reduced by

(B) The excess reported amount that is allocable to that reported section 163(j) interest dividend amount.

(iii) *Allocation of excess reported amount*—(A) *In general.* Except as provided in paragraph (b)(35)(iii)(B) of this section, the excess reported amount, if any, that is allocable to the reported section 163(j) interest dividend amount is that portion of the excess reported amount that bears the same ratio to the excess reported amount as the reported section 163(j) interest dividend amount bears to the aggregate reported amount.

(B) *Special rule for noncalendar year RICs.* In the case of any taxable year that does not begin and end in the same calendar year, if the post-December reported amount equals or exceeds the excess reported amount for that taxable year, paragraph (b)(35)(iii)(A) of this section is applied by substituting ''post-December reported amount'' for ''aggregate reported amount,'' and no excess reported amount is allocated to any dividend paid on or before December 31 of such taxable year.

(iv) *Definitions.* The following definitions apply for purposes of this paragraph (b)(35):

(A) *Reported section 163(j) interest dividend amount.* The term *reported section 163(j) interest dividend amount* means the amount of a dividend distribution reported to the RIC's shareholders under paragraph (b)(35)(i) of this section as a section 163(j) interest dividend.

(B) *Excess reported amount.* The term *excess reported amount* means the excess of the aggregate reported amount over the RIC's excess section 163(j) interest income for the taxable year.

(C) *Aggregate reported amount.* The term *aggregate reported amount* means the aggregate amount of dividends reported by the RIC under paragraph (b)(35)(i) of this section as section 163(j) interest dividends for the taxable year (including section 163(j) interest dividends paid after the close of the taxable year described in section 855).

(D) *Post-December reported amount.* The term *post-December reported amount* means the aggregate reported amount determined by taking into account only dividends paid after December 31 of the taxable year.

(E) *Excess section 163(j) interest income.* The term *excess section 163(j) interest income* means, with respect to a taxable year of a RIC, the excess of the RIC's business interest income for the taxable year over the sum of the RIC's business interest expense for the taxable year and the RIC's other deductions for the taxable year that are properly allocable to the RIC's business interest income.

(v) *Example*—(A) *Facts.* X is a domestic C corporation that has elected to be a RIC. For its taxable year ending December 31, 2021, X has $100x of business interest income (all of which is qualified interest income for purposes of section 871(k)(1)(E)) and $10x of dividend income (all of which is qualified dividend income within the meaning of section 1(h)(11) and would be eligible for the dividends received deduction under section 243, determined as described in section 854(b)(3)). X has $10x of business interest expense and $20x of other deductions. X has no other items for the taxable year. On December 31, 2021, X pays a dividend of $80x to its shareholders, and reports, in written statements to its shareholders, $71.82x as a section 163(j) interest dividend; $10x as dividends that may be treated as qualified dividend income or as dividends eligible for the dividends received deduction; and $72.73x as interest-related dividends under section 871(k)(1)(C). Shareholder A, a domestic C corporation, meets the holding period requirements in paragraph (b)(22)(iii)(F)(*4*) of this section with respect to the stock of X, and receives a dividend of $8x from X on December 31, 2021.

(B) *Analysis.* X determines that $18.18x of other deductions are properly allocable to X's business interest income. X's excess section 163(j) interest income under paragraph (b)(35)(iv)(E) of this section is $71.82x ($100x business interest income—($10x business interest expense + $18.18x other deductions allocated) = $71.82x). Thus, X may report up to $71.82x of its dividends paid on December 31, 2021, as section 163(j) interest dividends to its shareholders.

X may also report up to $10x of its dividends paid on December 31, 2021, as dividends that may be treated as qualified dividend income or as dividends that are eligible for the dividends received deduction. X determines that $9.09x of interest expense and $18.18x of other deductions are properly allocable to X's qualified interest income. Therefore, X may report up to $72.73x of its dividends paid on December 31, 2021, as interest-related dividends under section 871(k)(1)(C) ($100x qualified interest income—$27.27x deductions allocated = $72.73x). A treats $1x of its $8x dividend as a dividend eligible for the dividends received deduction and no part of the dividend as an interest-related dividend under section 871(k)(1)(C). Therefore, under paragraph (b)(22)(iii)(F)(*2*) of this section, A may treat $7x of the section 163(j) interest dividend as interest income for purposes of section 163(j) ($8x dividend—$1x conduit amount = $7x limitation).

(36) *Section 163(j) limitation.* The term *section 163(j) limitation* means the limit on the amount of business interest expense that a taxpayer may deduct in a taxable year under section 163(j) and §1.163(j)–2(b).

(37) *Section 163(j) regulations.* The term *section 163(j) regulations* means this section and §§1.163(j)–2 through 1.163(j)–11.

(38) *Separate return limitation year.* The term *separate return limitation year* (SRLY) has the meaning provided in §1.1502–1(f).

(39) *Separate return year.* The term *separate return year* has the meaning provided in §1.1502–1(e).

(40) *Separate tentative taxable income.* The term *separate tentative taxable income* with respect to a taxpayer and a taxable year has the meaning provided in §1.1502–12, but for this purpose computed without regard to the application of the section 163(j) limitation and with the addition of the adjustments made in paragraph (b)(43)(ii) of this section and §1.163(j)–4(d)(2)(iv).

(41) *Tax-exempt corporation.* The term *tax-exempt corporation* means any tax-exempt organization that is organized as a corporation.

(42) *Tax-exempt organization.* The term *tax-exempt organization* means any entity subject to tax under section 511.

(43) *Tentative taxable income*—(i) *In general.* The term *tentative taxable income,* with respect to a taxpayer and a taxable year, generally is determined in the same manner as taxable income under section 63 but for this purpose computed without regard to the application of the section 163(j) limitation. Tentative taxable income is computed without regard to any disallowed business interest expense carryforwards.

(ii) [Reserved]

(iii) *Special rules for defining tentative taxable income.* (A) For special rules defining the tentative taxable income of a RIC or REIT, see §1.163(j)–4(b)(4)(ii).

(B) For special rules defining the tentative taxable income of consolidated groups, see §1.163(j)–4(d)(2)(iv).

(C) For special rules defining the tentative taxable income of a partnership, see §1.163(j)–6(d)(1).

(D) For special rules defining the tentative taxable income of an S corporation, see §1.163(j)–6(l)(3).

(E) For special rules clarifying that tentative taxable income takes sections 461(l), 465, and 469 into account, see §1.163(j)–3(b)(4).

(F) For special rules clarifying that tentative taxable income takes sections 461(l), 465, and 469 into account, see §1.163(j)–3(b)(4).

(G) For special rules clarifying that tentative taxable income takes sections 461(l), 465, and 469 into account, see §1.163(j)–3(b)(4).

(44) *Trade or business*—(i) *In general.* The term *trade or business* means a trade or business within the meaning of section 162.

(ii) *Excepted trade or business.* The term *excepted trade or business* means the trade or business of performing services as an employee, an electing real property trade or business, an electing farming business, or an excepted regulated utility trade or business. For additional rules related to excepted trades or businesses, including elections made under section 163(j)(7)(B) and (C), see §1.163(j)–9.

(iii) *Non-excepted trade or business.* The term *non-excepted trade or business* means any trade or business that is not an excepted trade or business.

(45) *Unadjusted basis.* The term *unadjusted basis* means the basis as determined under section 1012 or other

applicable sections of chapter 1 of subtitle A of the Code, including subchapters O (relating to gain or loss on dispositions of property), C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses) of the Code. Unadjusted basis is determined without regard to any adjustments described in section 1016(a)(2) or (3), any adjustments for tax credits claimed by the taxpayer (for example, under section 50(c)), or any adjustments for any portion of the basis that the taxpayer has elected to treat as an expense (for example, under section 179, 179B, or 179C).

(46) *United States shareholder.* The term *United States shareholder* has the meaning provided in section 951(b).

(c) *Applicability date*—(1) *In general.* Except as provided in paragraphs (c)(2), (3), and (4) of this section, this section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, and before November 13, 2020 so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year. Additionally, taxpayers and their related parties within the meaning of sections 267(b) and 707(b)(1), otherwise relying on the notice of proposed rulemaking that was published on December 28, 2018, in the FEDERAL REGISTER (83 FR 67490) in its entirety under §1.163(j)–1(c), may alternatively choose to follow §1.163(j)–1(b)(1)(iii), rather than proposed §1.163(j)–1(b)(1)(iii).

(2) *Anti-avoidance rules.* The anti-avoidance rules in paragraph (b)(22)(iv) of this section apply to transactions entered into on or after September 14, 2020.

(3) *Swaps with significant nonperiodic payments*—(i) *In general.* Except as provided in paragraph (c)(3)(ii) of this section, the rules provided in paragraph (b)(22)(ii) of this section apply to notional principal contracts entered into on or after September 14, 2021. However, taxpayers may choose to apply the rules provided in paragraph (b)(22)(ii) of this section to notional principal contracts entered into before September 14, 2021.

(ii) *Anti-avoidance rule.* The anti-avoidance rules in paragraph (b)(22)(iv) of this section (applied without regard to the references to paragraph (b)(22)(ii) of this section) apply to a notional principal contract entered into on or after September 14, 2020.

(4) *Paragraphs (b)(1)(iv)(A)(2) through (4), (B) through (G), (b)(22)(iii)(F), and (b)(35).* Paragraphs (b)(1)(iv)(A)(*2*) through (*4*), (b)(1)(iv)(B) through (G), (b)(22)(iii)(F), and (b)(35) of this section apply to taxable years beginning on or after March 22, 2021. 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 paragraphs (b)(1)(iv)(A)(*2*) through (*4*), (b)(1)(iv) (B) through (G), (b)(22)(iii)(F), and (b)(35) of this section to 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 in the section 163(j) regulations contained in T.D. 9905 (§§1.163(j)–0 through 1.163(j)–11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4 contained in T.D. 9905, as modified by T.D. 9943, to that taxable year and all subsequent taxable years.

[T.D. 9905, 85 FR 56760, Sept. 14, 2020, as amended by T.D. 9943, 86 FR 5523, Jan. 19, 2021]

§ 1.163(j)–2 Deduction for business interest expense limited.

(a) *Overview.* This section provides general rules regarding the section 163(j) limitation. Paragraph (b) of this section provides rules regarding the basic computation of the section 163(j) limitation. Paragraph (c) of this section provides rules for disallowed business interest expense carryforwards. Paragraph (d) of this section provides rules regarding the small business exemption from the section 163(j) limitation. Paragraph (e) of this section that is part of provides rules regarding real estate mortgage investment conduits (REMICs). Paragraph (f) of this section provides rules regarding the calculation of ATI with respect to certain beneficiaries. Paragraph (g) of this section provides rules regarding tax-exempt organizations. Paragraph (h) of this section provides examples illustrating the application of this section. Paragraph (i) of this section is reserved. Paragraph (j) of this section provides an anti-avoidance rule.

(b) *General rule*—(1) *In general.* Except as otherwise provided in this section or in §§ 1.163(j)–3 through 1.163(j)–11, the amount allowed as a deduction for business interest expense for the taxable year cannot exceed the sum of—

(i) The taxpayer's business interest income for the taxable year;

(ii) 30 percent of the taxpayer's ATI for the taxable year, or zero if the taxpayer's ATI for the taxable year is less than zero; and

(iii) The taxpayer's floor plan financing interest expense for the taxable year.

(2) *50 percent ATI limitation for taxable years beginning in 2019 or 2020*—(i) *In general.* Except as otherwise provided in section 163(j)(10) and paragraph (b)(2) of this section, for any taxable year beginning in 2019 or 2020, paragraph (b)(1)(ii) of this section is applied by substituting 50 percent for 30 percent. The 50 percent ATI limitation does not apply to partnerships for taxable years beginning in 2019. Further, for a partnership taxable year beginning in 2020 for which an election out of section 163(j)(10)(A)(i) has not been made, § 1.163(j)–6(f)(2)(xi) is applied by substituting two for ten-thirds when grossing up each partner's final ATI capacity excess amount.

(ii) *Election out of the 50 percent ATI limitation.* A taxpayer may elect to not have paragraph (b)(2)(i) of this section apply for any taxable year beginning in 2019 or 2020. In the case of a partnership, the election must be made by the partnership and may be made only for taxable years beginning in 2020.

(3) *Election to use 2019 ATI in 2020*—(i) *In general.* Subject to paragraph (b)(3)(ii), a taxpayer may elect to use the taxpayer's ATI for the last taxable year beginning in 2019 (2019 ATI) as the ATI for any taxable year beginning in 2020.

(ii) *Short taxable years.* If an election is made under paragraph (b)(3)(i) of this section for a taxable year beginning in 2020 that is a short taxable year, the ATI for such taxable year is equal to the amount that bears the same ratio to 2019 ATI as the number of months in the short taxable year bears to 12.

(iii) *Transactions to which section 381 applies.* For purposes of the election described in paragraph (b)(3)(i) of this section, and subject to the limitation in paragraph (b)(3)(ii) of this section, the 2019 ATI of the acquiring corporation in a transaction to which section 381 applies equals the amount of the acquiring corporation's ATI for its last taxable year beginning in 2019.

(iv) *Consolidated groups.* For purposes of the election described in paragraph (b)(3)(i) of this section, and subject to the limitation in paragraph (b)(3)(ii) of this section, the 2019 ATI of a consolidated group equals the amount of the consolidated group's ATI for its last taxable year beginning in 2019.

(4) *Time and manner of making or revoking the elections.* The rules and procedures regarding the time and manner of making, or revoking, an election under paragraphs (b)(2) and (3) of this section are provided in Revenue Procedure 2020–22, 2020–18 I.R.B. 745, or in other guidance that may be issued (see §§ 601.601(d) and 601.602 of this chapter).

(c) *Disallowed business interest expense carryforward*—(1) *In general.* Any business interest expense disallowed under paragraph (b) of this section, or any disallowed disqualified interest that is properly allocable to a non-excepted trade or business under § 1.163(j)–10, is carried forward to the succeeding taxable year as a disallowed business interest expense carryforward, and is therefore business interest expense that is subject to paragraph (b) of this section in such succeeding taxable year. Disallowed business interest expense carryforwards are not re-allocated between non-excepted and excepted trades or businesses in a succeeding taxable year. Instead, the carryforwards continue to be treated as allocable to a non-excepted trade or business. See §1.163(j)–10(c)(4).

(2) *Coordination with small business exemption.* If disallowed business interest expense is carried forward under the rules of paragraph (c)(1) of this section to a taxable year in which the small business exemption in paragraph (d) of this section applies to the taxpayer, then the general rule in paragraph (b) of this section does not apply to limit the deduction of the disallowed business interest expense carryforward of the taxpayer in that taxable year. See §1.163(j)–6(m)(3) for rules applicable to the treatment of excess business interest expense from a partnership that is not subject to section 163(j) in a succeeding taxable year, and see §1.163(j)–6(m)(4) for rules applicable to S corporations with disallowed business interest expense carryforwards that are not subject to section 163(j) in a succeeding taxable year.

(3) *Cross-references*—(i) For special rules regarding disallowed business interest expense carryforwards for taxpayers that are C corporations, including members of a consolidated group, see §1.163(j)–5.

(ii) For special rules regarding disallowed business interest expense carryforwards of S corporations, see §§1.163(j)–5(b)(2) and 1.163(j)–6(l)(5).

(iii) For special rules regarding disallowed business interest expense carryforwards from partnerships, see §1.163(j)–6.

(iv)–(v) [Reserved]

(d) *Small business exemption*—(1) *Exemption.* The general rule in paragraph (b) of this section does not apply to any taxpayer, other than a tax shelter as defined in section 448(d)(3), in any taxable year in which the taxpayer meets the gross receipts test of section 448(c) and the regulations in this part under section 448 of the Code for the taxable year. See §1.163(j)–9(b) for elections available under section 163(j)(7)(B) and 163(j)(7)(C) for real property trades or businesses or farming businesses that also may be exempt small businesses. See §1.163(j)–6(m) for rules applicable to partnerships and S corporations not subject to section 163(j).

(2) *Application of the gross receipts test*—(i) *In general.* In the case of any taxpayer that is not a corporation or a partnership, and except as provided in paragraphs (d)(2)(ii), (iii), and (iv) of this section, the gross receipts test of section 448(c) and the regulations in this part under section 448 of the Code are applied in the same manner as if such taxpayer were a corporation or partnership.

(ii) *Gross receipts of individuals.* Except as provided in paragraph (d)(2)(iii) of this section (regarding partnership and S corporation interests), an individual taxpayer's gross receipts include all items specified as gross receipts in regulations under section 448(c), whether or not derived in the ordinary course of the taxpayer's trade or business. For purposes of section 163(j), an individual taxpayer's gross receipts do not include inherently personal amounts, including, but not limited to, personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W–2.

(iii) *Partners and S corporation shareholders.* Except when the aggregation rules of section 448(c) apply, each partner in a partnership includes a share of partnership gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Additionally, each shareholder in an S corporation includes a pro rata share of S corporation gross receipts.

(iv) *Tax-exempt organizations.* For purposes of section 163(j), the gross receipts of a tax-exempt organization include only gross receipts taken into account in determining its unrelated business taxable income.

(3) *Determining a syndicate's loss amount.* For purposes of section 163(j), losses allocated under section 1256(e)(3)(B) and §1.448–1T(b)(3) are determined without regard to section 163(j). See also §1.1256(e)–2(b).

(e) *REMICs.* For the treatment of interest expense by a REMIC as defined in section 860D, see §1.860C–2(b)(2)(ii).

(f) *Trusts*—(i) *Calculation of ATI with respect to certain trusts and estates.* The ATI of a trust or a decedent's estate taxable under section 641 is computed without regard to deductions under sections 642(c), 651, and 661.

(ii) *Calculation of ATI with respect to certain beneficiaries.* The ATI of a beneficiary (including a tax-exempt beneficiary) of a trust or a decedent's estate is reduced by any income (including any distributable net income) received from the trust or estate by the beneficiary to the extent such income was necessary to permit a deduction under section 163(j)(1)(B) and §1.163(j)–2(b) for any business interest expense of the trust or estate that was in excess of any business interest income of the trust or estate.

(g) *Tax-exempt organizations.* Except as provided in paragraph (d) of this section, the section 163(j) limitation applies to tax-exempt organizations for purposes of computing their unrelated business taxable income under section 512. For rules on determining the gross receipts of a tax-exempt organization for purposes of the small business exemption, see paragraph (d)(2)(iv) of this section. For special rules applicable to tax-exempt beneficiaries of a trust or a decedent's estate, see §1.163(j)–2(f). For special rules applicable to tax-exempt corporations, see §1.163(j)–4. For special allocation rules applicable to tax-exempt organizations, see §1.163(j)–10(a)(5).

(h) *Examples.* The examples in this paragraph (h) illustrate the application of section 163(j) and the provisions of this section. Unless otherwise indicated, X and Y are domestic C corporations; C and D are U.S. resident individuals not subject to any foreign income tax; PRS is a domestic partnership with partners who are all individuals; all taxpayers use a calendar taxable year; the exemption for certain small businesses in section 163(j)(3) and paragraph (d) of this section does not apply; and the interest expense would be deductible but for section 163(j).

(1) *Example 1: Limitation on business interest expense deduction*—(i) *Facts.* During its taxable year ending December 31, 2021, X has ATI of $100x. X has business interest expense of $50x, which includes $10x of floor plan financing interest expense, and business interest income of $20x.

(ii) *Analysis.* For the 2021 taxable year, X's section 163(j) limitation is $60x, which is the sum of its business interest income ($20x), plus 30 percent of its ATI ($100x × 30 percent = $30x), plus its floor plan financing interest expense ($10x). See §1.163(j)–2(b). Because X's business interest expense ($50x) does not exceed X's section 163(j) limitation ($60x), X can deduct all $50x of its business interest expense for the 2021 taxable year.

(2) *Example 2: Carryforward of business interest expense*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (h)(1)(i) of this section, except that X has $80x of business interest expense, which includes $10x of floor plan financing interest expense.

(ii) *Analysis.* As in *Example 1* in paragraph (h)(1)(ii) of this section, X's section 163(j) limitation is $60x. Because X's business interest expense ($80x) exceeds X's section 163(j) limitation ($60x), X may only deduct $60x of its business interest expense for the 2021 taxable year, and the remaining $20x of its business interest expense will be carried forward to the succeeding taxable year as a disallowed business interest expense carryforward. See §1.163(j)–2(c).

(3) *Example 3: ATI computation*—(i) *Facts.* During the 2020 taxable year, Y has tentative taxable income of $30x, which is determined without regard to the application of the section 163(j) limitation on business interest expense. Y's tentative taxable income includes the following: $20x of business interest income; $50x of business interest expense, which includes $10x of floor plan financing interest expense; $25x of net operating loss deduction under section 172; and $15x of depreciation under section 167, of which $10x is capitalized to inventory under section

263A. Of the $10x capitalized to inventory, only $7x is recovered through cost of goods sold during the 2020 taxable year and $3x remains in ending inventory at the end of the 2020 taxable year. The $3x of ending inventory is recovered through cost of goods sold during the 2021 taxable year. Y also has a disallowed business interest expense carryforward from the prior year of $8x.

(ii) *Analysis.* (A) For purposes of determining the section 163(j) limitation for 2020, Y's disallowed business interest expense carryforward is not taken into account in determining tentative taxable income or ATI. Y's ATI is $90x, calculated as follows:

TABLE 1 TO PARAGRAPH (h)(3)(ii)(A)

Tentative taxable income	$30x
Less:	
Floor plan financing interest	10x
Business interest income	20x
	0x

(B) Plus:

TABLE 2 TO PARAGRAPH (h)(3)(ii)(B)

Business interest expense	$50x
Net operating loss deduction	25x
Depreciation	15x
ATI	90x

(C) For Y's 2021 taxable year, the $3x of ending inventory that is recovered through cost of goods sold in 2021 is not added back to tentative taxable income (TTI) in determining ATI because it was already included as an addback in ATI in Y's 2020 taxable year. See §1.163(j)–1(b)(1)(iii).

(4) *Example 4: Floor plan financing interest expense*—(i) *Facts.* C is the sole proprietor of an automobile dealership that uses a cash method of accounting. In the 2021 taxable year, C paid $30x of interest on a loan that was obtained to purchase sedans for sale by the dealership. The indebtedness is secured by the sedans purchased with the loan proceeds. In addition, C paid $20x of interest on a loan, secured by the dealership's office equipment, which C obtained to purchase convertibles for sale by the dealership.

(ii) *Analysis.* For the purpose of calculating C's section 163(j) limitation, only the $30x of interest paid on the loan to purchase the sedans is floor plan financing interest expense. The $20x paid on the loan to purchase the convertibles is not floor plan financing interest expense for purposes of section 163(j) because the indebtedness was not secured by the inventory of convertibles. However, because under §1.163(j)–10 the interest paid on the loan to purchase the convertibles is properly allocable to C's dealership trade or business, and because floor plan financing interest expense is also business interest expense, C has $50x of business interest expense for the 2021 taxable year.

(5) *Example 5: Interest not properly allocable to non-excepted trade or business*—(i) *Facts.* The facts are the same as in *Example 4* in paragraph (h)(4)(i) of this section, except that the $20x of interest C pays is on acquisition indebtedness obtained to purchase C's personal residence and not to purchase convertibles for C's dealership trade or business.

(ii) *Analysis.* Because the $20x of interest expense is not properly allocable to a non-excepted trade or business, and therefore is not business interest expense, C's only business interest expense is the $30x that C pays on the loan used to purchase sedans for sale in C's dealership trade or business. C deducts the $20x of interest related to his residence under the rules of section 163(h), without regard to section 163(j).

(6) *Example 6: Small business exemption*—(i) *Facts.* During the 2021 taxable year, D, the sole proprietor of a trade or business reported on Schedule C, has interest expense properly allocable to that trade or business. D does not conduct an electing real property trade or business or an electing farming business. D also earns gross income from providing services as an employee that is reported on a Form W–2. Under section 448(c) and the regulations in this part under section 448, D has average annual gross receipts of $21 million, including $1 million of wages in each of the three prior taxable years and $2 million of income from investments

not related to a trade or business in each of the three prior taxable years. Also, in each of the three prior taxable years, D received $5 million in periodic payments of compensatory damages awarded in a personal injury lawsuit.

(ii) *Analysis.* Section 163(j) does not apply to D for the taxable year, because D qualifies for the small business exemption under §1.163(j)–2(d). The wages that D receives as an employee and the compensatory damages that D received from D's personal injury lawsuit are not gross receipts, as provided in §1.163(j)–2(d)(2)(ii). D may deduct all of its business interest expense for the 2021 taxable year without regard to section 163(j).

(7) *Example 7: Partnership with excess business interest expense qualifies for the small business exemption in a succeeding taxable year*—(i) *Facts.* X and Y are equal partners in partnership PRS. In addition to being partners in PRS, X and Y each operate their own sole proprietorships. For the taxable year ending December 31, 2021, PRS is subject to section 163(j) and has excess business interest expense of $10x. For the taxable year ending December 31, 2022, PRS has $40x of business interest expense, and X and Y have $20x of business interest expense from their respective sole proprietorships. For the taxable year ending December 31, 2022, PRS and Y qualify for the small business exemption under §1.163(j)–2(d), while X is subject to section 163(j) and has a section 163(j) limitation of $22x.

(ii) *Partnership-level analysis.* For the 2021 taxable year, PRS allocates the $10x of excess business interest expense equally to X and Y ($5x each). See §1.163(j)–6(f)(2). For the 2022 taxable year, section 163(j) does not apply to PRS because PRS qualifies for the small business exemption. As a result, none of PRS's $40x of business interest expense for the 2022 taxable year is subject to the section 163(j) limitation at the partnership level.

(iii) *Partner-level analysis.* For the 2022 taxable year, each partner treats its $5x of excess business interest expense from PRS as paid or accrued in that year. See §1.163(j)–6(m)(3). This amount becomes business interest expense that each partner must subject to its own section 163(j) limitation, if any. With this $5x, each partner has $25x of business interest expense for the 2022 taxable year ($20x from its sole proprietorship, plus $5x of excess business interest expense treated as paid or accrued in the 2020 taxable year). X deducts $22x of its business interest expense pursuant to its section 163(j) limitation and carries forward the remainder ($3x) as a disallowed business interest expense carryforward to the taxable year ending December 31, 2023. Y is not subject to section 163(j) because Y qualifies for the small business exemption. Y therefore deducts all $25x of its business interest expense for the 2022 taxable year.

(8) *Example 8: Aggregation of gross receipts*—(i) *Facts.* X and Y are domestic C corporations under common control, within the meaning of section 52(a) and §1.52–1(b). X's only trade or business is a farming business described in §1.263A–4(a)(4). During the taxable year ending December 31, 2020, X has average annual gross receipts under section 448(c) of $6 million. During the same taxable year, Y has average annual gross receipts under section 448(c) of $21 million.

(ii) *Analysis.* Because X and Y are under common control, they must aggregate gross receipts for purposes of section 448(c) and the small business exemption in §1.163(j)–2(d). See section 448(c)(2). Therefore, X and Y are both considered to have $27 million in average annual gross receipts for 2020. X and Y must separately apply section 163(j) to determine any limitation on the deduction for business interest expense. Assuming X otherwise meets the requirements in §1.163(j)–9 in 2020, X may elect for its farming business to be an excepted trade or business.

(i) [Reserved]

(j) *Anti-avoidance rule*—(1) *In general.* Arrangements entered into with a principal purpose of avoiding the rules of section 163(j) or the section 163(j) regulations, including the use of multiple entities to avoid the gross receipts test of section 448(c), may be disregarded or recharacterized by the Commissioner of the IRS to the extent necessary to carry out the purposes of section 163(j).

(2) *Examples.* The examples in this paragraph (j)(2) illustrate the application of this section.

(i) *Example 1*—(A) *Facts.* Individual A operates an excepted trade or business (Business X) and a non-excepted trade or business (Business Y). With a principal purpose of avoiding the rules of section 163(j) or the regulations in this part under section 163(j) of the Code, A contributes Business X to newly-formed C corporation B in exchange for stock; A then causes B to borrow funds from a third party and distributes a portion of the borrowed funds to A for use in Business Y. B takes the position that its interest payments on the debt are not subject to the section 163(j) limitation because B is engaged solely in an excepted trade or business.

(B) *Analysis.* A has entered into an arrangement with a principal purpose of avoiding the rules of section 163(j) or the regulations in this part under section 163(j). Thus, under paragraph (j)(1) of this section, the Commissioner of the IRS may disregard or recharacterize this transaction to the extent necessary to carry out the purposes of section 163(j). In this case, payments of interest on the debt may be recharacterized as payments of interest properly allocable to a non-excepted trade or business subject to the section 163(j) limitation.

(ii) *Example 2*—(A) *Facts.* Partnership UTP has two non-excepted trades or businesses. Business A has gross income of $1000x and gross deductions of $200x. Business B has gross income of $100x and gross deductions of $600x. With a principal purpose of avoiding the rules in section 163(j) or the regulations in this part under section 163(j), UTP and a partner of UTP form partnership LTP and UTP contributes Business B to LTP prior to borrowing funds. UTP takes the position that it does not take its share of LTP gross deductions into account when computing its ATI.

(B) *Analysis.* UTP has entered into an arrangement with a principal purpose of avoiding the rules of section 163(j) or the regulations in this part under section 163(j). Thus, under paragraph (j)(1) of this section, the Commissioner of the IRS may disregard or recharacterize this transaction to the extent necessary to carry out the purposes of section 163(j). In this case, UTP's share of gross deductions from LTP may be recharacterized as gross deductions incurred directly by UTP solely for purposes of computing UTP's ATI.

(k) *Applicability dates.* (1) *In general.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year.

(2) *Paragraphs (b)(3)(iii), (b)(3)(iv), and (d)(3).* Paragraphs (b)(3)(iii) and (iv) and (d)(3) of this section apply 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 paragraphs (b)(3)(iii), (b)(3)(iv), and (d)(3) of this section to 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 in paragraphs (b)(3)(iii) and (iv) of this section and the rules in the section 163(j) regulations contained in T.D. 9905 (§§1.163(j)–0 through 1.163(j)–11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4 contained in T.D. 9905 as modified by T.D. 9943, for that taxable

year and for each subsequent taxable year.

[T.D. 9905, 85 FR 56760, Sept. 14, 2020, as amended by T.D. 9943, 86 FR 5529, Jan. 19, 2021]

§ 1.163(j)–3 Relationship of the section 163(j) limitation to other provisions affecting interest.

(a) *Overview.* This section contains rules regarding the relationship between section 163(j) and certain other provisions of the Code. Paragraph (b) of this section provides the general rules concerning the relationship between section 163(j) and certain other provisions of the Code. Paragraph (c) of this section provides examples illustrating the application of this section. For rules regarding the relationship between sections 163(j) and 704(d), see § 1.163(j)–6(h)(1) and (2).

(b) *Coordination of section 163(j) with certain other provisions*—(1) *In general.* Section 163(j) and the regulations in this part under section 163(j) of the Code generally apply only to business interest expense that would be deductible in the current taxable year without regard to section 163(j). Thus, for example, a taxpayer must apply § 1.163–8T, if applicable, to determine which items of interest expense are investment interest under section 163(d) before applying the rules in this section to interest expense. Except as otherwise provided in this section, section 163(j) applies after the application of provisions that subject interest expense to disallowance, deferral, capitalization, or other limitation. For the rules that must be applied in determining whether excess business interest is paid or accrued by a partner, see section 163(j)(4)(B)(ii) and § 1.163(j)–6.

(2) *Disallowed interest provisions.* For purposes of section 163(j), business interest expense does not include interest expense that is permanently disallowed as a deduction under another provision of the Code, such as in section 163(e)(5)(A)(i), (f), (l), or (m), or section 264(a), 265, 267A, or 279.

(3) *Deferred interest provisions.* Other than sections 461(l), 465, and 469, Code provisions that defer the deductibility of interest expense, such as section 163(e)(3) and (e)(5)(A)(ii), 267(a)(2) and (3), 1277, or 1282, apply before the application of section 163(j).

(4) *At risk rules, passive activity loss provisions, and limitation on excess business losses of noncorporate taxpayers.* Section 163(j) generally applies to limit the deduction for business interest expense before the application of sections 461(l), 465, and 469. However, in determining tentative taxable income for purposes of computing ATI, sections 461(l), 465, and 469 are taken into account.

(5) *Capitalized interest expenses.* Section 163(j) applies after the application of provisions that require the capitalization of interest, such as sections 263A and 263(g). Capitalized interest expense under those sections is not treated as business interest expense for purposes of section 163(j). For ordering rules that determine whether interest expense is capitalized under section 263A(f), see the regulations under section 263A(f), including § 1.263A–9(g).

(6) *Reductions under section 246A.* Section 246A applies before section 163(j). Any reduction in the dividends received deduction under section 246A reduces the amount of interest expense taken into account under section 163(j).

(7) *Section 381.* Disallowed business interest expense carryforwards are items to which an acquiring corporation succeeds under section 381(a). See section 381(c)(20) and §§ 1.163(j)–5(c) and 1.381(c)(20)–1.

(8) *Section 382.* For rules governing the interaction of sections 163(j) and 382, see section 382(d)(3) and (k)(1), §§ 1.163(j)–5(e) and 1.163(j)–11(c), the regulations in this part under sections 382 and 383 of the Code, and §§ 1.1502–91 through 1.1502–99.

(c) *Examples.* The examples in this paragraph (c) illustrate the application of section 163(j) and the provisions of this section. Unless otherwise indicated, X and Y are calendar-year domestic C corporations; D is a U.S. resident individual not subject to any foreign income tax; none of the taxpayers have floor plan financing interest expense; and the exemption for certain small businesses in § 1.163(j)–2(d) does not apply.

(1) *Example 1: Disallowed interest expense*—(i) *Facts.* In 2021, X has $30x of

interest expense. Of X's interest expense, $10x is permanently disallowed under section 265. X's business interest income is $3x and X's ATI is $90x.

(ii) *Analysis.* Under paragraph (b)(2) of this section, the $10x interest expense that is permanently disallowed under section 265 cannot be taken into consideration for purposes of section 163(j) in the 2021 taxable year. X's section 163(j) limitation, or the amount of business interest expense that X may deduct is limited to $30x under §1.163(j)–2(b), determined by adding X's business interest income ($3x) and 30 percent of X's 2019 ATI ($27x). Therefore, in the 2021 taxable year, none of the $20x of X's deduction for its business interest expense is disallowed under section 163(j).

(2) *Example 2: Deferred interest expense*—(i) *Facts.* In 2021, Y has no business interest income, $120x of ATI, and $70x of interest expense. Of Y's interest expense, $30x is not currently deductible under section 267(a)(2). The $30x expense is allowed as a deduction under section 267(a)(2) in 2022.

(ii) *Analysis.* Under paragraph (b)(3) of this section, section 267(a)(2) is applied before section 163(j). Accordingly, $30x of Y's interest expense cannot be taken into consideration for purposes of section 163(j) in 2021 because it is not currently deductible under section 267(a)(2). Accordingly, in 2021, if the interest expense is properly allocable to a non-excepted trade or business, Y will have $4x of disallowed business interest expense because the $40x of business interest expense in 2021 ($70x − $30x) exceeds 30 percent of its ATI for the taxable year ($36x). The $30x of interest expense not allowed as a deduction in the 2021 taxable year under section 267(a)(2) will be taken into account in determining the business interest expense deduction under section 163(j) in 2022, the taxable year in which it is allowed as a deduction under section 267(a)(2), if it is allocable to a trade or business. Additionally, the $4x of disallowed business interest expense in 2021 will be carried forward to 2022 as a disallowed business interest expense carryforward. See §1.163(j)–2(c).

(3) *Example 3: Passive activity loss*—(i) *Facts.* D is engaged in a rental activity treated as a passive activity within the meaning of section 469. For the 2021 taxable year, D receives $200x of rental income and incurs $300x of expenses all properly allocable to the rental activity, consisting of $150x of interest expense, $60x of maintenance expenses, and $90x of depreciation expense. D's ATI is $400x.

(ii) *Analysis.* Under paragraph (b)(4) of this section, section 163(j) is applied before the section 469 passive loss rules apply, except that section 469 is taken into account in the determination of tentative taxable income for purposes of computing ATI. D's section 163(j) limitation is $120x, determined by adding to D's business interest income ($0), floor plan financing ($0), and 30 percent of D's ATI ($120x). See §1.163(j)–2(b). Because D's business interest expense of $150x exceeds D's section 163(j) limitation for 2021, $30x of D's business interest expense is disallowed under section 163(j) and will be carried forward as a disallowed business interest expense carryforward. See §1.163(j)–2(c). Because the section 163(j) limitation is applied before the limitation under section 469, only $120x of the business interest expense allowable under section 163(j) is included in determining D's passive activity loss limitation for the 2021 tax year under section 469. The $30x of disallowed business interest expense is not an allowable deduction under section 163(j) and, therefore, is not a deduction under section 469 in the current taxable year. See §1.469–2(d)(8).

(4) *Example 4: Passive activity loss by taxpayer that also participates in a non-passive activity*—(i) *Facts.* For 2021, D has no business interest income and ATI of $1,000x, entirely attributable to a passive activity within the meaning of section 469. D has business interest expense of $1,000x, $900x of which is properly allocable to a passive activity and $100x of which is properly allocable to a non-passive activity in which D materially participates. D has other business deductions that are not subject to section 469 of $600x, and a section 469 passive loss from the previous year of $250x.

(ii) *Analysis.* Under paragraph (b)(4) of this section, section 163(j) is applied before the section 469 passive loss rules apply. D's section 163(j) limitation is $300x, determined by adding D's business interest income ($0), floor plan financing ($0), and 30 percent of D's ATI ($300x)). Next, applying the limitation under section 469 to the $300x business interest expense deduction allowable under section 163(a) and (j), $270x (a proportionate amount of the $300x (0.90 × $300x)) is business interest expense included in determining D's passive activity loss limitation under section 469, and $30x (a proportionate amount of the $300x (0.10 × $300)) is business interest expense not included in determining D's passive activity loss limitation under section 469. Because D's interest expense of $1,000x exceeds 30 percent of its ATI for 2021, $700x of D's interest expense is disallowed under section 163(j) and will be carried forward as a disallowed business interest expense carryforward. Section 469 does not apply to any portion of the $700x disallowed business interest expense because that business interest expense is not an allowable deduction under section 163(j) and, therefore, is not an allowable deduction under section 469 in the current taxable year. See §1.469–2(d)(8).

(5) *Example 5: ATI calculation with passive activity loss*—(i) *Facts*. D is an individual who engages in a trade or business, V, as a sole proprietorship. D relies on employees to perform most of the work and, as a result, D does not materially participate in V. Therefore, V is a passive activity of D. V is not an excepted trade or business. In Year 1, V generates $500x of passive income, $400x of business interest expense, and $600x of ordinary and necessary expenses deductible under section 162 (not including any interest described in §1.163(j)–1(b)(22)). No disallowed business interest expense carryforward has been carried to Year 1 from a prior year, and no amounts have been carried over to Year 1 from a prior year under either section 465(a)(2) or section 469(b).

(ii) *Tentative taxable income*. Under §1.163(j)–1(b)(43), tentative taxable income is determined as though all business interest expense was not subject to the section 163(j) limitation. Sections 461(l), 465, and 469 apply in the determination of tentative taxable income. For year 1, D has $500x of allowable deductions and a $500x tentative passive activity loss under section 469, because D's $1000x of passive expenses exceeds D's $500x of passive income from V. The tentative disallowance of $500x is generally allocated pro rata between D's passive expenses under §1.469–1T(f)(2)(ii)(A). In this case, fifty percent ($500x of passive activity loss divided by $1000x of total passive expenses) of each category of passive expense is tentatively disallowed: $200x of business interest expense and $300x of section 162 expense. D's tentative taxable income is $0 (zero), which is determined by reducing $500x of gross income by the remaining $200x of business interest expense and $300x of section 162 expense ($500x − $200x − $300x).

(iii) *ATI*. Under section §1.163(j)–1(b)(1), to determine ATI, D must add business interest expense to tentative taxable income, but only to the extent that the business interest expense reduced tentative taxable income, or $200x. The $200x of business interest expense that was tentatively disallowed under section 469 is not added to tentative taxable income to determine ATI. D's ATI is $200x, which is determined by adding the $200x of business interest expense that reduced tentative taxable income to D's tentative taxable income, or $0 (0 + $200x).

(iv) *Section 163(j) limitation*. D's section 163(j) limitation in Year 1 is D's business interest income, or $0, plus 30 percent of ATI, or $60x (30 percent × $200x ATI), plus D's floor plan financing, or $0, for a total of $60x ($0 + $60x + $0). Before the application of section 469, D has $60x of deductible business interest expense and $340x of disallowed business interest expense carryforward under §1.163(j)–2(c).

(v) *Passive activity loss*. Because D's passive deductions exceed the passive income from V, and D does not have any passive income from other sources, section 469 applies to limit D's passive loss from V. Having first applied section 163(j), D has $660x of passive expenses, determined by adding D's $60x of business interest expense that is allowed by section 163(j) as a deduction and $600x of section 162 expense ($60x + $600x). D offsets $500x of the passive expenses against $500x of passive income; therefore, D has a passive activity loss of $160x in Year 1, determined as the excess of D's total passive expenses over D's passive income ($660x − $500x). The amount of D's loss from the passive activity that is disallowed under section 469 ($160x) is generally ratably allocated to each of D's passive activity deductions under §1.469–1T(f)(2)(ii)(A). As a general rule, each deduction is multiplied by the ratio of the total passive loss to total passive expenses (160x/660x). Of D's $60x business interest expense, $14.55x (($160x/$660x) × $60x) is disallowed in Year 1. Additionally, of D's $600x section 162 expense, $145.45x (($160x/$660x) × $600x) is disallowed. The amounts disallowed under section 469(a)(1) and §1.469–2T(f)(2) are carried over to the succeeding taxable year under section 469(b) and §1.469–1(f)(4).

(6) *Example 6: Effect of passive activity loss carryforwards*—(i) *Facts.* The facts are the same as in *Example 5* in paragraph (c)(5)(i) of this section. In Year 2, V generates $500x of passive income, $100x of business interest expense, and $0 (zero) of other deductible expenses. D is not engaged in any other trade or business activities. A disallowed business interest expense carryforward of $340x has been carried to Year 2 from Year 1. Under section 469, D has a suspended loss from Year 1 that includes $14.55x of business interest expense and $145.45x of section 162 expense. These amounts are treated as passive activity deductions in Year 2.

(ii) *Tentative taxable income.* To determine D's tentative taxable income, D must first determine D's allowable deductions. In year 2, D has $260x of allowable deductions, which includes $100x of business interest expense generated Year 2, $14.55x of business interest expense disallowed in Year 1 by section 469, and $145.45x of section 162 expense disallowed in Year 1 by section 469 ($100x + $14.55x + $145.45x)). D's disallowed business interest expense carryforward from Year 1 is not taken into account in determining tentative taxable income. See §1.163(j)–1(b)(43). Additionally, the $14.55x of business interest expense disallowed in Year 1 by section 469 is not business interest expense in Year 2 because it was deductible after the application of section 163(j) (but before the application of section 469) in Year 1. D does not have a tentative passive activity loss in Year 2, because D's $500x of passive income from V exceeds D's $260x of tentative passive expenses. Therefore, D's tentative taxable income in Year 2 is $240x, which is determined by subtracting D's allowable deductions other than disallowed business interest expense carryforwards, or $260x, from D's gross income, or $500x ($500x − $260x).

(iii) *ATI.* D's ATI in Year 2 is $340x, which is determined by adding D's business interest expense, or $100x, to D's tentative taxable income, or $240x ($240x + $100x). Because disallowed business interest expense carryforwards are not taken into account in determining tentative taxable income, there is no corresponding adjustment for disallowed business interest expense carryforwards in calculating ATI. Therefore, there is no adjustment for D's $340x of disallowed business interest expense carryforward in calculating D's ATI. D has no other adjustments to determine ATI.

(iv) *Section 163(j) limitation.* D's section 163(j) limitation in Year 2 is $102x, which is determined by adding D's business interest income, or $0, 30 percent of D's ATI for year 2, $102 ($340x × 30 percent), and D's floor plan financing for Year 2, or $0 ($0 + ($102x) + $0). Accordingly, before the application of section 469 in Year 2, $102x of D's $440x of total business interest expense (determined by adding $340x of disallowed business interest expense carryforward from Year 1 and $100x of business interest expense in Year 2) is deductible. D has $338x of disallowed business interest expense carryforward that will carry forward to subsequent taxable years under §1.163(j)–2(c), determined by subtracting D's deductible business interest expense in Year 2, or $102x, from D's total business interest expense in Year 2, or $440x ($440x − $102x).

(v) *Section 469.* After applying the section 163(j) limitation, D applies section 469 to determine if any amount of D's expense is a disallowed passive activity loss. For Year 2, D has $262x of passive expenses, determined by adding D's business interest expense deduction allowed by section 163(j) ($102x), D's section 162 expense carried forward from Year 1 under section 469 ($145.45x), and

D's interest expense carried forward from Year 1 under section 469 which is not business interest expense in Year 2, or $14.55x ($102x + $145.45x + $14.55x). Therefore, D has $238x of net passive income in Year 2, determined by reducing D's total passive income in Year 2 ($500x), by D's disallowed passive activity loss, or $262x ($500x − $262x). D does not have a passive activity loss in Year 2, and no part of D's $262x of passive expenses is disallowed in Year 2 under section 469.

(7) *Example 7: Capitalized interest expense*—(i) *Facts.* In 2020, X has $50x of interest expense. Of X's interest expense, $10x is required to be capitalized under section 263A. X capitalizes this interest expense to a depreciable asset. X's business interest income is $9x and X's ATI is $80x. X makes the election in §1.163(j)–2(b)(2)(ii) to use 30 percent, rather than 50 percent, of ATI in determining X's section 163(j) limitation for the 2020 taxable year.

(ii) *Analysis.* Under paragraph (b)(5) of this section, section 263A is applied before section 163(j). Accordingly, $10x of X's interest expense cannot be taken into consideration for purposes of section 163(j) in 2020. Additionally, under paragraph (b)(5) of this section, X's $10 of capitalized interest expense is not business interest expense for purposes of section 163(j). As a result, when X recovers its capitalized interest expense through depreciation deductions, such capitalized interest expense will not be taken into account as business interest expense in determining X's section 163(j) limitation. X's section 163(j) limitation in 2020, or the amount of business interest expense that X may deduct, is limited to $33x under §1.163(j)–2(b), determined by adding X's business interest income ($9x) and 30 percent of X's 2020 ATI ($24x). X therefore has $7x of disallowed business interest expense in 2020 that will be carried forward to 2021 as a disallowed business interest expense carryforward.

(d) *Applicability date.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year.

[T.D. 9905, 85 FR 56760, Sept. 14, 2020]

§1.163(j)–4 General rules applicable to C corporations (including REITs, RICs, and members of consolidated groups) and tax-exempt corporations.

(a) *Scope.* This section provides rules regarding the computation of items of income and expense under section 163(j) for taxpayers that are C corporations, including, for example, members of a consolidated group, REITs, RICs, tax-exempt corporations, and cooperatives. Paragraph (b) of this section provides rules regarding the characterization of items of income, gain, deduction, or loss. Paragraph (c) of this section provides rules regarding adjustments to earnings and profits. Paragraph (d) of this section provides rules applicable to members of a consolidated group. Paragraph (e) of this section provides rules governing the ownership of partnership interests by members of a consolidated group. Paragraph (f) of this section provides cross-references to other rules within the 163(j) regulations that may be applicable to C corporations.

(b) *Characterization of items of income, gain, deduction, or loss*—(1) *Interest expense and interest income.* Solely for purposes of section 163(j), all interest expense of a taxpayer that is a C corporation is treated as properly allocable to a trade or business. Similarly, solely for purposes of section 163(j), all interest income of a taxpayer that is a C corporation is treated as properly allocable to a trade or business. For rules governing the allocation of interest expense and interest income between excepted and non-excepted trades or businesses, see §1.163(j)–10.

(2) *Adjusted taxable income.* Solely for purposes of section 163(j), all items of

income, gain, deduction, or loss of a taxpayer that is a C corporation are treated as properly allocable to a trade or business. For rules governing the allocation of tax items between excepted and non-excepted trades or businesses, see §1.163(j)–10.

(3) *Investment interest, investment income, investment expenses, and certain other tax items of a partnership with a C corporation partner*—(i) *Characterization as expense or income properly allocable to a trade or business.* For purposes of section 163(j), any investment interest, investment income, or investment expense (within the meaning of section 163(d)) that a partnership pays, receives, or accrues and that is allocated to a C corporation partner as a separately stated item is treated by the C corporation partner as properly allocable to a trade or business of that partner. Similarly, for purposes of section 163(j), any other tax items of a partnership that are neither properly allocable to a trade or business of the partnership nor described in section 163(d) and that are allocated to a C corporation partner as separately stated items are treated as properly allocable to a trade or business of that partner.

(ii) *Effect of characterization on partnership.* The characterization of a partner's tax items pursuant to paragraph (b)(3)(i) of this section does not affect the characterization of these items at the partnership level.

(iii) *Separately stated interest expense and interest income of a partnership not treated as excess business interest expense or excess taxable income of a C corporation partner.* Investment interest expense and other interest expense of a partnership that is treated as business interest expense by a C corporation partner under paragraph (b)(3)(i) of this section is not treated as excess business interest expense of the partnership. Investment interest income and other interest income of a partnership that is treated as business interest income by a C corporation partner under paragraph (b)(3)(i) of this section is not treated as excess taxable income of the partnership. For rules governing excess business interest expense and excess taxable income, see §1.163(j)–6.

(iv) *Treatment of deemed inclusions of a domestic partnership that are not allocable to any trade or business.* If a United States shareholder that is a domestic partnership includes amounts in gross income under sections 951(a) or 951A(a) that are not properly allocable to a trade or business of the domestic partnership, then, notwithstanding paragraph (b)(3)(i) of this section, to the extent a C corporation partner, including an indirect partner in the case of tiered partnerships, takes such amounts into account as a distributive share in accordance with section 702 and §1.702–1(a)(8)(ii), the C corporation partner may not treat such amounts as properly allocable to a trade or business of the C corporation partner.

(4) *Application to RICs and REITs*—(i) *In general.* Except as otherwise provided in paragraphs (b)(4)(ii) and (iii) of this section, the rules in this paragraph (b) apply to RICs and REITs.

(ii) *Tentative taxable income of RICs and REITs.* The tentative taxable income of a RIC or REIT for purposes of calculating ATI is the tentative taxable income of the corporation, without any adjustment that would be made under section 852(b)(2) or 857(b)(2) to compute investment company taxable income or real estate investment trust taxable income, respectively. For example, the tentative taxable income of a RIC or REIT is not reduced by the deduction for dividends paid, but is reduced by the dividends received deduction (DRD) and the other deductions described in sections 852(b)(2)(C) and 857(b)(2)(A). See paragraph (b)(4)(iii) of this section for an adjustment to ATI in respect of these items.

(iii) *Other adjustments to adjusted taxable income for RICs and REITs.* In the case of a taxpayer that, for a taxable year, is a RIC to which section 852(b) applies or a REIT to which section 857(b) applies, the taxpayer's ATI for the taxable year is increased by the amounts of any deductions described in section 852(b)(2)(C) or 857(b)(2)(A).

(5) *Application to tax-exempt corporations.* The rules in this paragraph (b) apply to a tax-exempt corporation only with respect to that corporation's items of income, gain, deduction, or loss that are taken into account in computing the corporation's unrelated business taxable income, as defined in section 512.

(6) *Adjusted taxable income of cooperatives.* Solely for purposes of computing the ATI of a cooperative under §1.163(j)–1(b)(1), tentative taxable income is not reduced by the amount of any patronage dividend under section 1382(b)(1) or by any amount paid in redemption of nonqualified written notices of allocation distributed as patronage dividends under section 1382(b)(2) (for cooperatives subject to taxation under sections 1381 through 1388), any amount described in section 1382(c) (for cooperatives described in section 1381(a)(1) and section 521), or any equivalent amount deducted by an organization that operates on a cooperative basis but is not subject to taxation under sections 1381 through 1388.

(7) *Examples.* The principles of this paragraph (b) are illustrated by the following examples. For purposes of the examples in this paragraph (b)(7) of this section, T is a taxable domestic C corporation whose taxable year ends on December 31; T is neither a consolidated group member nor a RIC or a REIT; neither T nor PS1, a domestic partnership, owns at least 80 percent of the stock of any corporation; neither T nor PS1 qualifies for the small business exemption in §1.163(j)–2(d) or is engaged in an excepted trade or business; T has no floor plan financing expense; all interest expense is deductible except for the potential application of section 163(j); and the facts set forth the only corporate or partnership activity.

(i) *Example 1: C corporation items properly allocable to a trade or business*—(A) *Facts.* In taxable year 2021, T's tentative taxable income (without regard to the application of section 163(j)) is $320x. This amount is comprised of the following tax items: $1,000x of revenue from inventory sales; $500x of ordinary and necessary business expenses (excluding interest and depreciation); $200x of interest expense; $50x of interest income; $50x of depreciation deductions under section 168; and a $20x gain on the sale of stock.

(B) *Analysis.* For purposes of section 163(j), each of T's tax items is treated as properly allocable to a trade or business. Thus, T's ATI for the 2021 taxable year is $520x ($320x of tentative taxable income + $200x business interest expense − $50x business interest income + $50x depreciation deductions = $520x), and its section 163(j) limitation for the 2021 taxable year is $206x ($50x of business interest income + 30 percent of its ATI (30 percent × $520x) = $206x). As a result, all $200x of T's interest expense is deductible in the 2021 taxable year under section 163(j).

(C) *Taxable year beginning in 2022.* The facts are the same as in *Example 1* in paragraph (b)(7)(i)(A) of this section, except that the taxable year begins in 2022 and therefore depreciation deductions are not added back to ATI under §1.163(j)–1(b)(1)(i)(E). As a result, T's ATI for 2022 is $470x ($320x of tentative taxable income + $200x business interest expense − $50x business interest income = $470x), and its section 163(j) limitation for the 2022 taxable year is $191x ($50x of business interest income + 30 percent of its ATI (30 percent × $470x) = $191x). As a result, T may only deduct $191x of its business interest expense for the taxable year, and the remaining $9x is carried forward to the 2023 taxable year as a disallowed business interest expense carryforward. See §1.163(j)–2(c).

(ii) *Example 2: C corporation partner*—(A) *Facts.* T and individual A each own a 50 percent interest in PS1, a general partnership. PS1 borrows funds from a third party (Loan 1) and uses those funds to buy stock in publicly-traded corporation X. PS1's only activities are holding X stock (and receiving dividends) and making payments on Loan 1. In the 2021 taxable year, PS1 receives $150x in dividends and pays $100x in interest on Loan 1.

(B) *Analysis.* For purposes of section 163(d) and (j), PS1 has investment interest expense of $100x and investment income of $150x, and PS1 has no interest expense or interest income that is properly allocable to a trade or business. PS1 allocates its investment interest expense and investment income equally to its two partners pursuant to §1.163(j)–6(k). Pursuant to paragraph (b)(3) of this section, T's allocable share of PS1's investment interest expense is treated as a business interest expense of T, and T's allocable share of PS1's investment income is treated as properly allocable to a trade or business of T. This business interest expense is not treated as excess business interest expense, and this income is not treated as excess taxable income. See paragraph (b)(3)(iii) of this section. T's treatment of its allocable share of PS1's investment interest expense and investment income as business interest expense and income properly allocable to a trade or business, respectively, does not affect the character of these items at the PS1 level and does not affect the character of A's allocable share of PS1's investment interest and investment income.

(C) *Partnership engaged in a trade or business.* The facts are the same as in *Example 2* in paragraph (b)(7)(ii)(A) of this section, except that PS1 also is engaged in Business 1, and PS1 borrows funds from a third party to finance Business 1 (Loan 2). In 2021, Business 1 earns $150x of net income (excluding interest expense and depreciation), and PS1 pays $100x of interest on Loan 2. For purposes of section 163(d) and (j), PS1 treats the interest paid on Loan 2 as properly allocable to a trade or business. As a result, PS1 has investment interest expense of $100x (attributable to Loan 1), business interest expense of $100x (attributable to Loan 2), $150x of investment income, and $150x of income from Business 1. PS1's ATI is $150x (its net income from Business 1 excluding interest and depreciation), and its section 163(j) limitation is $45x (30 percent × $150x). Pursuant to § 1.163(j)–6, PS1 has $55x of excess business interest expense ($100x − $45x), half of which ($27.5x) is allocable to T. Additionally, pursuant to paragraph (b)(3)(i) of this section, T's allocable share of PS1's investment interest expense ($50x) is treated as a business interest expense of T for purposes of section 163(j), and T's allocable share of PS1's investment income ($75x) is treated as properly allocable to a trade or business of T. Therefore, with respect to T's interest in PS1, T is treated as having $50x of business interest expense that is not treated as excess business interest expense, $75x of income that is properly allocable to a trade or business, and $27.5x of excess business interest expense.

(c) *Effect on earnings and profits*—(1) *In general.* In the case of a taxpayer that is a domestic C corporation, except as otherwise provided in paragraph (c)(2) of this section, the disallowance and carryforward under § 1.163(j)–2 (and § 1.163(j)–5, in the case of a taxpayer that is a consolidated group member) of a deduction for business interest expense of the taxpayer or of a partnership in which the taxpayer is a partner does not affect whether or when the business interest expense reduces the taxpayer's earnings and profits. In the case of a foreign corporation, the disallowance and carryforward of a deduction for the corporation's business interest expense under § 1.163(j)–2 does not affect whether and when such business interest expense reduces the corporation's earnings and profits. Thus, for example, if a United States person has elected under section 1295 to treat a passive foreign investment company (as defined in section 1297) (PFIC) as a qualified electing fund, then the disallowance and carryforward of a deduction for the PFIC's business interest expense under § 1.163(j)–2 does not affect whether or when such business interest expense reduces the PFIC's earnings and profits.

(2) *Special rule for RICs and REITs.* In the case of a taxpayer that is a RIC or a REIT for the taxable year in which a deduction for the taxpayer's business interest expense is disallowed under § 1.163(j)–2(b), or in which the RIC or REIT is allocated any excess business interest expense from a partnership under section 163(j)(4)(B)(i) and § 1.163(j)–6, the taxpayer's earnings and profits are adjusted in the taxable year or years in which the business interest expense is deductible or, if earlier, in the first taxable year for which the taxpayer no longer is a RIC or a REIT.

(3) *Special rule for partners that are C corporations.* If a taxpayer that is a C corporation is allocated any excess business interest expense from a partnership, and if all or a portion of the excess business interest expense has not yet been treated as business interest expense by the taxpayer at the time of the taxpayer's disposition of all or a portion of its interest in the partnership, the taxpayer must increase its earnings and profits immediately prior

to the disposition by an amount equal to the amount of the basis adjustment required under section 163(j)(4)(B)(iii)(II) and § 1.163(j)–6(h)(3).

(4) *Examples.* The principles of this paragraph (c) are illustrated by the following examples. For purposes of the examples in this paragraph (c)(4), except as otherwise provided in the examples, X is a taxable domestic C corporation whose taxable year ends on December 31; X is not a member of a consolidated group; X does not qualify for the small business exemption under § 1.163(j)–2(d); X is not engaged in an excepted trade or business; X has no floor plan financing indebtedness; all interest expense is deductible except for the potential application of section 163(j); X has no accumulated earnings and profits at the beginning of the 2021 taxable year; and the facts set forth the only corporate activity.

(i) *Example 1: Earnings and profits of a taxable domestic C corporation other than a RIC or a REIT*—(A) *Facts.* X is a corporation that does not intend to qualify as a RIC or a REIT for its 2021 taxable year. In that year, X has tentative taxable income (without regard to the application of section 163(j)) of $0, which includes $100x of gross income and $100x of interest expense on a loan from an unrelated third party. X also makes a $100x distribution to its shareholders that year.

(B) *Analysis.* The $100x of interest expense is business interest expense for purposes of section 163(j) (see paragraph (b)(1) of this section). X's ATI in the 2021 taxable year is $100x ($0 of tentative taxable income computed without regard to $100x of business interest expense). Thus, X may deduct $30x of its $100x of business interest expense in the 2021 taxable year under § 1.163(j)–2(b) (30 percent × $100x), and X may carry forward the remainder ($70x) to X's 2022 taxable year as a disallowed business interest expense carryforward under § 1.163(j)–2(c). Although X may not currently deduct all $100x of its business interest expense in the 2021 taxable year, X must reduce its earnings and profits in that taxable year by the full amount of its business interest expense ($100x) in that taxable year. As a result, no portion of X's distribution of $100x to its shareholders in the 2021 taxable year is a dividend within the meaning of section 316(a).

(ii) *Example 2: RIC adjusted taxable income and earnings and profits*—(A) *Facts.* X is a corporation that intends to qualify as a RIC for its 2021 taxable year. In that taxable year, X's only items are $100x of interest income, $50x of dividend income from C corporations that only issue common stock and in which X has less than a twenty percent interest (by vote and value), $10x of net capital gain, and $125x of interest expense. None of the dividends are received on debt financed portfolio stock under section 246A. The DRD determined under section 243(a) with respect to X's $50x of dividend income is $25x. X pays $42x in dividends to its shareholders, meeting the requirements of section 562 during X's 2021 taxable year, including $10x that X reports as capital gain dividends in written statements furnished to X's shareholders.

(B) *Analysis.* (*1*) Under paragraph (b) of this section, all of X's interest expense is considered business interest expense, all of X's interest income is considered business interest income, and all of X's other income is considered to be properly allocable to a trade or business. Under paragraph (b)(4)(ii) of this section, prior to the application of section 163(j), X's tentative taxable income is $10x ($100x business interest income + $50x dividend income + $10x net capital gain − $125x business interest expense − $25x DRD = $10x). Under paragraph (b)(4)(iii) of this section, X's ATI is increased by the DRD. As such, X's ATI for the 2021 taxable year is $60x ($10x tentative taxable income + $125x business interest expense − $100x business interest income + $25x DRD = $60x).

(*2*) X may deduct $118x of its $125x of business interest expense in the 2021 taxable year under section 163(j)(1) ($100x business interest income + (30 percent × $60x of ATI) = $118x), and X may carry forward the remainder ($7x) to X's 2022 taxable year. See § 1.163(j)–2(b) and (c).

(*3*) After the application of section 163(j), X has taxable income of $17x ($100x interest income + $50x dividend income + $10x capital gain − $25x DRD − $118x allowable interest expense = $17x) for the 2021 taxable year. X will have investment company taxable income (ICTI) in the amount of $0 ($17x taxable income − $10x capital gain + $25x DRD − $32x dividends paid deduction for ordinary dividends = $0). The excess of X's net capital gain ($10x) over X's dividends paid deduction determined with reference to capital gain dividends ($10x) is also $0.

(*4*) Under paragraph (c)(2) of this section, X will not reduce its earnings and profits by the amount of interest expense disallowed as a deduction in the 2021 taxable year under section 163(j). Thus, X has current earnings and profits in the amount of $42x ($100x interest income + $50x dividend income + $10x capital gain − $118x allowable business interest expense = $42x) before giving effect to dividends paid during the 2021 taxable year.

(iii) *Example 3: Carryforward of disallowed interest expense*—(A) *Facts*. The facts are the same as the facts in *Example 2* in paragraph (c)(4)(ii)(A) of this section for the 2021 taxable year. In addition, X has $50x of interest income and $20x of interest expense for the 2022 taxable year.

(B) *Analysis*. Under paragraph (b) of this section, all of X's interest expense is considered business interest expense, all of X's interest income is considered business interest income, and all of X's other income is considered to be properly allocable to a trade or business. Because X's $50x of business interest income exceeds the $20x of business interest expense from the 2022 taxable year and the $7x of disallowed business interest expense carryforward from the 2021 taxable year, X may deduct $27x of business interest expense in the 2022 taxable year. Under paragraph (c)(2) of this section, X must reduce its current earnings and profits for the 2022 taxable year by the full amount of the deductible business interest expense ($27x).

(iv) *Example 4: REIT adjusted taxable income and earnings and profits*—(A) *Facts*. X is a corporation that intends to qualify as a REIT for its 2021 taxable year. X is not engaged in an excepted trade or business and is not engaged in a trade or business that is eligible to make any election under section 163(j)(7). In that year, X's only items are $100x of mortgage interest income, $30x of dividend income from C corporations that only issue common stock and in which X has less than a ten percent interest (by vote and value), $10x of net capital gain from the sale of mortgages on real property that is not property described in section 1221(a)(1), and $125x of interest expense. None of the dividends are received on debt financed portfolio stock under section 246A. The DRD determined under section 243(a) with respect to X's $30x of dividend income is $15x. X pays $28x in dividends meeting the requirements of section 562 during X's 2021 taxable year, including $10x that X properly designates as capital gain dividends under section 857(b)(3)(B).

(B) *Analysis*. (*1*) Under paragraph (b) of this section, all of X's interest expense is considered business interest expense, all of X's interest income is considered business interest income, and all of X's other income is considered to be properly allocable to a trade or business. Under paragraph (b)(4)(ii) of this section, prior to the application of section 163(j), X's tentative taxable income is $0 ($100x business interest income + $30x dividend income + $10x net capital gain − $125x business interest expense − $15x DRD = $0). Under paragraph (b)(4)(iii) of this section, X's ATI is increased by the DRD. As such, X's ATI for the 2021 taxable year is $40x ($0 tentative taxable income + $125x business interest expense − $100x business interest income + $15x DRD = $40x).

(*2*) X may deduct $112x of its $125x of business interest expense in the 2021 taxable year under section 163(j)(1) ($100x business interest income + (30 percent × $40x of ATI) = $112x), and X may carry forward the remainder of its business interest expense ($13x) to X's 2022 taxable year.

(*3*) After the application of section 163(j), X has taxable income of $13x ($100x business interest income + $30x dividend income + $10x capital gain − $15x DRD − $112x allowable business interest expense = $13x) for the 2021 taxable year. X will have real estate investment trust taxable income (REITTI) in the amount of $0 ($13x taxable income + $15x of DRD − $28x dividends paid deduction = $0).

(*4*) Under paragraph (c)(2) of this section, X will not reduce earnings and profits by the amount of business interest expense disallowed as a deduction in the 2021 taxable year. Thus, X has current earnings and profits in the amount of $28x ($100x business interest income + $30x dividend income + $10x capital gain − $112x allowable business interest expense = $28x) before giving effect to dividends paid during X's 2021 taxable year.

(v) *Example 5: Carryforward of disallowed interest expense*—(A) *Facts.* The facts are the same as in *Example 4* in paragraph (c)(4)(iv)(A) of this section for the 2021 taxable year. In addition, X has $50x of mortgage interest income and $20x of interest expense for the 2022 taxable year. X has no other tax items for the 2022 taxable year.

(B) *Analysis.* Because X's $50x of business interest income exceeds the $20x of business interest expense from the 2022 taxable year and the $13x of disallowed business interest expense carryforwards from the 2021 taxable year, X may deduct $33x of business interest expense in 2022. Under paragraph (c)(2) of this section, X must reduce its current earnings and profits for 2022 by the full amount of the deductible interest expense ($33x).

(d) *Special rules for consolidated groups*—(1) *Scope.* This paragraph (d) provides rules applicable to members of a consolidated group. For all members of a consolidated group for a consolidated return year, the computations required by section 163(j) and the regulations in this part under section 163(j) are made in accordance with the rules of this paragraph (d) unless otherwise provided elsewhere in the section 163(j) regulations. For rules governing the ownership of partnership interests by members of a consolidated group, see paragraph (e) of this section.

(2) *Calculation of the section 163(j) limitation for members of a consolidated group*—(i) *In general.* A consolidated group has a single section 163(j) limitation, the absorption of which is governed by §1.163(j)–5(b)(3)(ii).

(ii) *Interest.* For purposes of determining whether amounts, other than amounts in respect of intercompany obligations (as defined in §1.1502–13(g)(2)(ii)), intercompany items (as defined in §1.1502–13(b)(2)), or corresponding items (as defined in §1.1502–13(b)(3)), are treated as interest within the meaning of §1.163(j)–1(b)(22), all members of a consolidated group are treated as a single taxpayer.

(iii) *Calculation of business interest expense and business interest income for a consolidated group.* For purposes of calculating the section 163(j) limitation for a consolidated group, the consolidated group's current-year business interest expense and business interest income, respectively, are the sum of each member's current-year business interest expense and business interest income, including amounts treated as business interest expense and business interest income under paragraph (b)(3) of this section.

(iv) *Calculation of adjusted taxable income.* For purposes of calculating the ATI for a consolidated group, the tentative taxable income is the consolidated group's consolidated taxable income, determined under §1.1502–11 but without regard to any carryforwards or disallowances under section 163(j). Further, for purposes of calculating the ATI of the group, intercompany items and corresponding items are disregarded to the extent that they offset in amount. Thus, for example, certain portions of the intercompany items and corresponding items of a group member engaged in a non-excepted trade or business will not be included in ATI to the extent that the counterparties to the relevant intercompany transactions are engaged in one or more excepted trades or businesses.

(v) *Treatment of intercompany obligations*—(A) *In general.* Except as otherwise provided in paragraph (d)(2)(v)(B) of this section, for purposes of determining a member's business interest expense and business interest income, and for purposes of calculating the consolidated group's ATI, all intercompany obligations, as defined in §1.1502–13(g)(2)(ii), are disregarded. Therefore, except as otherwise provided in paragraph (d)(2)(v)(B) of this section, interest expense and interest income from intercompany obligations are not treated as business interest expense and business interest income.

(B) *Repurchase premium.* This paragraph (d)(2)(v)(B) applies if a member of a consolidated group purchases an obligation of another member of the same consolidated group in a transaction to which § 1.1502–13(g)(5) applies. Notwithstanding the general rule of paragraph (d)(2)(v)(A) of this section, if, as a result of the deemed satisfaction of the obligation under § 1.1502–13(g)(5)(ii), the debtor member has repurchase premium that is deductible under § 1.163–7(c), such repurchase premium is treated as interest that is subject to the section 163(j) limitation. See § 1.163(j)–1(b)(22)(i)(H).

(3) *Investment adjustments.* For rules governing investment adjustments within a consolidated group, see § 1.1502–32(b).

(4) *Examples.* The principles in this paragraph (d) are illustrated by the following examples. For purposes of the examples in this paragraph (d)(4), S is a member of the calendar-year consolidated group of which P is the common parent; the P group does not qualify for the small business exemption in § 1.163(j)–2(d); no member of the P group is engaged in an excepted trade or business; all interest expense is deductible except for the potential application of section 163(j); and the facts set forth the only corporate activity.

(i) *Example 1: Calculation of the section 163(j) limitation*—(A) *Facts.* In the 2021 taxable year, P has $50x of separate tentative taxable income after taking into account $65x of interest paid on a loan from a third party (without regard to any disallowance under section 163(j)) and $35x of depreciation deductions under section 168. In turn, S has $40x of separate tentative taxable income in the 2021 taxable year after taking into account $10x of depreciation deductions under section 168. S has no interest expense in the 2021 taxable year. The P group's tentative taxable income the 2021 taxable year is $90x, determined under § 1.1502–11 without regard to any disallowance under section 163(j).

(B) *Analysis.* As provided in paragraph (b)(1) of this section, P's interest expense is treated as business interest expense for purposes of section 163(j). If P and S were to apply the section 163(j) limitation on a separate-entity basis, then P's ATI would be $150x ($50x + $65x + $35x = $150x), its section 163(j) limitation would be $45x (30 percent × $150x = $45x), and a deduction for $20x of its $65x of business interest expense would be disallowed in the 2021 taxable year under section 163(j). However, as provided in paragraph (d)(2) of this section, the P group computes a single section 163(j) limitation, and that computation begins with the P group's tentative taxable income (as determined prior to the application of section 163(j)), or $90x. The P group's ATI is $200x ($50x + $40x + $65x + $35x + $10x = $200x). Thus, the P group's section 163(j) limitation for the 2021 taxable year is $60x (30 percent × $200x = $60x). As a result, all but $5x of the P group's business interest expense is deductible in the 2021 taxable year. P carries over the $5x of disallowed business interest expense to the succeeding taxable year.

(ii) *Example 2: Intercompany obligations*—(A) *Facts.* On January 1, 2021, G, a corporation unrelated to P and S, lends P $100x in exchange for a note that accrues interest at a 10 percent annual rate. A month later, P lends $100x to S in exchange for a note that accrues interest at a 12 percent annual rate. In 2021, P accrues and pays $10x of interest to G on P's note, and S accrues and pays $12x of interest to P on S's note. For that year, the P group's only other items of income, gain, deduction, and loss are $40x of income earned by S from the sale of inventory, and a $30x deductible expense arising from P's payment of tort liability claims.

(B) *Analysis.* As provided in paragraph (d)(2)(v) of this section, the intercompany obligation between P and S is disregarded in determining P and S's business interest expense and business interest income and in determining the P group's ATI. For purposes of section 163(j), P has $10x of business interest expense and a $30x deduction for the payment of tort liability claims, and S has $40x of income. The P group's ATI is $10x ($40x − $30x = $10x), and its section 163(j) limitation is $3x (30 percent × $10x = $3x). The P group may deduct $3x of its business interest expense in the 2021 taxable year. A deduction for P's remaining $7x of business interest expense is disallowed in the 2021 taxable year, and this amount is carried forward to the 2022 taxable year.

(e) *Ownership of partnership interests by members of a consolidated group.*

(1) [Reserved]

(2) *Change in status of a member.* A change in status of a member (that is, becoming or ceasing to be a member of the group) is not treated as a disposition for purposes of section 163(j)(4)(B)(iii)(II) and § 1.163(j)–6(h)(3).

(3) *Basis adjustments under § 1.1502–32.* A member's allocation of excess business interest expense from a partnership and the resulting decrease in basis in the partnership interest under section 163(j)(4)(B)(iii)(I) is not a noncapital, nondeductible expense for purposes of § 1.1502–32(b)(3)(iii). Additionally, an increase in a member's basis in a partnership interest under section 163(j)(4)(B)(iii)(II) to reflect excess business interest expense not deducted by the consolidated group is not tax-exempt income for purposes of § 1.1502–32(b)(3)(ii). Investment adjustments are made under § 1.1502–32(b)(3)(i) when the excess business interest expense from the partnership is converted into business interest expense, deducted, and absorbed by the consolidated group. See § 1.1502–32(b).

(4) *Excess business interest expense and § 1.1502–36.* Excess business interest expense is a Category D asset within the meaning of § 1.1502–36(d)(4)(i).

(f) *Cross-references.* For rules governing the treatment of disallowed business interest expense carryforwards for C corporations, including rules governing the treatment of disallowed business interest expense carryforwards when members enter or leave a consolidated group, see § 1.163(j)–5. For rules governing the application of section 163(j) to a C corporation or a consolidated group engaged in both excepted and non-excepted trades or businesses, see § 1.163(j)–10.

(g) *Applicability date*—(1) *In general.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year.

(2) [Reserved]

[T.D. 9905, 85 FR 56760, Sept. 14, 2020]

§ 1.163(j)–5 General rules governing disallowed business interest expense carryforwards for C corporations.

(a) *Scope and definitions*—(1) *Scope.* This section provides rules regarding disallowed business interest expense carryforwards for taxpayers that are C corporations, including members of a consolidated group. Paragraph (b) of this section provides rules regarding the treatment of disallowed business interest expense carryforwards. Paragraph (c) of this section provides a cross-reference to other rules regarding disallowed business interest expense carryforwards in transactions to which section 381(a) applies. Paragraph (d) of this section provides rules regarding limitations on disallowed business interest expense carryforwards from separate return limitation years (SRLYs). Paragraph (e) of this section provides cross-references to other rules regarding the application of section 382 to disallowed business interest expense carryforwards. Paragraph (f) of this section provides a cross-reference to other rules regarding the overlap of the SRLY limitation with section 382. Paragraph (g) of this section references additional rules that may limit the deductibility of interest or the use of disallowed business interest expense carryforwards.

(2) *Definitions*—(i) *Allocable share of the consolidated group's remaining section 163(j) limitation.* The term *allocable share of the consolidated group's remaining section 163(j) limitation* means, with respect to any member of a consolidated group, the product of the consolidated group's remaining section 163(j) limitation and the member's remaining current-year interest ratio.

(ii) *Consolidated group's remaining section 163(j) limitation*. The term *consolidated group's remaining section 163(j) limitation* means the amount of the consolidated group's section 163(j) limitation calculated pursuant to §1.163(j)–4(d)(2), reduced by the amount of interest deducted by members of the consolidated group pursuant to paragraph (b)(3)(ii)(C)(*2*) of this section.

(iii) *Remaining current-year interest ratio*. The term *remaining current-year interest ratio* means, with respect to any member of a consolidated group for a particular taxable year, the ratio of the remaining current-year business interest expense of the member after applying the rule in paragraph (b)(3)(ii)(C)(*2*) of this section, to the sum of the amounts of remaining current-year business interest expense for all members of the consolidated group after applying the rule in paragraph (b)(3)(ii)(C)(*2*) of this section.

(b) *Treatment of disallowed business interest expense carryforwards*—(1) *In general*. The amount of any business interest expense of a C corporation not allowed as a deduction for any taxable year as a result of the section 163(j) limitation is carried forward to the succeeding taxable year as a disallowed business interest expense carryforward under section 163(j)(2) and §1.163(j)–2(c).

(2) *Deduction of business interest expense*. For a taxpayer that is a C corporation, current-year business interest expense is deducted in the current taxable year before any disallowed business interest expense carryforwards from a prior taxable year are deducted in that year. Disallowed business interest expense carryforwards are deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, subject to certain limitations (for example, the limitation under section 382). For purposes of section 163(j), disallowed disqualified interest is treated as carried forward from the taxable year in which a deduction was disallowed under old section 163(j).

(3) *Consolidated groups*—(i) *In general*. A consolidated group's disallowed business interest expense carryforwards for the current consolidated return year (the current year) are the carryforwards from the group's prior consolidated return years plus any carryforwards from separate return years.

(ii) *Deduction of business interest expense*—(A) *General rule*. All current-year business interest expense of members of a consolidated group is deducted in the current year before any disallowed business interest expense carryforwards from prior taxable years are deducted in the current year. Disallowed business interest expense carryforwards from prior taxable years are deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year, subject to the limitations described in this section.

(B) *Section 163(j) limitation equals or exceeds the current-year business interest expense and disallowed business interest expense carryforwards from prior taxable years*. If a consolidated group's section 163(j) limitation for the current year equals or exceeds the aggregate amount of its members' current-year business interest expense and disallowed business interest expense carryforwards from prior taxable years that are available for deduction, then none of the current-year business interest expense or disallowed business interest expense carryforwards is subject to disallowance in the current year under section 163(j). However, a deduction for the members' business interest expense may be subject to limitation under other provisions of the Code or the Income Tax Regulations (see, for example, paragraphs (c), (d), (e), and (f) of this section).

(C) *Current-year business interest expense and disallowed business interest expense carryforwards exceed section 163(j) limitation*. If the aggregate amount of members' current-year business interest expense and disallowed business interest expense carryforwards from prior taxable years exceeds the consolidated group's section 163(j) limitation for the current year, then the following rules apply in the order provided:

(*1*) The group first determines whether its section 163(j) limitation for the current year equals or exceeds the aggregate amount of the members' current-year business interest expense.

(*i*) If the group's section 163(j) limitation for the current year equals or exceeds the aggregate amount of the members' current-year business interest expense, then no amount of the group's current-year business interest expense is subject to disallowance in the current year under section 163(j). Once the group has taken into account its members' current-year business interest expense, the group applies the rules of paragraph (b)(3)(ii)(C)(*4*) of this section.

(*ii*) If the aggregate amount of members' current-year business interest expense exceeds the group's section 163(j) limitation for the current year, then the group applies the rule in paragraph (b)(3)(ii)(C)(*2*) of this section.

(*2*) If this paragraph (b)(3)(ii)(C)(*2*) applies (see paragraph (b)(3)(ii)(C)(*1*)(*ii*) of this section), then each member with current-year business interest expense and with current-year business interest income or floor plan financing interest expense deducts current-year business interest expense in an amount that does not exceed the sum of the member's business interest income and floor plan financing interest expense for the current year.

(*3*) After applying the rule in paragraph (b)(3)(ii)(C)(*2*) of this section, if the group has any section 163(j) limitation remaining for the current year, then each member with remaining current-year business interest expense deducts a portion of its expense based on its allocable share of the consolidated group's remaining section 163(j) limitation.

(*4*) If this paragraph (b)(3)(ii)(C)(*4*) applies (see paragraph (b)(3)(ii)(C)(*1*)(*i*) of this section), and if the group has any section 163(j) limitation remaining for the current year after applying the rules in paragraph (b)(3)(ii)(C)(*1*) of this section, then disallowed business interest expense carryforwards permitted to be deducted (including under paragraph (d)(1)(A) of this section) in the current year are to be deducted in the order of the taxable years in which they arose, beginning with the earliest taxable year. Disallowed business interest expense carryforwards from taxable years ending on the same date that are available to offset tentative taxable income for the current year generally are to be deducted on a pro rata basis under the principles of paragraph (b)(3)(ii)(C)(*3*) of this section. For example, assume that P and S are the only members of a consolidated group with a section 163(j) limitation for the current year (Year 2) of \$200x; the amount of current-year business interest expense deducted in Year 2 is \$100x; and P and S, respectively, have \$140x and \$60x of disallowed business interest expense carryforwards from Year 1 that are not subject to limitation under paragraph (c), (d), or (e) of this section. Under these facts, P would be allowed to deduct \$70x of its carryforwards from Year 1 ($\$100x \times (\$140x/(\$60x + \$140x)) = \$70x$), and S would be allowed to deduct \$30x of its carryforwards from Year 1 ($\$100x \times (\$60x/(\$60x + \$140x)) = \$30x$). But see §1.383–1(d)(1)(ii), providing that, if losses subject to and not subject to the section 382 limitation are carried from the same taxable year, losses subject to the limitation are deducted before losses not subject to the limitation.

(*5*) Each member with remaining business interest expense after applying the rules of this paragraph (b)(3)(ii), taking into account the limitations in paragraphs (c), (d), (e), and (f) of this section, carries the expense forward to the succeeding taxable year as a disallowed business interest expense carryforward under section 163(j)(2) and §1.163(j)–2(c).

(iii) *Departure from group.* If a corporation ceases to be a member during a consolidated return year, the corporation's current-year business interest expense from the taxable period ending on the day of the corporation's change in status as a member, as well as the corporation's disallowed business interest expense carryforwards from prior taxable years that are available to offset tentative taxable income in the consolidated return year, are first made available for deduction during that consolidated return year. See §1.1502–76(b)(1)(i); see also §1.1502–36(d) (regarding reductions of deferred deductions on the transfer of loss shares of subsidiary stock). Only the amount that is neither deducted by the group in that consolidated return year nor otherwise reduced under the Code or regulations may be carried to the corporation's first separate return year after its change in status.

(iv) *Example: Deduction of interest expense*—(A) *Facts*. (*1*) P wholly owns A, which is a member of the consolidated group of which P is the common parent. P and A each borrow money from Z, an unrelated third party. The business interest expense of P and A in Years 1, 2, and 3, and the P group's section 163(j) limitation for those years, are as follows:

TABLE 1 TO PARAGRAPH (b)(3)(iv)(A)(*1*)

Year	P's business interest expense	A's business interest expense	P group's section 163(j) limitation
1	$150x	$50x	$100x
2	60x	90x	120x
3	25x	50x	185x

(*2*) P and A have neither business interest income nor floor plan financing interest expense in Years 1, 2, and 3. Additionally, the P group is neither eligible for the small business exemption in §1.163(j)–2(d) nor engaged in an excepted trade or business.

(B) *Analysis*—(*1*) *Year 1*. In Year 1, the aggregate amount of the P group members' current-year business interest expense ($150x + $50x) exceeds the P group's section 163(j) limitation ($100x). As a result, the rules of paragraph (b)(3)(ii)(C) of this section apply. Because the P group members' current-year business interest expense exceeds the group's section 163(j) limitation for Year 1, P and A must apply the rule in paragraph (b)(3)(ii)(C)(*2*) of this section. Pursuant to paragraph (b)(3)(ii)(C)(*2*) of this section, each of P and A must deduct its current-year business interest expense to the extent of its business interest income and floor plan financing interest expense. Neither P nor A has business interest income or floor plan financing interest expense in Year 1. Next, pursuant to paragraph (b)(3)(ii)(C)(*3*) of this section, each of P and A must deduct a portion of its current-year business interest expense based on its allocable share of the consolidated group's remaining section 163(j) limitation ($100x). P's allocable share is $75x ($100x × ($150x/$200x) = $75x), and A's allocable share is $25x ($100x × ($50x/$200x) = $25x). Accordingly, in Year 1, P deducts $75x of its current-year business interest expense, and A deducts $25x of its current-year business interest expense. P has a disallowed business interest expense carryforward from Year 1 of $75x ($150x − $75x = $75x), and A has a disallowed business interest expense carryforward from Year 1 of $25x ($50x − $25x = $25x).

(*2*) *Year 2*. In Year 2, the aggregate amount of the P group members' current-year business interest expense ($60x + $90x) and disallowed business interest expense carryforwards ($75x + $25x) exceeds the P group's section 163(j) limitation ($120x). As a result, the rules of paragraph (b)(3)(ii)(C) of this section apply. Because the P group members' current-year business interest expense exceeds the group's section 163(j) limitation for Year 2, P and A must apply the rule in paragraph (b)(3)(ii)(C)(*2*) of this section. Pursuant to paragraph (b)(3)(ii)(C)(*2*) of this section, each of P and A must deduct its current-year business interest expense to the extent of its business interest income and floor plan financing interest expense. Neither P nor A has business interest income or floor plan financing interest expense in Year 2. Next, pursuant to paragraph (b)(3)(ii)(C)(*3*) of this section, each of P and A must deduct a portion of its current-year business interest expense based on its allocable share of the consolidated group's remaining section 163(j) limitation ($120x). P's allocable share is $48x (($120x × ($60x/$150x)) = $48x), and A's allocable share is $72x (($120x × ($90x/$150x)) = $72x). Accordingly, in Year 2, P deducts $48x of current-year business interest expense, and A deducts $72x of current-year business interest expense. P has a disallowed business interest expense carryforward from Year 2 of $12x ($60x − $48x = $12x), and A has a disallowed business interest expense carryforward from Year 2 of $18x ($90x − $72x = $18x). Additionally, because the P group has no section 163(j) limitation remaining after deducting current-year business interest expense in Year 2, the full amount of P and A's disallowed business interest expense carryforwards from Year 1 ($75x and $25x, respectively) also are carried forward to Year 3. As a result, at the beginning of Year 3, P and A's respective disallowed business interest expense carryforwards are as follows:

TABLE 2 TO PARAGRAPH (b)(3)(iv)(B)(*2*)

	Year 1 disallowed business interest expense carryforwards	Year 2 disallowed business interest expense carryforwards	Total disallowed business interest expense carryforwards
P	$75x	$12x	$87x
A	25x	18x	43x
Total	100x	30x	130x

(*3*) *Year 3.* In Year 3, the aggregate amount of the P group members' current-year business interest expense ($25x + $50x = $75x) and disallowed business interest expense carryforwards ($130x) exceeds the P group's section 163(j) limitation ($185x). As a result, the rules of paragraph (b)(3)(ii)(C) of this section apply. Because the P group's section 163(j) limitation for Year 3 equals or exceeds the P group members' current-year business interest expense, no amount of the members' current-year business interest expense is subject to disallowance under section 163(j) (see paragraph (b)(3)(ii)(C)(*1*) of this section). After each of P and A deducts its current-year business interest expense, the P group has $110x of section 163(j) limitation remaining for Year 3 ($185x − $25x − $50x = $110x). Next, pursuant to paragraph (b)(3)(ii)(C)(*4*) of this section, $110x of disallowed business interest expense carryforwards are deducted on a pro rata basis, beginning with carryforwards from Year 1. Because the total amount of carryforwards from Year 1 ($100x) is less than the section 163(j) limitation remaining after the deduction of Year 3 business interest expense ($110x), all of the Year 1 carryforwards are deducted in Year 3. After current-year business interest expense and Year 1 carryforwards are deducted, the P group's remaining section 163(j) limitation in Year 3 is $10x. Because the Year 2 carryforwards ($30x) exceed the remaining section 163(j) limitation ($10x), under paragraph (b)(3)(ii)(C)(*4*) of this section, each of P and A will deduct a portion of its Year 2 carryforwards based on its allocable share of the consolidated group's remaining section 163(j) limitation. P's allocable share is $4x (($10x × ($12x/$30x)) = $4x), and A's allocable share is $6x (($10x × ($18x/ $30x)) = $6x). Accordingly, P and A may deduct $4x and $6x, respectively, of their Year 2 carryforwards. For Year 4, P and A have $8x and $12x of disallowed business interest expense carryforwards from Year 2, respectively.

(c) *Disallowed business interest expense carryforwards in transactions to which section 381(a) applies.* For rules governing the application of section 381(c)(20) to disallowed business interest expense carryforwards, including limitations on an acquiring corporation's use of the disallowed business interest expense carryforwards of the transferor or distributor corporation in the acquiring corporation's first taxable year ending after the date of distribution or transfer, see § 1.381(c)(20)–1.

(d) *Limitations on disallowed business interest expense carryforwards from separate return limitation years*—(1) *General rule*—(A) *Cumulative section 163(j) SRLY limitation.* This paragraph (d) applies to disallowed business interest expense carryforwards of a member arising in a SRLY (see § 1.1502–1(f))) or treated as arising in a SRLY under the principles of § 1.1502–21(c) and (g). The amount of the carryforwards described in the preceding sentence that are included in the consolidated group's business interest expense deduction for any taxable year under paragraph (b) of this section may not exceed the aggregate section 163(j) limitation for all consolidated return years of the group, determined by reference only to the member's items of income, gain, deduction, and loss, and reduced (including below zero) by the member's business interest expense (including disallowed business interest expense carryforwards) absorbed by the group in all consolidated return years (cumulative section 163(j) SRLY limitation). For purposes of computing the member's cumulative section 163(j) SRLY limitation, intercompany items referred to in §1.163(j)–4(d)(2)(iv) are included, with the exception of interest items with regard to intercompany obligations. See §1.163(j)–4(d)(2)(v). Thus, for purposes of this paragraph (d), income and expense items arising from intercompany transactions (other than interest income and expense with regard to intercompany obligations) are included in the calculation of the cumulative section 163(j) SRLY limitation. In addition, items of interest expense with regard to intercompany obligations are not characterized as business interest expense for purposes of the reduction described in the second sentence of this paragraph (d)(1)(A).

(B) *Subgrouping.* For purposes of this paragraph (d), the SRLY subgroup principles of §1.1502–21(c)(2)(i) (with regard to carryovers of SRLY losses) apply with appropriate adjustments.

(2) *Deduction of disallowed business interest expense carryforwards arising in a SRLY.* Notwithstanding paragraph (d)(1) of this section, disallowed business interest expense carryforwards of a member arising in a SRLY are available for deduction by the consolidated group in the current year only to the extent the group has remaining section 163(j) limitation for the current year after the deduction of current-year business interest expense and disallowed business interest expense carryforwards from earlier taxable years that are permitted to be deducted in the current year (see paragraph (b)(3)(ii)(A) of this section). SRLY-limited disallowed business interest expense carryforwards are deducted on a pro rata basis (under the principles of paragraph (b)(3)(ii)(C)(*3*) of this section) with non-SRLY limited disallowed business interest expense carryforwards from taxable years ending on the same date. See also §1.1502–21(b)(1).

(3) *Examples.* The principles of this paragraph (d) are illustrated by the following examples. For purposes of the examples in this paragraph (d)(3), unless otherwise stated, P, R, S, and T are taxable domestic C corporations that are not RICs or REITs and that file their tax returns on a calendar-year basis; none of P, R, S, or T qualifies for the small business exemption under section 163(j)(3) or is engaged in an excepted trade or business; all interest expense is deductible except for the potential application of section 163(j); and the facts set forth the only corporate activity.

(i) *Example 1: Determination of SRLY limitation*—(A) *Facts.* Individual A owns P. In 2021, A forms T, which pays or accrues a $100x business interest expense for which a deduction is disallowed under section 163(j) and that is carried forward to 2022. P does not pay or accrue business interest expense in 2021, and P has no disallowed business interest expense carryforwards from prior taxable years. At the close of 2021, P acquires all of the stock of T, which joins with P in filing a consolidated return beginning in 2022. Neither P nor T pays or accrues business interest expense in 2022, and the P group has a section 163(j) limitation of $300x in that year. This limitation would be $70x if determined by reference solely to T's items for all consolidated return years of the P group.

(B) *Analysis.* T's $100x of disallowed business interest expense carryforwards from 2021 arose in a SRLY. P's acquisition of T was not an ownership change as defined by section 382(g); thus, T's disallowed business interest expense carryforwards are subject to the SRLY limitation in paragraph (d)(1) of this section. T's cumulative section 163(j) SRLY limitation for 2022 is the P group's section 163(j) limitation, determined by reference solely to T's items for all consolidated return years of the P group ($70x). See paragraph (d)(1) of this section. Thus, $70x of T's disallowed business interest expense carryforwards are available to be deducted by the P group in 2022, and the remaining $30x of T's disallowed business interest expense carryforwards are carried forward to 2023. After the P group deducts $70x of T's disallowed business interest expense carryforwards, T's cumulative section 163(j) SRLY limitation is reduced by $70x to $0.

(C) *Cumulative section 163(j) SRLY limitation of $0*. The facts are the same as in *Example 1* in paragraph (d)(3)(i)(A) of this section, except that T's cumulative section 163(j) SRLY limitation for 2022 is $0. Because the amount of T's disallowed business interest expense carryforwards that may be deducted by the P group in 2022 may not exceed T's cumulative section 163(j) SRLY limitation, none of T's carryforwards from 2021 may be deducted by the P group in 2022. Because none of T's disallowed business interest expense carryforwards are absorbed by the P group in 2022, T's cumulative section 163(j) SRLY limitation remains at $0 entering 2023.

(ii) *Example 2: Cumulative section 163(j) SRLY limitation less than zero*—(A) *Facts*. P and S are the only members of a consolidated group. P has neither current-year business interest expense nor disallowed business interest expense carryforwards. For the current year, the P group has a section 163(j) limitation of $150x, $25x of which is attributable to P, and $125x of which is attributable to S. S has $100x of disallowed business interest expense carryforwards that arose in a SRLY and $150x of current-year business interest expense. S's cumulative section 163(j) SRLY limitation entering the current year (computed by reference solely to S's items for all consolidated return years of the P group) is $0.

(B) *Analysis*. Under paragraph (d)(1) of this section, S's cumulative section 163(j) SRLY limitation is increased by $125x to reflect S's tax items for the current year. The P group's section 163(j) limitation permits the P group to deduct all $150x of S's current-year business interest expense. S's cumulative section 163(j) SRLY limitation is reduced by the $150x of S's business interest expense absorbed by the P group in the current year, which results in a −$25x balance. Thus, none of S's SRLY'd disallowed business interest expense carryforwards may be deducted by the P group in the current year. Entering the subsequent year, S's cumulative section 163(j) SRLY limitation remains −$25x.

(iii) *Example 3: Pro rata absorption of SRLY-limited disallowed business interest expense carryforwards*—(A) *Facts*. P, R, and S are the only members of a consolidated group, and no member has floor plan financing or business interest income. P has $60x of current-year business interest expense and $40x of disallowed business interest expense carryforwards from the previous year, which was not a separate return year. R has $120x of current-year business interest expense and $80x of disallowed business interest expense carryforwards from the previous year, which was not a separate return year. S has $70x of current-year business interest expense and $30x of disallowed business interest expense carryforwards from the previous year, which was a separate return year. The P group has a section 163(j) limitation of $300x, $50x of which is attributable to P, $90x to R, and $160x to S. S's cumulative section 163(j) SRLY limitation entering the current year (computed by reference solely to S's items for all consolidated return years of the P group) is $0.

TABLE 3 TO PARAGRAPH (d)(3)(iii)(A)

	Current-year business interest expense	Disallowed business interest expense carryforwards from prior taxable year	Section 163(j) limitation
P	$60x	$40x	$50x
R	120x	80x	90x
S	70x	(SRLY) 30x	160x
Total	250x	150x	300x

(B) *Analysis*. Under paragraph (d)(1) of this section, S's cumulative section 163(j) SRLY limitation is increased in the current year by $160x. The P group's section 163(j) limitation permits the P group to deduct all $70x of S's current-year business interest expense (and all $180x of P and R's current-year business interest expense). S's cumulative section 163(j) SRLY limitation is reduced by the $70x of S's business interest expense absorbed by the P group in the current year, resulting in a $90x balance. Because the P group has $50x of section 163(j) limitation remaining after the absorption of current-year business interest expense, the P group can absorb $50x of its members' disallowed business interest expense carryforwards. Under paragraph (d)(2) of this section, SRLY-limited disallowed business interest expense carryforwards are deducted on a pro rata basis with other disallowed business interest expense carryforwards from the same taxable year. Accordingly, the P group can deduct $10x ($50x × ($30x/$150x)) of S's SRLY-limited disallowed business interest expense carryforwards. S's cumulative section 163(j) SRLY limitation is reduced (to $80x) by the $10x of SRLY-limited disallowed business interest carryforwards absorbed by the P group in the current year.

(C) *Cumulative section 163(j) SRLY limitation of −$75x.* The facts are the same as in *Example 3* in paragraph (d)(3)(iii)(A) of this section, except that S's cumulative section 163(j) SRLY limitation entering the current year is −$75x. After adjusting for S's tax items for the current year ($160x) and the P group's absorption of S's current-year business interest expense ($70x), S's cumulative section 163(j) SRLY limitation is $15x (−$75x + $160x−$70x). Because S's cumulative section 163(j) SRLY limitation ($15x) is less than the amount of S's SRLY-limited disallowed business interest expense carryforwards ($30x), the pro rata calculation under paragraph (d)(2) of this section is applied to $15x (rather than $30x) of S's carryforwards. Accordingly, the P group can deduct $5.56x ($50x × ($15x/$135x)) of S's SRLY-limited disallowed business interest expense carryforwards. S's cumulative section 163(j) SRLY limitation is reduced (to $9.44x) by the $5.56x of SRLY-limited disallowed business interest carryforwards absorbed by the P group in the current year.

(e) *Application of section 382*—(1) *Prechange loss.* For rules governing the treatment of a disallowed business interest expense as a pre-change loss for purposes of section 382, see §§1.382–2(a) and 1.382–6. For rules governing the application of section 382 to disallowed disqualified interest carryforwards, see §1.163(j)–11(c)(4).

(2) *Loss corporation.* For rules governing when a disallowed business interest expense causes a corporation to be a loss corporation within the meaning of section 382(k)(1), see §1.382–2(a). For the application of section 382 to disallowed disqualified interest carryforwards, see §1.163(j)–11(c)(4).

(3) *Ordering rules for utilization of prechange losses and for absorption of the section 382 limitation.* For ordering rules for the utilization of disallowed business interest expense, net operating losses, and other pre-change losses, and for the absorption of the section 382 limitation, see §1.383–1(d).

(4) *Disallowed business interest expense from the pre-change period in the year of a testing date.* For rules governing the treatment of disallowed business interest expense from the pre-change period (within the meaning of §1.382–6(g)(2)) in the year of a testing date, see §1.382–2.

(5) *Recognized built-in loss.* For a rule providing that a section 382 disallowed business interest carryforward (as defined in §1.382–2(a)(7)) is not treated as a recognized built-in loss for purposes of section 382, see §1.382–7(d)(5).

(f) *Overlap of SRLY limitation with section 382.* For rules governing the overlap of the application of section 382 and the application of the SRLY rules, see §1.1502–21(g).

(g) *Additional limitations.* Additional rules provided under the Code or regulations also apply to limit the use of disallowed business interest expense carryforwards. For rules governing the relationship between section 163(j) and other provisions affecting the deductibility of interest, see §1.163(j)–3.

(h) *Applicability date.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year.

[T.D. 9905, 85 FR 56760, Sept. 14, 2020]

§ 1.163(j)–6 Application of the section 163(j) limitation to partnerships and subchapter S corporations.

(a) *Overview.* If a deduction for business interest expense of a partnership or an S corporation is subject to the section 163(j) limitation, section 163(j)(4) provides that the section 163(j) limitation applies at the partnership or S corporation level and any deduction for business interest expense is taken into account in determining the nonseparately stated taxable income or loss of the partnership or S corporation. Once a partnership or an S corporation determines its business interest expense, business interest income, ATI, and floor plan financing interest expense, the partnership or S corporation calculates its section 163(j) limitation by applying the rules of §1.163(j)–2(b) and this section. Paragraph (b) of this section provides definitions used in this section. Paragraph (c) of this section provides rules regarding the character of a partnership's deductible business interest expense and excess business interest expense. Paragraph (d) of this section provides rules regarding the calculation of a partnership's ATI and floor plan financing interest expense. Paragraph (e) of this section provides rules regarding a partner's ATI and business interest income. Paragraph (f) of this section provides an eleven-step computation necessary for properly allocating a partnership's deductible business interest expense and section 163(j) excess items to its partners. Paragraph (g) of this section applies carryforward rules at the partner level if a partnership has excess business interest expense. Paragraph (h) of this section provides basis adjustment rules, and paragraph (k) of this section provides rules regarding investment items of a partnership. Paragraph (l) of this section provides rules regarding S corporations. Paragraph (m) of this section provides rules for partnerships and S corporations not subject to section 163(j). Paragraph (o) of this section provides examples illustrating the rules of this section.

(b) *Definitions.* In addition to the definitions contained in §1.163(j)–1, the following definitions apply for purposes of this section.

(1) *Section 163(j) items.* The term *section 163(j) items* means the partnership or S corporation's business interest expense, business interest income, and items comprising ATI.

(2) *Partner basis items.* The term *partner basis items* means any items of income, gain, loss, or deduction resulting from either an adjustment to the basis of partnership property used in a non-excepted trade or business made pursuant to section 743(b) or the operation of section 704(c)(1)(C)(i) with respect to such property. Partner basis items also include section 743(b) basis adjustments used to increase or decrease a partner's share of partnership gain or loss on the sale of partnership property used in a non-excepted trade or business (as described in §1.743–1(j)(3)(i)) and amounts resulting from the operation of section 704(c)(1)(C)(i) used to decrease a partner's share of partnership gain or increase a partner's share of partnership loss on the sale of such property.

(3) *Remedial items.* The term *remedial items* means any allocation to a partner of remedial items of income, gain, loss, or deduction pursuant to section 704(c) and §1.704–3(d).

(4) *Excess business interest income.* The term *excess business interest income* means the amount by which a partnership's or S corporation's business interest income exceeds its business interest expense in a taxable year.

(5) *Deductible business interest expense.* The term *deductible business interest expense* means the amount of a partnership's or S corporation's business interest expense that is deductible under section 163(j) in the current taxable year following the application of the limitation contained in §1.163(j)–2(b).

(6) *Section 163(j) excess items.* The term *section 163(j) excess items* means the partnership's excess business interest expense, excess taxable income, and excess business interest income.

(7) *Non-excepted assets.* The term *non-excepted assets* means assets from a non-excepted trade or business.

(8) *Excepted assets.* The term *excepted assets* means assets from an excepted trade or business.

(c) *Business interest income and business interest expense of a partnership—*

(1) *Modification of business interest income for partnerships*. The business interest income of a partnership generally is determined in accordance with §1.163(j)–1(b)(4). However, to the extent that interest income of a partnership that is properly allocable to trades or businesses that are per se non-passive activities is allocated to partners that do not materially participate (within the meaning of section 469), as described in §1.469–1T(e)(6) and subject to section 163(d)(5)(A)(ii), such interest income shall not be considered business interest income for purposes of determining the section 163(j) limitation of a partnership pursuant to §1.163(j)–2(b). A per se non-passive activity is an activity that is not treated as a passive activity for purposes of section 469 regardless of whether the owners of the activity materially participate in the activity.

(2) *Modification of business interest expense for partnerships*. The business interest expense of a partnership generally is determined in accordance with §1.163(j)–1(b)(3). However, to the extent that interest expense of a partnership that is properly allocable to trades or businesses that are per se non-passive activities is allocated to partners that do not materially participate (within the meaning of section 469), as described in §1.469–1T(e)(6) and subject to section 163(d)(5)(A)(ii), such interest expense shall not be considered business interest expense for purposes of determining the section 163(j) limitation of a partnership pursuant to §1.163(j)–2(b).

(3) *Transition rule*. With respect to a partner in a partnership engaged in a trade or business described in §1.469–1T(e)(6) and subject to section 163(d)(5)(A)(ii), if such partner had been allocated EBIE from the partnership with respect to the trade or business described in §1.469–1T(e)(6) and subject to section 163(d)(5)(A)(ii) in any prior taxable year in which the partner did not materially participate, such partner may treat such excess business interest expense not previously treated as paid or accrued under §1.163(j)–6(g)(2) as paid or accrued by the partner in the first taxable year ending on or after the effective date of the final regulations and not subject to further limitation under section 163(j) or 163(d).

(4) *Character of business interest expense*. If a partnership has deductible business interest expense, such deductible business interest expense is not subject to any additional application of section 163(j) at the partner-level because it is taken into account in determining the nonseparately stated taxable income or loss of the partnership. However, for all other purposes of the Code, deductible business interest expense and excess business interest expense retain their character as business interest expense at the partner-level. For example, for purposes of section 469, such business interest expense retains its character as either passive or non-passive in the hands of the partner. Additionally, for purposes of section 469, deductible business interest expense and excess business interest expense from a partnership remain interest derived from a trade or business in the hands of a partner even if the partner does not materially participate in the partnership's trade or business activity. For additional rules regarding the interaction between sections 465, 469, and 163(j), see §1.163(j)–3.

(d) *Adjusted taxable income of a partnership*—(1) *Tentative taxable income of a partnership*. For purposes of computing a partnership's ATI under §1.163(j)–1(b)(1), the tentative taxable income of a partnership is the partnership's taxable income determined under section 703(a), but computed without regard to the application of the section 163(j) limitation.

(2) *Section 734(b), partner basis items, and remedial items*. A partnership takes into account items resulting from adjustments made to the basis of its property pursuant to section 734(b) for purposes of calculating its ATI pursuant to §1.163(j)–1(b)(1). However, partner basis items and remedial items are not taken into account in determining a partnership's ATI under §1.163(j)–1(b)(1). Instead, partner basis items and remedial items are taken into account by the partner in determining the partner's ATI pursuant to §1.163(j)–1(b)(1). See *Example 6* in paragraph (o)(6) of this section.

(3) *Section 743(b) adjustments and publicly traded partnerships.* Solely for purposes of §1.163(j)–6, a publicly traded partnership, as defined in §1.7704–1, shall treat the amount of any section 743(b) adjustment of a purchaser of a partnership unit that relates to a remedial item that the purchaser inherits from the seller as an offset to the related section 704(c) remedial item. For this purpose, §1.163(j)–6(e)(2)(ii) applies. See *Example 25* in paragraph (o)(25) of this section.

(4) *Modification of adjusted taxable income for partnerships.* The adjusted taxable income of a partnership generally is determined in accordance with §1.163(j)–1(b)(1). However, to the extent that the items comprising the adjusted taxable income of a partnership that are properly allocable to trades or businesses that are per se non-passive activities are allocated to partners that do not materially participate (within the meaning of section 469), as described in section 163(d)(5)(A)(ii), such partnership items shall not be considered adjusted taxable income for purposes of determining the section 163(j) limitation of a partnership pursuant to §1.163(j)–2(b).

(5) *Election to use 2019 adjusted taxable income for taxable years beginning in 2020.* In the case of any taxable year beginning in 2020, a partnership may elect to apply this section by substituting its adjusted taxable income for the last taxable year beginning in 2019 for the adjusted taxable income for such taxable year (post-election ATI or 2019 ATI). See §1.163(j)–2(b)(4) for the time and manner of making or revoking this election. An electing partnership determines each partner's allocable ATI (as defined in paragraph (f)(2)(ii) of this section) by using the partnership's 2019 section 704 income, gain, loss, and deduction as though such amounts were recognized by the partnership in 2020. See *Example 34* in paragraph (o)(34) of this section.

(e) *Adjusted taxable income and business interest income of partners*—(1) *Modification of adjusted taxable income for partners.* The ATI of a partner in a partnership generally is determined in accordance with §1.163(j)–1(b)(1), without regard to such partner's distributive share of any items of income, gain, deduction, or loss of such partnership, except as provided for in paragraph (m) of this section, and is increased by such partner's distributive share of such partnership's excess taxable income determined under paragraph (f) of this section. For rules regarding corporate partners, see §1.163(j)–4(b)(3).

(2) *Partner basis items and remedial items.* Partner basis items and remedial items are taken into account as items derived directly by the partner in determining the partner's ATI for purposes of the partner's section 163(j) limitation. If a partner is allocated remedial items, such partner's ATI is increased or decreased by the amount of such items. Additionally, to the extent a partner is allocated partner basis items, such partner's ATI is increased or decreased by the amount of such items. See *Example 6* in paragraph (o)(6) of this section.

(3) *Disposition of partnership interests.* If a partner recognizes gain or loss upon the disposition of interests in a partnership, and the partnership in which the interest is being disposed owns only non-excepted trade or business assets, the gain or loss on the disposition of the partnership interest is included in the partner's ATI. See §1.163(j)–10(b)(4)(ii) for dispositions of interests in partnerships that own—

(i) Non-excepted assets and excepted assets; or

(ii) Investment assets; or

(iii) Both.

(4) *Double counting of business interest income and floor plan financing interest expense prohibited.* For purposes of calculating a partner's section 163(j) limitation, the partner does not include—

(i) Business interest income from a partnership that is subject to section 163(j), except to the extent the partner is allocated excess business interest income from that partnership pursuant to paragraph (f)(2) of this section; and

(ii) The partner's allocable share of the partnership's floor plan financing interest expense, because such floor plan financing interest expense already has been taken into account by the partnership in determining its non-separately stated taxable income or loss for purposes of section 163(j).

(5) *Partner basis items, remedial items, and publicly traded partnerships.* Solely

for purposes of §1.163(j)–6, a publicly traded partnership, as defined in §1.7704–1, shall either allocate gain that would otherwise be allocated under section 704(c) based on a partner's section 704(b) sharing ratios, or, for purposes of allocating cost recovery deductions under section 704(c), determine a partner's remedial items, as defined in §1.163(j)–6(b)(3), based on an allocation of the partnership's asset basis (inside basis) items among its partners in proportion to their share of corresponding section 704(b) items (rather than applying the traditional method, described in §1.704–3(b)). See *Example 24* in paragraph (o)(24) of this section.

(f) *Allocation and determination of section 163(j) excess items made in the same manner as nonseparately stated taxable income or loss of the partnership*—(1) *Overview*—(i) *In general.* The purpose of this paragraph is to provide guidance regarding how a partnership must allocate its deductible business interest expense and section 163(j) excess items, if any, among its partners. For purposes of section 163(j)(4) and this section, allocations and determinations of deductible business interest expense and section 163(j) excess items are considered made in the same manner as the nonseparately stated taxable income or loss of the partnership if, and only if, such allocations and determinations are made in accordance with the eleven-step computation set forth in paragraphs (f)(2)(i) through (xi) of this section. A partnership first determines its section 163(j) limitation, total amount of deductible business interest expense, and section 163(j) excess items under paragraph (f)(2)(i) of this section. The partnership then applies paragraphs (f)(2)(ii) through (xi) of this section, in that order, to determine how those items of the partnership are allocated among its partners. At the conclusion of the eleven-step computation set forth in paragraphs (f)(2)(i) through (xi) of this section, the total amount of deductible business interest expense and section 163(j) excess items allocated to each partner will equal the partnership's total amount of deductible business interest expense and section 163(j) excess items.

(ii) *Relevance solely for purposes of section 163(j).* No rule set forth in paragraph (f)(2) of this section prohibits a partnership from making an allocation to a partner of any item of partnership income, gain, loss, or deduction that is otherwise permitted under section 704 and the regulations under section 704 of the Code. Accordingly, any calculations in paragraphs (f)(2)(i) through (xi) of this section are solely for the purpose of determining each partner's deductible business interest expense and section 163(j) excess items and do not otherwise affect any other provision under the Code, such as section 704(b). Additionally, floor plan financing interest expense is not allocated in accordance with paragraph (f)(2) of this section. Instead, floor plan financing interest expense of a partnership is allocated to its partners under section 704(b) and is taken into account as a nonseparately stated item of loss for purposes of section 163(j).

(iii) *Exception applicable to publicly traded partnerships.* Publicly traded partnerships, as defined in §1.7704–1, do not apply the rules in paragraph (f)(2) of this section to determine a partner's share of section 163(j) excess items. Rather, publicly traded partnerships determine a partner's share of section 163(j) excess items by applying the same percentage used to determine the partner's share of the corresponding section 704(b) items that comprise ATI.

(2) *Steps for allocating deductible business interest expense and section 163(j) excess items*—(i) *Partnership-level calculation required by section 163(j)(4)(A).* First, a partnership must determine its section 163(j) limitation pursuant to §1.163(j)–2(b). This calculation determines a partnership's total amounts of excess business interest income, excess taxable income, excess business interest expense (that is, the partnership's section 163(j) excess items), and deductible business interest expense under section 163(j) for a taxable year.

(ii) *Determination of each partner's relevant section 163(j) items.* Second, a partnership must determine each partner's allocable share of each section 163(j) item under section 704(b) and the regulations under section 704 of the Code, including any allocations under section 704(c), other than remedial items. Only section 163(j) items that were actually taken into account in the partnership's section 163(j) calculation under paragraph (f)(2)(i) of this section are taken into account for purposes of this paragraph (f)(2)(ii). Partner basis items, allocations of investment income and expense, remedial items, and amounts determined for the partner under §1.163–8T are not taken into account for purposes of this paragraph (f)(2)(ii). For purposes of paragraphs (f)(2)(ii) through (xi) of this section, the term *allocable ATI* means a partner's distributive share of the partnership's ATI (that is, a partner's distributive share of gross income and gain items comprising ATI less such partner's distributive share of gross loss and deduction items comprising ATI), the term *allocable business interest income* means a partner's distributive share of the partnership's business interest income, and the term *allocable business interest expense* means a partner's distributive share of the partnership's business interest expense that is not floor plan financing interest expense. If the partnership determines that each partner has a pro rata share of allocable ATI, allocable business interest income, and allocable business interest expense, then the partnership may bypass paragraphs (f)(2)(iii) through (xi) of this section and allocate its section 163(j) excess items in the same proportion. See *Example 1* through *Example 16* in paragraphs (o)(1) through (16), respectively. This pro-rata exception does not result in allocations of section 163(j) excess items that vary from the array of allocations of section 163(j) excess items that would have resulted had paragraphs (f)(2)(iii) through (xi) been applied.

(iii) *Partner-level comparison of business interest income and business interest expense.* Third, a partnership must compare each partner's allocable business interest income to such partner's allocable business interest expense. Paragraphs (f)(2)(iii) through (v) of this section determine how a partnership must allocate its excess business interest income among its partners, as well as the amount of each partner's allocable business interest expense that is not deductible business interest expense after taking the partnership's business interest income into account. To the extent a partner's allocable business interest income exceeds its allocable business interest expense, the partner has an *allocable business interest income excess*. The aggregate of all the partners' allocable business interest income excess amounts is the *total allocable business interest income excess*. To the extent a partner's allocable business interest expense exceeds its allocable business interest income, the partner has an *allocable business interest income deficit*. The aggregate of all the partners' allocable business interest income deficit amounts is the *total allocable business interest income deficit*. These amounts are required to perform calculations in paragraphs (f)(2)(iv) and (v) of this section, which appropriately reallocate allocable business interest income excess to partners with allocable business interest income deficits in order to reconcile the partner-level calculation under paragraph (f)(2)(iii) of this section with the partnership-level result under paragraph (f)(2)(i) of this section.

(iv) *Matching partnership and aggregate partner excess business interest income.* Fourth, a partnership must determine each partner's final allocable business interest income excess. A partner's *final allocable business interest income excess* is determined by reducing, but not below zero, such partner's allocable business interest income excess (if any) by the partner's step four adjustment amount. A partner's *step four adjustment amount* is the product of the total allocable business interest income deficit and the ratio of such partner's allocable business interest income excess to the total allocable business interest income excess. The rules of this paragraph (f)(2)(iv) ensure that, following the application of paragraph (f)(2)(xi) of this section, the aggregate of all the partners' allocations of excess business interest income equals the total amount of the partnership's excess business interest income as determined in paragraph (f)(2)(i) of this section.

(v) *Remaining business interest expense determination.* Fifth, a partnership must determine each partner's remaining business interest expense. A partner's *remaining business interest expense* is determined by reducing, but not below zero, such partner's allocable business interest income deficit (if any) by such partner's step five adjustment amount. A partner's *step five adjustment amount* is the product of the total allocable business interest income excess and the ratio of such partner's allocable business interest income deficit to the total allocable business interest income deficit. Generally, a partner's remaining business interest expense is a partner's allocable business interest income deficit adjusted to reflect a reallocation of allocable business interest income excess from other partners. Determining a partner's remaining business interest expense is necessary to perform an ATI calculation that begins in paragraph (f)(2)(vii) of this section.

(vi) *Determination of final allocable ATI.* Sixth, a partnership must determine each partner's final allocable ATI. Paragraphs (f)(2)(vi) through (x) of this section determine how a partnership must allocate its excess taxable income and excess business interest expense among its partners.

(A) *Positive allocable ATI.* To the extent a partner's income and gain items comprising its allocable ATI exceed its deduction and loss items comprising its allocable ATI, the partner has *positive allocable ATI.* The aggregate of all the partners' positive allocable ATI amounts is the *total positive allocable ATI.*

(B) *Negative allocable ATI.* To the extent a partner's deduction and loss items comprising its allocable ATI exceed its income and gain items comprising its allocable ATI, the partner has negative allocable ATI. The aggregate of all the partners' negative allocable ATI amounts is the *total negative allocable ATI.*

(C) *Final allocable ATI.* Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Any partner with a positive allocable ATI of $0 has a final allocable ATI of $0. The final allocable ATI of any partner with a positive allocable ATI greater than $0 is such partner's positive allocable ATI reduced, but not below zero, by the partner's step six adjustment amount. A partner's *step six adjustment amount* is the product of the total negative allocable ATI and the ratio of such partner's positive allocable ATI to the total positive allocable ATI. The total of the partners' final allocable ATI amounts must equal the partnership's ATI amount used to compute its section 163(j) limitation pursuant to §1.163(j)–2(b).

(vii) *Partner-level comparison of 30 percent of adjusted taxable income and remaining business interest expense.* Seventh, a partnership must compare each partner's ATI capacity to such partner's remaining business interest expense as determined under paragraph (f)(2)(v) of this section. A partner's *ATI capacity* is the amount that is 30 percent of such partner's final allocable ATI as determined under paragraph (f)(2)(vi) of this section. A partner's final allocable ATI is grossed down to 30 percent prior to being compared to its remaining business interest expense in this calculation to parallel the partnership's adjustment to its ATI under section 163(j)(1)(B). To the extent a partner's ATI capacity exceeds its remaining business interest expense, the partner has an *ATI capacity excess.* The aggregate of all the partners' ATI capacity excess amounts is the *total ATI capacity excess.* To the extent a partner's remaining business interest expense exceeds its ATI capacity, the partner has an *ATI capacity deficit.* The aggregate of all the partners' ATI capacity deficit amounts is the *total ATI capacity deficit.* These amounts (which may be subject to adjustment under paragraph (f)(2)(viii) of this section) are required to perform calculations in paragraphs (f)(2)(ix) and (x) of this section, which appropriately reallocate ATI capacity excess to partners with ATI capacity deficits in order to reconcile the partner-level calculation under paragraph (f)(2)(vii) of this section with the partnership-level result under paragraph (f)(2)(i) of this section.

(viii) *Partner priority right to ATI capacity excess determination.* (A) Eighth, the partnership must determine whether it is required to make any adjustments described in this paragraph (f)(2)(viii) and, if it is, make such adjustments. The rules of this paragraph (f)(2)(viii) are necessary to account for adjustments made to a partner's allocable ATI in paragraph (f)(2)(vi) of this section to ensure that the partners who had a negative allocable ATI do not inappropriately benefit under the rules of paragraphs (f)(2)(ix) through (xi) of this section to the detriment of the partners who had positive allocable ATI. The partnership must perform the calculations and make the necessary adjustments described under paragraphs (f)(2)(viii)(B) and (C) or paragraph (f)(2)(viii)(D) of this section if, and only if, there is—

(*1*) An excess business interest expense amount greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI amount greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATI capacity excess amount greater than $0 under paragraph (f)(2)(vii) of this section.

(B) A partnership must determine each partner's priority amount and usable priority amount. A partner's *priority amount* is 30 percent of the amount by which a partner's positive allocable ATI under paragraph (f)(2)(vi)(A) of this section exceeds such partner's final allocable ATI under paragraph (f)(2)(vi)(C) of this section. However, only partners with an ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section can have a priority amount greater than $0. The aggregate of all the partners' priority amounts is the *total priority amount*. A partner's *usable priority amount* is the lesser of such partner's priority amount or such partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section. The aggregate of all the partners' usable priority amounts is the *total usable priority amount*. If the total ATI capacity excess amount, as determined under paragraph (f)(2)(vii) of this section, is greater than or equal to the total usable priority amount, then the partnership must perform the adjustments described in paragraph (f)(2)(viii)(C) of this section. If the total usable priority amount is greater than the total ATI capacity excess amount, as determined under paragraph (f)(2)(vii) of this section, then the partnership must perform the adjustments described in paragraph (f)(2)(viii)(D) of this section.

(C) For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATI capacity excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, the following terms have the following meanings for each partner:

(*1*) Each partner's *ATI capacity deficit* is such partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section, reduced by such partner's usable priority amount.

(*2*) The *total ATI capacity deficit* is the total ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section, reduced by the total usable priority amount.

(*3*) The *total ATI capacity excess* is the total ATI capacity excess as determined under paragraph (f)(2)(vii) of this section, reduced by the total usable priority amount.

(D) Any partner with a priority amount greater than $0 is a *priority partner*. Any partner that is not a priority partner is a *non-priority partner*. For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATI capacity excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, each non-priority partner's final ATI capacity deficit amount is such partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section. For purposes of paragraph (f)(2)(x) of this section, the following terms have the following meanings for priority partners.

(*1*) Each priority partner must determine its step eight excess share. A partner's *step eight excess share* is the product of the total ATI capacity excess as determined under paragraph (f)(2)(vii) of this section and the ratio of the partner's priority amount to the total priority amount.

(*2*) To the extent a priority partner's step eight excess share exceeds its ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section, such excess amount is the priority partner's *ATI capacity excess* for purposes of paragraph (f)(2)(x) of this section. The *total ATI capacity excess* is the aggregate of the priority partners' ATI capacity excess amounts as determined under this paragraph (f)(2)(viii)(D)(*2*).

(*3*) To the extent a priority partner's ATI capacity deficit as determined under paragraph (f)(2)(vii) of this section exceeds its step eight excess share, such excess amount is the priority partner's *ATI capacity deficit* for purposes of paragraph (f)(2)(x) of this section. The *total ATI capacity deficit* is the aggregate of the priority partners' ATI capacity deficit amounts as determined under this paragraph (f)(2)(viii)(D)(*3*).

(ix) *Matching partnership and aggregate partner excess taxable income.* Ninth, a partnership must determine each partner's final ATI capacity excess. A partner's *final ATI capacity excess* amount is determined by reducing, but not below zero, such partner's ATI capacity excess (if any) by the partner's step nine adjustment amount. A partner's *step nine adjustment amount* is the product of the total ATI capacity deficit and the ratio of such partner's ATI capacity excess to the total ATI capacity excess. The rules of this paragraph (f)(2)(ix) ensure that, following the application of paragraph (f)(2)(xi) of this section, the aggregate of all the partners' allocations of excess taxable income equals the total amount of the partnership's excess taxable income as determined in paragraph (f)(2)(i) of this section.

(x) *Matching partnership and aggregate partner excess business interest expense.* Tenth, a partnership must determine each partner's final ATI capacity deficit. A partner's *final ATI capacity deficit* amount is determined by reducing, but not below zero, such partner's ATI capacity deficit (if any) by the partner's step ten adjustment amount. A partner's *step ten adjustment amount* is the product of the total ATI capacity excess and the ratio of such partner's ATI capacity deficit to the total ATI capacity deficit. Generally, a partner's final ATI capacity deficit is a partner's ATI capacity deficit adjusted to reflect a reallocation of ATI capacity excess from other partners. The rules of this paragraph (f)(2)(x) ensure that, following the application of paragraph (f)(2)(xi) of this section, the aggregate of all the partners' allocations of excess business interest expense equals the total amount of the partnership's excess business interest expense as determined in paragraph (f)(2)(i) of this section.

(xi) *Final section 163(j) excess item and deductible business interest expense allocation.* Eleventh, a partnership must allocate section 163(j) excess items and deductible business interest expense to its partners. Excess business interest income calculated under paragraph (f)(2)(i) of this section, if any, is allocated dollar for dollar by the partnership to its partners with final allocable business interest income excess amounts. Excess business interest expense calculated under paragraph (f)(2)(i) of this section, if any, is allocated dollar for dollar to partners with final ATI capacity deficit amounts. After grossing up each partner's final ATI capacity excess amount by ten-thirds, excess taxable income calculated under paragraph (f)(2)(i) of this section, if any, is allocated dollar for dollar to partners with final ATI capacity excess amounts. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. See *Example 17* through *Example 21* in paragraphs (o)(17) through (21) of this section, respectively.

(g) *Carryforwards*—(1) *In general.* The amount of any business interest expense not allowed as a deduction to a partnership by reason of §1.163(j)–2(b) and paragraph (f)(2) of this section for any taxable year is—

(i) Not treated as business interest expense of the partnership in the succeeding taxable year; and

(ii) Subject to paragraph (g)(2) of this section, treated as excess business interest expense, which is allocated to each partner pursuant to paragraph (f)(2) of this section.

(2) *Treatment of excess business interest expense allocated to partners.* If a partner is allocated excess business interest expense from a partnership under paragraph (f)(2) of this section for any taxable year and the excess business interest expense is treated as such under paragraph (h)(2) of this section—

(i) Solely for purposes of section 163(j), such excess business interest expense is treated as business interest expense paid or accrued by the partner in the next succeeding taxable year in which the partner is allocated excess taxable income or excess business interest income from such partnership, but only to the extent of such excess taxable income or excess business interest income; and

(ii) Any portion of such excess business interest expense remaining after the application of paragraph (g)(2)(i) of this section is excess business interest expense that is subject to the limitations of paragraph (g)(2)(i) of this section in succeeding taxable years, unless paragraph (m)(3) of this section applies. See *Example 1* through *Example 16* in paragraphs (o)(1) through (16) of this section, respectively.

(3) *Excess taxable income and excess business interest income ordering rule.* In the event a partner has excess business interest expense from a prior taxable year and is allocated excess taxable income or excess business interest income from the same partnership in a succeeding taxable year, the partner must treat, for purposes of section 163(j), the excess business interest expense as business interest expense paid or accrued by the partner in an amount equal to the partner's share of the partnership's excess taxable income or excess business interest income in such succeeding taxable year. See *Example 2* through *Example 16* in paragraphs (o)(2) through (16) of this section, respectively.

(4) *Special rule for taxable years beginning in 2019 and 2020.* In the case of any excess business interest expense of a partnership for any taxable year beginning in 2019 that is allocated to a partner under paragraph (f)(2) of this section, 50 percent of such excess business interest expense (§1.163(j)–6(g)(4) business interest expense) is treated as business interest expense that, notwithstanding paragraph (g)(2) of this section, is paid or accrued by the partner in the partner's first taxable year beginning in 2020. Additionally, §1.163(j)–6(g)(4) business interest expense is not subject to the section 163(j) limitation at the level of the partner. For purposes of paragraph (h)(1) of this section, any §1.163(j)–6(g)(4) business interest expense is, similar to deductible business interest expense, taken into account before any excess business interest expense. This paragraph applies after paragraph (n) of this section. If a partner disposes of a partnership interest in the partnership's 2019 or 2020 taxable year, §1.163(j)–6(g)(4) business interest expense is deductible by the partner (except to the extent that the business interest expense is negative section 163(j) expense as defined in §1.163(j)–6(h)(1) immediately prior to the disposition) and thus does not result in a basis increase under paragraph (h)(3) of this section. See *Example 35* and *Example 36* in paragraphs (o)(35) and (o)(36), respectively, of this section. A partner may elect to not have this provision apply with respect to each partnership interest held by the partner on an interest by interest basis. The rules and procedures regarding the time and manner of making, or revoking, such an election are provided in Revenue Procedure 2020–22, 2020–18 I.R.B. 745, and may be further modified through other guidance (see §§601.601(d) and 601.602 of this chapter).

(h) *Basis adjustments*—(1) *Section 704(d) ordering.* Deductible business interest expense and excess business interest expense are subject to section 704(d). If a partner is subject to a limitation on loss under section 704(d) and a partner is allocated losses from a partnership in a taxable year, §1.704–1(d)(2) requires that the limitation on losses under section 704(d) be apportioned amongst these losses based on the character of each loss (each grouping of losses based on character being a *section 704(d) loss class*). If there are multiple section 704(d) loss classes in a given year, §1.704–1(d)(2) requires the partner to apportion the limitation on losses under section 704(d) to each section 704(d) loss class proportionately. For purposes of applying this proportionate rule, any deductible business interest expense and business interest expense of an exempt entity (whether allocated to the partner in the current taxable year or suspended under section 704(d) in a prior taxable year), any excess business interest expense allocated to the partner in the current taxable year, and any excess business interest expense from a prior taxable year that was suspended under section 704(d) (negative section 163(j) expense) shall comprise the same section 704(d) loss class. Once the partner determines the amount of limitation on losses apportioned to this section 704(d) loss class, any deductible business interest expense is taken into account before any excess business interest expense or negative section 163(j) expense. See *Example 7* in paragraph (o)(7) of this section.

(2) *Excess business interest expense basis adjustments.* The adjusted basis of a partner in a partnership interest is reduced, but not below zero, by the amount of excess business interest expense allocated to the partner pursuant to paragraph (f)(2) of this section. Negative section 163(j) expense is not treated as excess business interest expense in any subsequent year until such negative section 163(j) expense is no longer suspended under section 704(d). Therefore, negative section 163(j) expense does not affect, and is not affected by, any allocation of excess taxable income to the partner. Accordingly, any excess taxable income allocated to a partner from a partnership while the partner still has negative section 163(j) expense will be included in the partner's ATI. However, once the negative section 163(j) expense is no longer suspended under section 704(d), it becomes excess business interest expense, which is subject to the general rules in paragraph (g) of this section. See *Example 8* in paragraph (o)(8) of this section.

(3) *Partner basis adjustment upon disposition of partnership interest.* If a partner (transferor) disposes of an interest in a partnership, the adjusted basis of the partnership interest being disposed of (transferred interest) is increased immediately before the disposition by the amount of the excess (if any) of the amount of the basis reduction under paragraph (h)(2) of this section over the portion of any excess business interest expense allocated to the transferor under paragraph (f)(2) of this section which has previously been treated under paragraph (g) of this section as business interest expense paid or accrued by the transferor, multiplied by the ratio of the fair market value of the transferred interest to the total fair market value of the transferor's partnership interest immediately prior to the disposition. Therefore, the adjusted basis of the transferred interest is not increased immediately before the disposition by any allocation of excess business interest expense from the partnership that did not reduce the transferor's adjusted basis in its partnership interest pursuant to paragraph (h) of this section prior to the disposition, or by any excess business interest expense that was treated under paragraph (g) of this section as business interest expense paid or accrued by the transferor prior to the disposition. If the transferor disposes of all of its partnership interest, no deduction under section 163(j) is allowed to the transferor or transferee under chapter 1 of subtitle A of the Code for any excess business interest expense or negative section 163(j) expense. If the transferor disposes of a portion of its partnership interest, no deduction under section 163(j) is allowed to the transferor or transferee under chapter 1 of subtitle A of the Code for the amount of excess business interest expense proportionate to the transferred interest. The amount of excess business interest expense proportionate to the partnership interest retained by the transferor shall remain as excess business interest expense of the transferor until such time as such excess business interest expense is treated as business interest expense paid or accrued by the transferor pursuant to paragraph (g) of this section. Further, if the transferor disposes of a portion of its partnership interest, any negative section 163(j) expense shall remain negative section 163(j) expense of the transferor partner until such negative section 163(j) expense is no longer suspended under section 704(d). For purposes of this paragraph, a disposition includes a distribution of money or other property by the partnership to a partner in complete liquidation of its interest in the partnership. Further, solely for purposes of this section, each partner is considered to have disposed of its partnership interest if the partnership terminates under section 708(b)(1). See *Example 9* and *Example 10* in paragraphs (o)(9) and (o)(10) of this section, respectively.

(i)–(j) [Reserved]

(k) *Investment items and certain other items.* Any item of a partnership's income, gain, deduction, or loss that is investment interest income or expense pursuant to §1.163–8T, and any other tax item of a partnership that is neither properly allocable to a trade or business of the partnership nor described in section 163(d), is allocated to each partner in accordance with section 704(b) and the regulations under section 704 of the Code, and the effect of such allocation for purposes of section 163 is determined at the partner-level. See §1.163(j)–4(b)(3), section 163(d), and §1.163–8T.

(l) *S corporations*—(1) *In general—(i) Corporate level limitation.* In the case of any S corporation, the section 163(j) limitation is applied at the S corporation level, and any deduction allowed for business interest expense is taken into account in determining the nonseparately stated taxable income or loss of the S corporation. An S corporation determines its section 163(j) limitation in the same manner as set forth in §1.163(j)–2(b). Allocations of excess taxable income and excess business interest income are made in accordance with the shareholders' pro rata interests in the S corporation pursuant to section 1366(a)(1) after determining the S corporation's section 163(j) limitation pursuant to §1.163(j)–2(b). See *Example 22* and *Example 23* in paragraphs (o)(22) and (23) of this section, respectively.

(ii) *Short taxable periods.* For rules on applying the section 163(j) limitation where an S corporation has a two short taxable periods or where its taxable year consists of two separate taxable years see §§1.1362–3(c), 1.1368–1(g), and 1.1377–1(b).

(2) *Character of deductible business interest expense.* If an S corporation has deductible business interest expense, such deductible business interest expense is not subject to any additional application of section 163(j) at the shareholder-level because such deductible business interest expense is taken into account in determining the nonseparately stated taxable income or loss of the S corporation. However, for all other purposes of the Code, deductible business interest expense retains its character as business interest expense at the shareholder-level. For example, for purposes of section 469, such deductible business interest expense retains its character as either passive or non-passive in the hands of the shareholder. Additionally, for purposes of section 469, deductible business interest expense from an S corporation remains interest derived from a trade or business in the hands of a shareholder even if the shareholder does not materially participate in the S corporation's trade or business activity. For additional rules regarding the interaction between sections 465, 469, and 163(j), see §1.163(j)–3.

(3) *Adjusted taxable income of an S corporation.* The ATI of an S corporation generally is determined in accordance with §1.163(j)–1(b)(1). For purposes of computing the S corporation's ATI, the tentative taxable income of the S corporation is determined under section 1363(b) and includes—

(i) Any item described in section 1363(b)(1); and

(ii) Any item described in §1.163(j)–1(b)(1), to the extent such item is consistent with subchapter S of the Code.

(4) *Adjusted taxable income and business interest income of S corporation shareholders*—(i) *Adjusted taxable income of S corporation shareholders.* The ATI of an S corporation shareholder is determined in accordance with §1.163(j)–1(b)(1) without regard to such shareholder's distributive share of any items of income, gain, deduction, or loss of such S corporation, except as provided in paragraph (m), and is increased by such shareholder's distributive share of such S corporation's excess taxable income.

(ii) *Disposition of S corporation stock.* If a shareholder of an S corporation recognizes gain or loss upon the disposition of stock of the S corporation, and the corporation the stock of which is being disposed of only owns non-excepted trade or business assets, the gain or loss on the disposition of the stock is included in the shareholder's ATI. See §1.163(j)–10(b)(4)(ii) for dispositions of stock of S corporations that own—

(A) Non-excepted assets and excepted assets; or

(B) Investment assets; or

(C) Both.

(iii) *Double counting of business interest income and floor plan financing interest expense prohibited.* For purposes of calculating an S corporation shareholder's section 163(j) limitation, the shareholder does not include—

(A) Business interest income from an S corporation that is subject to section 163(j), except to the extent the shareholder is allocated excess business interest income from that S corporation pursuant to paragraph (l)(1) of this section; and

(B) The shareholder's share of the S corporation's floor plan financing interest expense, because such floor plan financing interest expense already has been taken into account by the S corporation in determining its nonseparately stated taxable income or loss for purposes of section 163(j).

(5) *Carryforwards.* The amount of any business interest expense not allowed as a deduction for any taxable year by reason of the limitation contained in §1.163(j)–2(b) is carried forward in the succeeding taxable year as a disallowed business interest expense carryforward under the rules set forth in §1.163(j)–2(c) (whether to an S corporation taxable year or a C corporation taxable year). For purposes of applying section 163(j), S corporations are subject to the same ordering rules as a C corporation that is not a member of a consolidated group. See §1.163(j)–5(b)(2).

(6) *Basis adjustments and disallowed business interest expense carryforwards.* An S corporation shareholder's adjusted basis in its S corporation stock is reduced, but not below zero, when a disallowed business interest expense carryforward becomes deductible under section 163(j).

(7) *Accumulated adjustment accounts.* The accumulated adjustment account of an S corporation is adjusted to take into account business interest expense in the year in which the S corporation treats such business interest expense as deductible under the section 163(j) limitation. See section 1368(e)(1).

(8) *Termination of qualified subchapter S subsidiary election.* If a corporation's qualified subchapter S subsidiary election terminates and any disallowed business interest expense carryforward is attributable to the activities of the qualified subchapter S subsidiary at the time of termination, such disallowed business interest expense carryforward remains with the parent S corporation, and no portion of these items is allocable to the former qualified subchapter S subsidiary.

(9) *Investment items.* Any item of an S corporation's income, gain, deduction, or loss that is investment interest income or expense pursuant to §1.163–8T is allocated to each shareholder in accordance with the shareholders' pro rata interests in the S corporation pursuant to section 1366(a)(1). See section 163(d) and §1.163–8T.

(10) *Application of section 382.* In the event of an ownership change, within the meaning of section 382(g), the S corporation's business interest expense is subject to section 382. Therefore, the allocation of the S corporation's business interest expense between the pre-change period (as defined in §1.382–6(g)(2)) and the post-change period (as defined in §1.382–6(g)(3)), and the determination of the amount that is deducted and carried forward, is determined pursuant to §1.382–6. If the date of the ownership change is also the date of a qualifying disposition (as defined in §1.1368–1(g)(2)) or the date for a termination of shareholder interest (as defined in §1.1377–1(b)(4)), then—

(i) The rules of this paragraph govern the S corporation's business interest expense;

(ii) The S corporation must make an election under §1.382–6(b) with respect to such date if it also makes an election under §1.1368–1(g)(2) or a shareholder termination election to apply normal tax accounting rules, as applicable, with respect to such date; and

(iii) The S corporation may not make an election under §1.382–6(b) with respect to such date if it does not make an election under §1.1368–1(g)(2) or a termination election under §1.1377–1(b)(1), as applicable, with respect to such date.

(m) *Partnerships and S corporations not subject to section 163(j)*—(1) *Exempt partnerships and S corporations.* If the small business exemption in §1.163(j)–2(d) applies to a partnership or an S corporation in a taxable year (exempt entity), the general rule in §1.163(j)–2 and this section does not apply to limit the deduction for business interest expense of the exempt entity in that taxable year. Additionally, if a partner or S corporation shareholder is allocated business interest expense from an exempt entity, such business interest expense is not subject to the section 163(j) limitation at the partner's or S corporation shareholder's level. However, see paragraph (h)(1) of this section. Further, a partner or S corporation shareholder of an exempt entity includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of such exempt entity when calculating its ATI. However, if a partner's or S corporation shareholder's allocations of non-excepted trade or business items of loss and deduction from an exempt entity exceed its allocations of non-excepted trade or business items of income and gain from such exempt entity (net loss allocation), then such net loss allocation will not reduce a partner's or S corporation shareholder's ATI. See *Example 11* and *Example 12* in paragraphs (o)(11) and (12) of this section, respectively.

(2) *Partnerships and S corporations engaged in excepted trades or businesses.* To the extent a partnership or an S corporation is engaged in an excepted trade or business, the general rule in §1.163(j)–2 and this section does not apply to limit the deduction for business interest expense that is allocable to such excepted trade or business. If a partner or S corporation shareholder is allocated any section 163(j) item that is allocable to an excepted trade or business of the partnership or S corporation (excepted 163(j) items), such excepted 163(j) items are excluded from the partner's or shareholder's section 163(j) deduction calculation. See §1.163(j)–10(c) (regarding the allocation of items between excepted and non-excepted trades or businesses). See also *Example 13* in paragraph (o)(13) of this section.

(3) *Treatment of excess business interest expense from partnerships that are exempt entities in a succeeding taxable year.* If a partner is allocated excess business interest expense from a partnership and, in a succeeding taxable year, such partnership is an exempt entity, then the partner shall treat any of its excess business interest expense that was previously allocated from such partnership as business interest expense paid or accrued by the partner in such succeeding taxable year, which is potentially subject to limitation at the partner level under section 163(j). However, if a partner is allocated excess business interest expense from a partnership and, in a succeeding taxable year, such partnership engages in excepted trades or businesses, then the partner shall not treat any of its excess business interest expense that was previously allocated from such partnership as business interest expense paid or accrued by the partner in such succeeding taxable year by reason of the partnership engaging in excepted trades or businesses. See *Example 14* through *Example 16* in paragraphs (o)(14) through (o)(16) of this section, respectively. For rules regarding the treatment of excess business interest expense from a partnership that terminates under section 708(b)(1), see paragraph (h)(3) of this section.

(4) *S corporations with disallowed business interest expense carryforwards prior to becoming exempt entities.* If an S corporation has a disallowed business interest expense carryforward for a taxable year and, in a succeeding taxable year, such S corporation is an exempt entity, then such disallowed business interest expense carryforward—

(i) Continues to be carried forward at the S corporation level;

(ii) Is no longer subject to the section 163(j) limitation; and

(iii) Is taken into account in determining the nonseparately stated taxable income or loss of the S corporation.

(n) *Treatment of self-charged lending transactions between partnerships and partners.* In the case of a lending transaction between a partner (lending partner) and partnership (borrowing partnership) in which the lending partner owns a direct interest (self-charged lending transaction), any business interest expense of the borrowing partnership attributable to the self-charged lending transaction is business interest expense of the borrowing partnership for purposes of this section. If in a given taxable year the lending partner is allocated excess business interest expense from the borrowing partnership and has interest income attributable to the self-charged lending transaction (interest income), the lending partner is deemed to receive an allocation of excess business interest income from the borrowing partnership in such taxable year. The amount of the lending partner's deemed allocation of excess business interest income is the lesser of such lending partner's allocation of excess business interest expense from the borrowing partnership in such taxable year or the interest income attributable to the self-charged lending transaction in such taxable year. To prevent the double counting of business interest income, the lending partner includes interest income that was treated as excess business interest income pursuant to this paragraph (n) only once when calculating its own section 163(j) limitation. To the extent an amount of interest income received by a lending partner is attributable to a self-charged lending transaction, and is deemed to be an allocation of excess business interest income from the borrowing partnership pursuant to this paragraph (n), such an amount of interest income will not be treated as investment income for purposes of section 163(d). In cases where the lending partner is not a C corporation, to the extent that any interest income exceeds the lending partner's allocation of excess business interest expense from the borrowing partnership for the taxable year, and such interest income otherwise would be properly treated as investment income of the lending partner for purposes of section 163(d) for that year, such excess amount of interest income will continue to be treated as investment income of the lending partner for that year for purposes of section 163(d). See *Example 26* in paragraph (o)(26) of this section.

(o) *Examples.* The examples in this paragraph illustrate the provisions of section 163(j) as applied to partnerships and subchapter S corporations. For purposes of these examples, unless stated otherwise, each partnership and S corporation is subject to the provisions of section 163(j), is only engaged in non-excepted trades or businesses, was created or organized in the United States, and uses the calendar year for its annual accounting period. Unless stated otherwise, all partners and shareholders are subject to the provisions of section 163(j), are not subject to a limitation under section 704(d) or 1366(d), have no tax items other than those listed in the example, are U.S. citizens, and use the calendar year for their annual accounting period. The phrase ''section 163(j) limit'' shall equal the maximum potential deduction allowed under section 163(j)(1). Unless stated otherwise, business interest expense means business interest expense that is not floor plan financing interest expense. With respect to partnerships, all allocations are in accordance with section 704(b) and the regulations in this part under section 704 of the Code.

(1) *Example 1*—(i) *Facts.* X and Y are equal partners in partnership PRS. In Year 1, PRS has $100 of ATI and $40 of business interest expense. PRS allocates the items comprising its $100 of ATI $50 to X and $50 to Y. PRS allocates its $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level.* In Year 1, PRS's section 163(j) limit is 30 percent of its ATI, or $30 ($100 × 30 percent). Thus, PRS has $30 of deductible business interest expense and $10 of excess business interest expense. Such $30 of deductible business interest expense is includable in PRS's nonseparately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations.* Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $15 of deductible business interest expense and $5 of excess business interest expense. At the end of Year 1, X and Y each have $5 of excess business interest expense from PRS, which is not treated as paid or accrued by the partner until such partner is allocated excess taxable income or excess business interest income from PRS in a succeeding taxable year. Pursuant to § 1.163(j)–6(e)(1), X and Y, in computing their limit under section 163(j), do not increase any of their section 163(j) items by any of PRS's section 163(j) items. X and Y each increase their outside basis in PRS by $30 ($50 − $20).

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $100 of ATI and $20 of business interest expense from its sole proprietorship. X's section 163(j) limit is $30 ($100 × 30 percent). Thus, X's $20 of business interest expense is deductible business interest expense. Y, in computing its limit under section 163(j), has $20 of business interest expense from its sole proprietorship. Y's section 163(j) limit is $0 ($0 × 30 percent). Thus, Y's $20 of business interest expense is not allowed as a deduction and is treated as business interest expense paid or accrued by Y in Year 2.

(2) *Example 2*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section. In Year 2, PRS has $200 of ATI, $0 of business interest income, and $30 of business interest expense. PRS allocates the items comprising its $200 of ATI $100 to X and $100 to Y. PRS allocates its $30 of business interest expense $15 to X and $15 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $60 ($200 × 30 percent). Thus, PRS has $100 of excess taxable income, $30 of deductible business interest expense, and $0 of excess business interest expense. Such $30 of deductible business interest expense is includable in PRS's nonseparately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations.* Pursuant to §1.163(j)–6(f)(2), X and Y are each allocated $50 of excess taxable income, $15 of deductible business interest expense, and $0 of excess business interest expense. As a result, X and Y each increase their ATI by $50. Because X and Y are each allocated $50 of excess taxable income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, X and Y each treat $5 of excess business interest expense (the carryforward from Year 1) as paid or accrued in Year 2. X and Y each increase their outside basis in PRS by $85 ($100 − $15).

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $150 of ATI ($100 from its sole proprietorship, plus $50 excess taxable income) and $25 of business interest expense ($20 from its sole proprietorship, plus $5 excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $45 ($150 × 30 percent). Thus, X's $25 of business interest expense is deductible business interest expense. At the end of Year 2, X has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2). Y, in computing its limit under section 163(j), has $50 of ATI ($0 from its sole proprietorship, plus $50 excess taxable income) and $45 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $5 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $15 ($50 × 30 percent). Thus, $15 of Y's business interest expense is deductible business interest expense. The $30 of Y's business interest expense not allowed as a deduction ($45 business interest expense, less $15 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2).

(3) *Example 3*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section. In Year 2, PRS has $0 of ATI, $60 of business interest income, and $40 of business interest expense. PRS allocates its $60 of business interest income $30 to X and $30 to Y. PRS allocates its $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $60 (($0 × 30 percent) + $60). Thus, PRS has $20 of excess business interest income, $0 of excess taxable income, $40 of deductible business interest expense, and $0 of excess business interest expense. Such $40 of deductible business interest expense is includable in PRS's nonseparately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations.* Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $10 of excess business interest income, and $20 of deductible business interest expense. As a result, X and Y each increase their business interest income by $10. Because X and Y are each allocated $10 of excess business interest income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, X and Y each treat $5 of excess business interest expense (the carryforward from Year 1) as paid or accrued in Year 2. X and Y each increase their outside basis in PRS by $10 ($30 − $20).

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $100 of ATI (from its sole proprietorship), $10 of business interest income (from the allocation of $10 of excess business interest income from PRS), and $25 of business interest expense ($20 from its sole proprietorship, plus $5 excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $40 (($100 × 30 percent) + $10). Thus, X's $25 of business interest expense is deductible business interest expense. At the end of Year 2, X has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2). Y, in computing its limit under section 163(j), has $0 of ATI (from its sole proprietorship), $10 of business interest income, and $45 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $5 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $10 (($0 × 30 percent) + $10). Thus, $10 of Y's business interest expense is deductible business interest expense. The $35 of Y's business interest expense not allowed as a deduction ($45 business interest expense, less $10 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2).

(4) *Example 4*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section. In Year 2, PRS has $100 of ATI, $60 of business interest income, and $40 of business interest expense. PRS allocates the items comprising its $100 of ATI $50 to X and $50 to Y. PRS allocates its $60 of business interest income $30 to X and $30 to Y. PRS allocates its $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $90 (($100 × 30 percent)) + $60). Thus, PRS has $20 of excess business interest income, $100 of excess taxable income, $40 of deductible business interest expense, and $0 of excess business interest expense. Such $40 of deductible business interest expense is includable in PRS's nonseparately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations.* Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $10 of excess business interest income, $50 of excess taxable income, and $20 of deductible business interest expense. As a result, X and Y each increase their business interest income by $10 and ATI by $50. Because X and Y are each allocated $10 of excess business interest income and $50 of excess taxable income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, X and Y each treat $5 of excess business interest expense (the carryforward from Year 1) as paid or accrued in Year 2. X and Y each increase their outside basis in PRS by $60 ($80 − $20).

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $150 of ATI ($100 from its sole proprietorship, plus $50 excess taxable income), $10 of business interest income, and $25 of business interest expense ($20 from its sole proprietorship, plus $5 excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $55 (($150 × 30 percent) + $10). Thus, $25 of X's business interest expense is deductible business interest expense. At the end of Year 2, X has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2). Y, in computing its limit under section 163(j), has $50 of ATI ($0 from its sole proprietorship, plus $50 excess taxable income), $10 of business interest income, and $45 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $5 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $25 (($50 × 30 percent) + $10). Thus, $25 of Y's business interest expense is deductible business interest expense. Y's $20 of business interest expense not allowed as a deduction ($45 business interest expense, less $25 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $0 of excess business interest expense from PRS ($5 from Year 1, less $5 treated as paid or accrued in Year 2).

(5) *Example 5*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section. In Year 2, PRS has $100 of ATI, $11.20 of business interest income, and $40 of business interest expense. PRS allocates the items comprising its $100 of ATI $50 to X and $50 to Y. PRS allocates its $11.20 of business interest income $5.60 to X and $5.60 to Y. PRS allocates its $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $41.20 (($100 × 30 percent) + $11.20). Thus, PRS has $0 of excess business interest income, $4 of excess taxable income, and $40 of deductible business interest expense. Such $40 of deductible business interest expense is includable in PRS's nonseparately stated income or loss, and is not subject to further limitation under section 163(j) at the partners' level.

(iii) *Partner-level allocations.* Pursuant to § 1.163(j)–6(f)(2), X and Y are each allocated $2 of excess taxable income, $20 of deductible business interest expense, and $0 of excess business interest expense. As a result, X and Y each increase their ATI by $2. Because X and Y are each allocated $2 of excess taxable income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, X and Y each treat $2 of excess business interest expense (a portion of the carryforward from Year 1) as paid or accrued in Year 2. X and Y each increase their outside basis in PRS by $35.60 ($55.60 − $20).

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $102 of ATI ($100 from its sole proprietorship, plus $2 excess taxable income), $0 of business interest income, and $22 of business interest expense ($20 from its sole proprietorship, plus $2 excess business interest expense treated as paid or accrued). X's section 163(j) limit is $30.60 ($102 × 30 percent). Thus, X's $22 of business interest expense is deductible business interest expense. At the end of Year 2, X has $3 of excess business interest expense from PRS ($5 from Year 1, less $2 treated as paid or accrued in Year 2). Y, in computing its limit under section 163(j), has $2 of ATI ($0 from its sole proprietorship, plus $2 excess taxable income), $0 of business interest income, and $42 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $2 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $0.60 ($2 × 30 percent). Thus, $0.60 of Y's business interest expense is deductible business interest expense. Y's $41.40 of business interest expense not allowed as a deduction ($42 business interest expense, less $0.60 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $3 of excess business interest expense from PRS ($5 from Year 1, less $2 treated as paid or accrued in Year 2).

(6) *Example 6*—(i) *Facts.* In Year 1, X, Y, and Z formed partnership PRS. Upon formation, X and Y each contributed $100, and Z contributed non-excepted and non-depreciable trade or business property with a basis of $0 and fair market value of $100 (Blackacre). PRS allocates all items pro rata between its partners. Immediately after the formation of PRS, Z sold all of its interest in PRS to A for $100 (assume the interest sale is respected for U.S. Federal income tax purposes). In connection with the interest transfer, PRS made a valid election under section 754. Therefore, after the interest sale, A had a $100 positive section 743(b) adjustment in Blackacre. In Year 1, PRS had $0 of ATI, $15 of business interest expense, and $0 of business interest income. Pursuant to § 1.163(j)–6(f)(2), PRS allocated each of the partners $5 of excess business interest expense. In Year 2, PRS sells Blackacre for $100 which generated $100 of ATI. The sale of Blackacre was PRS's only item of income in Year 2. In accordance with section 704(c), PRS allocates all $100 of gain resulting from the sale of Blackacre to A. Additionally, PRS has $15 of business interest expense, all of which it allocates to X. A has $50 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI, or $30 ($100 × 30 percent). Thus, PRS has $15 of deductible business interest expense and $50 of excess taxable income. Such $15 of deductible business interest expense is includable in PRS's nonseparately stated income or loss, and is not subject to further limitation under section 163(j) at X's level.

(iii) *Partner-level allocations.* Pursuant to § 1.163(j)–6(f)(2), X is allocated $15 of deductible business interest expense and X's outside basis in PRS is reduced by $15. A is allocated $50 of excess taxable income and, as a result, A increases its ATI by $50. Because A is allocated $50 of excess taxable income, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to a partner, A treats $5 of excess business interest expense (the carryforward from Year 1) as paid or accrued in Year 2. PRS's $100 of gain allocated to A in Year 2 is fully reduced by A's $100 section 743(b) adjustment. Therefore, at the end of Year 2, there is no change to A's outside basis in PRS.

(iv) *Partner-level.* A, in computing its limit under section 163(j), has $0 of ATI ($50 from its sole proprietorship, plus $50 excess taxable income, less $100 ATI reduction as a result of A's section 743(b) adjustment under § 1.163(j)–6(e)(2)) and $25 of business interest expense ($20 from its sole proprietorship, plus $5 excess business interest expense treated as paid or accrued in Year 2). A's section 163(j) limit is $0 ($0 × 30 percent). Thus, all $25 of A's business interest expense is not allowed as a deduction and is treated as business interest expense paid or accrued by A in Year 3.

(7) *Example 7*—(i) *Facts.* X and Y are equal partners in partnership PRS. At the beginning of Year 1, X and Y each have an outside basis in PRS of $5. In Year 1, PRS has $0 of ATI, $20 of business interest income, and $40 of business interest expense. PRS allocates its $20 of business interest income $10 to X and $10 to Y. PRS allocates $40 of business interest expense $20 to X and $20 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level.* In Year 1, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $20 (($0 × 30 percent) + $20). Thus, PRS has $0 of excess business interest income, $0 of excess taxable income, $20 of deductible business interest expense, and $20 of excess business interest expense. Such $20 of deductible business interest expense is includable in nonseparately stated income or loss of PRS, and not subject to further limitation under section 163(j) by the partners.

(iii) *Partner-level allocations.* Pursuant to §1.163(j)–6(f)(2), X and Y are each allocated $10 of deductible business interest expense and $10 of excess business interest expense. After adjusting each partner's respective basis for business interest income under section 705(a)(1)(A), pursuant to §1.163(j)–6(h)(1), X and Y each take their $10 of deductible business interest expense into account when reducing their outside basis in PRS before taking the $10 of excess business interest expense into account. Following each partner's reduction in outside basis due to the $10 of deductible business interest expense, each partner has $5 of outside basis remaining in PRS. Pursuant to §1.163(j)–6(h)(2), each partner has $5 of excess business interest expense and $5 of negative section 163(j) expense. In sum, at the end of Year 1, X and Y each have $5 of excess business interest expense from PRS which reduces each partner's outside basis to $0 (and is not treated as paid or accrued by the partners until such partner is allocated excess taxable income or excess business interest income from PRS in a succeeding taxable year), and $5 of negative section 163(j) expense (which is suspended under section 704(d) and not treated as excess business interest expense of the partners until such time as the negative section 163(j) expense is no longer subject to a limitation under section 704(d)).

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $100 of ATI (from its sole proprietorship) and $20 of business interest expense (from its sole proprietorship). X's section 163(j) limit is $30 ($100 × 30 percent). Thus, $20 of X's business interest expense is deductible business interest expense. Y, in computing its limit under section 163(j), has $20 of business interest expense (from its sole proprietorship). Y's section 163(j) limit is $0 ($0 × 30 percent). Thus, $20 of Y's business interest expense is not allowed as a deduction in Year 1, and is treated as business interest expense paid or accrued by Y in Year 2.

(8) *Example 8*—(i) *Facts.* The facts are the same as in *Example 7* in paragraph (o)(7)(i) of this section. In Year 2, PRS has $20 of gross income that is taken into account in determining PRS's ATI (in other words, properly allocable to a trade or business), $30 of gross deductions from an investment activity, and $0 of business interest expense. PRS allocates the items comprising its $20 of ATI $10 to X and $10 to Y. PRS allocates the items comprising its $30 of gross deductions $15 to X and $15 to Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $6 ($20 × 30 percent). Because PRS has no business interest expense, all $20 of its ATI is excess taxable income.

(iii) *Partner-level allocations.* Pursuant to §1.163(j)–6(f)(2), X and Y are each allocated $10 of excess taxable income. Because X and Y are each allocated $10 of excess taxable income from PRS, X and Y each increase their ATI by $10. Pursuant to §1.704–(1)(d)(2), each partner's limitation on losses under section 704(d) must be allocated to its distributive share of each such loss. Thus, each partner reduces its adjusted basis of $10 (attributable to the allocation of items comprising PRS's ATI in Year 2) by $7.50 of gross deductions from Year 2 ($10 × ($15 of total gross deductions from Year 2/$20 of total losses disallowed)), and $2.50 of excess business interest expense that was carried over as negative section 163(j) expense from Year 1 ($10 × ($5 of negative section 163(j) expense treated as excess business interest expense solely for the purposes of section 704(d)/$20 of total losses disallowed)). Following the application of section 704(d), each partner has $7.50 of excess business interest expense from PRS ($5 excess business interest expense from Year 1, plus $2.50 of excess business interest expense that was formerly negative section 163(j) expense carried over from Year 1). Excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess taxable income and excess business interest income are allocated from such partnership to the partner. As a result, X and Y each treat $7.50 of excess business interest expense as paid or accrued in Year 2.

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $110 of ATI ($100 from its sole proprietorship, plus $10 excess taxable income) and $27.50 of business interest expense ($20 from its sole proprietorship, plus $7.50 excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $33 ($110 × 30 percent). Thus, $27.50 of X's business interest expense is deductible business interest expense. At the end of Year 2, X has $0 of excess business interest expense from PRS ($5 from Year 1, plus $2.50 treated as excess business interest expense in Year 2, less $7.50 treated as paid or accrued in Year 2), and $2.50 of negative section 163(j) expense from PRS. Y, in computing its limit under section 163(j), has $10 of ATI ($0 from its sole proprietorship, plus $10 excess taxable income) and $47.50 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $7.50 excess business interest expense treated as paid or accrued in Year 2). Y's section 163(j) limit is $3 ($10 × 30 percent). Thus, $3 of Y's business interest expense is deductible business interest expense. The $44.50 of Y's business interest expense not allowed as a deduction ($47.50 business interest expense, less $3 section 163(j) limit) is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $0 of excess business interest expense from PRS ($5 from Year 1, plus $2.50 treated as excess business interest expense in Year 2, less $7.50 treated as paid or accrued in Year 2), and $2.50 of negative section 163(j) expense from PRS.

(9) *Example 9*—(i) *Facts.* X and Y are equal partners in partnership PRS, and are not members of a consolidated group. At the beginning of Year 1, X and Y each have $120 of outside basis in PRS. Neither X nor Y's share of partnership liabilities exceeds the adjusted basis of its entire interest. In Year 1, X is allocated $20 of excess business interest expense, which reduces its outside basis from $120 to $100. In Year 2, X sells 80 percent of its interest in PRS to Z for $160. Immediately prior to the sale, X's entire PRS interest had a fair market value of $200 and the transferred portion of the interest had a fair market value of $160.

(ii) *Basis adjustment.* Immediately before the sale to Z, X increases its basis in the portion of the interest sold by 80 percent of the amount of the excess of the amount of the basis reduction under paragraph (h)(2) of this section ($20) over the portion of any excess business interest expense allocated the partner under paragraph (f)(2) of this section that has previously been treated under paragraph (g) of this section as business interest expense paid or accrued by X ($0). Therefore, X's basis in the portion of its interest sold is $96 (($100 × 80%) + ($20 × 80%)), and X's gain is $64 ($160 − $96). Following the sale, X has $20 of outside basis in its remaining partnership interest and $4 of excess business interest expense.

(10) *Example 10*—(i) *Facts.* X and Y are equal partners in partnership PRS, and are not members of a consolidated group. At the beginning of Year 1, X and Y each have an outside basis in PRS of $10. Neither X nor Y's share of partnership liabilities exceeds the adjusted basis of its entire interest. In Year 1, X is allocated $8 of excess business interest expense and $12 of loss from PRS. As a result, X has $4 of excess business interest expense, $4 of negative section 163(j) expense, $6 of allowable loss, $6 of loss suspended under section 704(d), and $0 of outside basis in PRS at the end of Year 1. In Year 2, X sells 50 percent of its interest in PRS to Z for $20. Immediately prior to the sale, X's entire partnership interest had a fair market value of $40 and the transferred portion of the interest had a fair market value of $20.

(ii) *Basis adjustment.* Immediately before the sale to Z, X increases its basis in the portion of the interest sold by 50 percent of the amount of the excess of the amount of the basis reduction under paragraph (h)(2) of this section ($4) over the portion of any excess business interest expense allocated the partner under paragraph (f)(2) of this section that has previously been treated under paragraph (g) of this section as business interest expense paid or accrued by X ($0). Therefore, X's basis in the portion of its interest sold is $2 (($0 × 50%) + $2), and X's gain is $18 ($20 − $2). Following the sale, X has $0 of outside basis in its remaining partnership interest, $2 of excess business interest expense, $4 of negative section 163(j) expense, and $6 of loss suspended under section 704(d).

(11) *Example 11*—(i) *Facts.* X (a corporation), Y (an individual), and Z (an individual) are equal partners in partnership PRS. X, Y, and Z are subject to section 163(j). PRS is not subject to section 163(j) under section 163(j)(3). In 2021, PRS has $150 of trade or business income (not taking into account business interest income or business interest expense), $30 of business interest income, and $45 of business interest expense. PRS also has $75 of investment income and $60 of investment interest expense. PRS allocates its items of income, gain, loss, and deduction equally among its partners. X, Y, and Z each have $10 of business interest expense from their respective businesses.

(ii) *Partnership-level.* PRS is not subject to section 163(j) by reason of section 163(j)(3). As a result, none of PRS's $45 of business interest expense is subject to the section 163(j) limitation.

(iii) *Partner-level allocations.* Because PRS is not subject to section 163(j) by reason of section 163(j)(3), PRS's $45 of business interest expense does not retain its character as business interest expense for purposes of section 163(j). As a result, such business interest expense is not subject to the section 163(j) limitation at the level of either the partnership or partner. Additionally, pursuant to §1.163(j)–6(m)(1), each partner includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of PRS when calculating its ATI. As a result, each partner increases its ATI by $45 (one third of $150 + $30 − $45). Also, X increases its ATI by an additional $25 because its items of investment income and loss from PRS are recharacterized as non-excepted trade or business income and loss at its level pursuant to §§1.163(j)–4(b)(3)(i) and 1.163(j)–10(b)(6). Further, X increases its business interest expense by its $20 allocation of investment interest expense from PRS pursuant to §§1.163(j)–4(b)(3)(i) and 1.163(j)–10(b)(6).

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $70 of ATI and $30 of business interest expense. X's section 163(j) limit is $21 ($70 × 30 percent). Thus, X has $21 of deductible business interest expense. X's $9 of business interest expense not allowed as a deduction is treated as business interest expense paid or accrued by X in 2020. Y and Z, in computing their respective limits under section 163(j), each have $45 of ATI and $10 of business interest expense. Y and Z each have a section 163(j) limit of $13.50 ($45 − 30 percent). Thus, Y and Z each have $10 of deductible business interest expense.

(12) *Example 12*—(i) *Facts.* The facts are the same as in *Example 11* in paragraph (o)(11)(i) of this section, except PRS has $200 of depreciation deductions in addition to its other items of income, gain, loss, and deduction.

(ii) *Partnership-level.* Same analysis as *Example 11* in paragraph (o)(11)(ii) of this section.

(iii) *Partner-level allocations.* Because PRS is not subject to section 163(j) by reason of section 163(j)(3), PRS's $45 of business interest expense does not retain its character as business interest expense for purposes of section 163(j). As a result, such business interest expense is not subject to the section 163(j) limitation at the level of either the partnership or partner. Additionally, pursuant to §1.163(j)–6(m)(1), each partner includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of PRS when calculating its ATI; however, a net loss allocation of trade or business items from an exempt entity does not reduce a partner's ATI. Because each of the partners has a net loss allocation of trade or business items from PRS, none of the partners adjust their ATI for the trade or business items of PRS. X, the corporate partner, increases its ATI by

$25 because its items of investment income and loss from PRS are recharacterized as trade or business income and loss at its level pursuant to §§ 1.163(j)–4(b)(3)(i) and 1.163(j)–10(b)(6). Further, X increases its business interest expense by its $20 allocation of investment interest expense from PRS pursuant to §§ 1.163(j)–4(b)(3)(i) and 1.163(j)–10(b)(6).

(iv) *Partner-level computations.* In computing its limit under section 163(j), each partner has $0 of ATI and $10 of business interest expense. Each partner's section 163(j) limit is $0 ($0 × 30 percent). Thus, each partner's $10 of business interest expense is not allowed as a deduction and is treated as business interest expense paid or accrued by the partner in 2020. X, in computing its limit under section 163(j), has $25 of ATI and $30 of business interest expense. X's section 163(j) limit is $7.50 ($25 × 30 percent). Thus, X has $7.50 of deductible business interest expense. X's $22.50 of business interest expense not allowed as a deduction is treated as business interest expense paid or accrued by X in 2020. Y and Z, in computing their respective limits under section 163(j), each have $0 of ATI and $10 of business interest expense. Thus, Y and Z each have $10 of business interest expense not allowed as a deduction that is treated as business interest expense paid or accrued in 2020.

(13) *Example 13*—(i) *Facts.* X, Y, and Z are equal partners in partnership PRS. X, Y, and Z are each individuals subject to section 163(j). PRS is not subject to section 163(j) under section 163(j)(3). PRS has one excepted and one non-excepted trade or business. In Year 1, PRS has $200 of income and $10 of business interest expense from its excepted trade or business, and $60 of business interest income and $30 of business interest expense from its non-excepted trade or business. PRS allocates its items of income, gain, loss, and deduction equally among its partners. X, Y, and Z each have $10 of business interest expense from their respective businesses.

(ii) *Partnership-level.* PRS is not subject to section 163(j) by reason of section 163(j)(3). As a result, none of PRS's business interest expense is subject to the section 163(j) limitation.

(iii) *Partner-level allocations.* Because PRS's business interest expense is not subject to the section 163(j) limitation, such business interest expense is not subject to the section 163(j) limitation at the level of either the partnership or partner. Additionally, pursuant to § 1.163(j)–6(m)(1), each partner includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of PRS when calculating its ATI. Therefore, each partner increases its ATI by $10 (each partner's share of $20 of non-excepted income less each partner's share of $10 of non-excepted loss).

(iv) *Partner-level computations.* In computing its limit under section 163(j), each partner has $10 of ATI and $10 of business interest expense. Each partner's section 163(j) limit is $3 ($10 × 30 percent). Thus, each partner has $3 of deductible business interest expense. Each partner has $7 of business interest expense not allowed as a deduction that is treated as business interest expense paid or accrued by the partner in Year 2.

(14) *Example 14*—(i) *Facts.* The facts are the same as in *Example 5* in paragraph (o)(5)(i) of this section, except in Year 2 Y is not subject to section 163(j) under section 163(j)(3).

(ii) *Partnership-level.* Same analysis as *Example 5* in paragraph (o)(5)(ii) of this section.

(iii) *Partner-level allocations.* Same analysis as *Example 5* in paragraph (o)(5)(iii) of this section.

(iv) *Partner-level computations.* For X, same analysis as *Example 5* in paragraph (o)(5)(iv) of this section. Y is not subject to section 163(j) under section 163(j)(3). Thus, all $42 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1, plus $2 excess business interest expense treated as paid or accrued in Year 2) is not subject to limitation under § 1.163(j)–2(d). At the end of Year 2, Y has $3 of excess business interest expense from PRS ($5 from Year 1, less $2 treated as paid or accrued in Year 2).

(15) *Example 15*—(i) *Facts.* The facts are the same as in *Example 5* in paragraph (o)(5)(i) of this section, except in Year 2 PRS and Y become not subject to section 163(j) by reason of section 163(j)(3).

(ii) *Partnership-level.* In Year 2, PRS is not subject to section 163(j) by reason of section 163(j)(3). As a result, none of PRS's $40 of business interest expense is subject to the section 163(j) limitation at the level of either the partnership or partner.

(iii) *Partner-level allocations.* Because PRS is not subject to section 163(j) by reason of section 163(j)(3), PRS's $40 of business interest expense does not retain its character as business interest expense for purposes of section 163(j). As a result, such business interest expense is not subject to the section 163(j) limitation at the level of either the partnership or partner. Additionally, pursuant to §1.163(j)–6(m)(1), each partner includes its share of non-excepted trade or business items of income, gain, loss, and deduction (including business interest expense and business interest income) of PRS when calculating its ATI. As a result, X and Y each increase their ATI by $35.60. Further, because PRS is not subject to section 163(j) by reason of section 163(j)(3), the excess business interest expense from Year 1 is treated as paid or accrued by the partners pursuant to §1.163(j)–6(m)(3). As a result, X and Y each treat their $5 of excess business interest expense from Year 1 as paid or accrued in Year 2, and increase their business interest expense by $5.

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $135.60 of ATI ($100 from its sole proprietorship, plus $35.60 ATI from PRS) and $25 of business interest expense ($20 from its sole proprietorship, plus $5 of excess business interest expense treated as paid or accrued in Year 2). X's section 163(j) limit is $40.68 ($135.60 × 30 percent). Thus, $25 of X's business interest expense is deductible business interest expense. Y is not subject to section 163(j) under section 163(j)(3). As a result, Y's business interest expense is not subject to the section 163(j) limitation. Thus, all $45 of Y's business interest expense ($20 from its sole proprietorship, plus $20 disallowed from year 1, plus $5 of excess business interest expense treated as paid or accrued in Year 2) is not subject to the section 163(j) limitation.

(16) *Example 16*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (o)(1)(i) of this section, except that PRS's only trade or business is a real property trade or business for which PRS does not make the election provided for in section 163(j)(7)(B). In Year 2, when PRS's only trade or business is still its real property trade or business, PRS makes the election provided for in section 163(j)(7)(B). Further, in Year 2, PRS has $100 of income and $40 of business interest expense. PRS allocates its items of income, gain, deduction, and loss equally between X and Y. X has $100 of ATI and $20 of business interest expense from its sole proprietorship. Y has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *Partnership-level.* In Year 2, PRS is not subject to section 163(j) because its only trade or business is an excepted trade or business. As a result, none of PRS's $40 of business interest expense is subject to the section 163(j) limitation at the level of either the partnership or partner.

(iii) *Partner-level allocations.* Because PRS is not subject to section 163(j), PRS's $40 of business interest expense does not retain its character as business interest expense for purposes of section 163(j). As a result, such business interest expense is not subject to the section 163(j) limitation at the partners' level. Pursuant to §1.163(j)–6(m)(1), the partners do not include their respective $50 shares of income from PRS when calculating their own ATI because such $50 is excepted trade or business income.

(iv) *Partner-level computations.* X, in computing its limit under section 163(j), has $100 of ATI ($100 from its sole proprietorship) and $20 of business interest expense ($20 from its sole proprietorship). X's section 163(j) limit is $30 ($100 × 30 percent). Thus, $20 of X's business interest expense is deductible business interest expense. At the end of Year 2, X has $5 of excess business interest expense from PRS ($5 from Year

1). Y, in computing its limit under section 163(j), has $0 of ATI and $40 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from Year 1). Y's section 163(j) limit is $0. Thus, Y's $40 of business interest expense not allowed as a deduction is treated as business interest expense paid or accrued by Y in Year 3. At the end of Year 2, Y has $5 of excess business interest expense from PRS ($5 from Year 1).

(17) *Example 17: Facts*. A (an individual) and B (a corporation) own all of the interests in partnership PRS. At the beginning of Year 1, A and B each have $100 section 704(b) capital account and $100 of basis in PRS. In Year 1, PRS has $100 of ATI, $10 of investment interest income, $20 of business interest income (BII), $60 of business interest expense (BIE), and $10 of floor plan financing interest expense. PRS's ATI consists of $100 of gross income and $0 of gross deductions. PRS allocates its items comprising ATI $100 to A and $0 to B. PRS allocates its business interest income $10 to A and $10 to B. PRS allocates its business interest expense $30 to A and $30 to B. PRS allocates all $10 of its investment interest income and all $10 of its floor plan financing interest expense to B. A has ATI from a sole proprietorship, unrelated to PRS, in the amount of $300.

(i) First, PRS determines its limitation pursuant to §1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $50 (($100 × 30 percent) + $20). Thus, PRS has $0 of excess business interest income (EBII), $0 of excess taxable income, $50 of deductible business interest expense, and $10 of excess business interest expense. PRS takes its $10 of floor plan financing into account in determining its nonseparately stated taxable income or loss.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation. B's $10 of investment interest income is not included in B's allocable business interest income amount because the $10 of investment interest income was not taken into account in PRS's section 163(j) calculation. B's $10 of floor plan financing interest expense is not included in B's allocable business interest expense. The $300 of ATI from A's sole proprietorship is not included in A's allocable ATI amount because the $300 was not taken into account in PRS's section 163(j) calculation.

TABLE 1 TO PARAGRAPH (o)(17)(ii)

	A	B	Total
Allocable ATI	$100	$0	$100
Allocable BII	10	10	20
Allocable BIE	30	30	60

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. Because each partner's allocable business interest expense exceeds its allocable business interest income by $20 ($30 − $10), each partner has an allocable business interest income deficit of $20. Thus, the total allocable business interest income deficit is $40 ($20 + $20). No partner has allocable business interest income excess because no partner has allocable business interest income in excess of its allocable business interest expense. Thus, the total allocable business interest income excess is $0.

TABLE 2 TO PARAGRAPH (o)(17)(iii)

	A	B	Total
Allocable BII	$10	$10	N/A
Allocable BIE	30	30	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	0	0	$0

TABLE 2 TO PARAGRAPH (o)(17)(iii)—Continued

	A	B	Total
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	20	20	40

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because no partner had any allocable business interest income excess, each partner has final allocable business interest income excess of $0.

(v) Fifth, PRS determines each partner's remaining business interest expense. PRS determines A's remaining business interest expense by reducing, but not below $0, A's allocable business interest income deficit ($20) by the product of the total allocable business interest income excess ($0) and the ratio of A's allocable business interest income deficit to the total business interest income deficit ($20/$40). Therefore, A's allocable business interest income deficit of $20 is reduced by $0 ($0 × 50 percent). As a result, A's remaining business interest expense is $20. PRS determines B's remaining business interest expense by reducing, but not below $0, B's allocable business interest income deficit ($20) by the product of the total allocable business interest income excess ($0) and the ratio of B's allocable business interest income deficit to the total business interest income deficit ($20/$40). Therefore, B's allocable business interest income deficit of $20 is reduced by $0 ($0 × 50 percent). As a result, B's remaining business interest expense is $20.

TABLE 3 TO PARAGRAPH (o)(17)(v)

	A	B	Total
Allocable BII deficit	$20	$20	$40
Less: (Total allocable BII excess) × (Allocable BII deficit/ Total allocable BII deficit)	0	0	N/A
= Remaining BIE	20	20	40

(vi) Sixth, PRS determines each partner's final allocable ATI. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, B has a positive allocable ATI of $0. Because A's allocable ATI is comprised of $100 of income and gain and $0 of deduction and loss, A has positive allocable ATI of $100. Thus, the total positive allocable ATI is $100 ($100 + $0). PRS determines A's final allocable ATI by reducing, but not below $0, A's positive allocable ATI ($100) by the product of total negative allocable ATI ($0) and the ratio of A's positive allocable ATI to the total positive allocable ATI ($100/$100). Therefore, A's positive allocable ATI is reduced by $0 ($0 × 100 percent). As a result, A's final allocable ATI is $100. Because B has a positive allocable ATI of $0, B's final allocable ATI is $0.

TABLE 4 TO PARAGRAPH (o)(17)(vi)

	A	B	Total
Allocable ATI	$100	$0	$100

TABLE 4 TO PARAGRAPH (o)(17)(vi)—Continued

	A	B	Total
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	0	0	0
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	100	0	100

TABLE 5 TO PARAGRAPH (o)(17)(vi)

	A	B	Total
Positive allocable ATI	$100	$0	$100
Less: (Total negative allocable ATI) × (Positive allocable ATI/ Total positive allocable ATI)	0	0	N/A
= Final allocable ATI	100	0	100

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $30 ($100 × 30 percent) and B's ATIC amount is $0 ($0 × 30 percent). Because A's ATIC amount exceeds its remaining business interest expense by $10 ($30 − $20), A has an ATIC excess of $10. B does not have any ATIC excess. Thus, the total ATIC excess is $10 ($10 + $0). A does not have any ATIC deficit. Because B's remaining business interest expense exceeds its ATIC amount by $20 ($20 − $0), B has an ATIC deficit of $20. Thus, the total ATIC deficit is $20 ($0 + $20).

TABLE 6 TO PARAGRAPH (o)(17)(vii)

	A	B	Total
ATIC (Final allocable ATI × 30 percent) ...	$30	$0	N/A
Remaining BIE	20	20	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	10	0	$10

TABLE 6 TO PARAGRAPH (o)(17)(vii)—Continued

	A	B	Total
If remaining BIE exceeds ATIC, then such excess = ATIC deficit ..	0	20	20

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has—

(*1*) An excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATIC excess amount greater than $0 under paragraph (f)(2)(vii) of this section.

(B) Because PRS does not meet all three requirements in paragraph (o)(17)(viii)(A) of this section, PRS does not perform the calculations or adjustments described in paragraph (f)(2)(viii) of this section. In sum, the correct amounts to be used in paragraphs (o)(17)(ix) and (x) of this section are as follows.

TABLE 7 TO PARAGRAPH (o)(17)(viii)(B)

	A	B	Total
ATIC excess	$10	$0	$10
ATIC deficit	0	20	20

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Because A has an ATIC excess, PRS must determine A's final ATIC excess amount. A's final ATIC excess amount is A's ATIC excess ($10), reduced, but not below $0, by the product of the total ATIC deficit ($20) and the ratio of A's ATIC excess to the total ATIC excess ($10/$10). Therefore, A has $0 of final ATIC excess ($10 − ($20 × 100 percent)).

TABLE 8 TO PARAGRAPH (o)(17)(ix)

	A	B	Total
ATIC excess	$10	$0	N/A
Less: (Total ATIC deficit) × (ATIC excess/ Total ATIC excess)	20	0	N/A
= Final ATIC excess	0	0	$0

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because B has an ATIC deficit, PRS must determine B's final ATIC deficit amount. B's final ATIC deficit amount is B's ATIC deficit ($20), reduced, but not below $0, by the product of the total ATIC excess ($10) and the ratio of B's ATIC deficit to the total ATIC deficit ($20/$20). Therefore, B has $10 of final ATIC deficit ($20 − ($10 × 100 percent)).

TABLE 9 TO PARAGRAPH (o)(17)(x)

	A	B	Total
ATIC deficit	$0	$20	N/A
Less: (Total ATIC excess) × (ATIC deficit/ Total ATIC deficit)	0	10	N/A
= Final ATIC deficit ..	0	10	$10

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $10 of excess business interest expense. PRS allocates the excess business interest expense dollar for dollar to the partners with final ATIC deficits amounts. Thus, PRS allocates all $10 of its excess business interest expense to B. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. Therefore, A has deductible business interest expense of $30 ($30 − $0) and B has deductible business interest expense of $20 ($30 − $10). As a result of its allocations from PRS, A increases its section 704(b) capital account and basis in PRS by $80 to $180. As a result of its allocations from PRS, B decreases its capital account and basis in PRS by $20 to $80.

TABLE 10 TO PARAGRAPH (o)(17)(xi)

	A	B	Total
Deductible BIE	$30	$20	$50
EBIE allocated ..	0	10	10
ETI allocated ..	0	0	0
EBII allocated ..	0	0	0

(18) *Example 18: Facts*. A, B, and C own all of the interests in partnership PRS. In Year 1, PRS has $150 of ATI, $10 of business interest income, and $40 of business interest expense. PRS's ATI consists of $200 of gross income and $50 of gross deductions. PRS allocates its items comprising ATI ($50) to A, $200 to B, and $0 to C. PRS allocates its business interest income $0 to A, $0 to B, and $10 to C. PRS allocates its business interest expense $30 to A, $10 to B, and $0 to C.

(i) First, PRS determines its limitation pursuant to § 1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $55 (($150 × 30 percent) + $10). Thus, PRS has $0 of excess business interest income, $50 of excess taxable income, $40 of deductible business interest expense, and $0 of excess business interest expense.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation.

TABLE 11 TO PARAGRAPH (o)(18)(ii)

	A	B	C	Total
Allocable ATI	($50)	$200	$0	$150
Allocable BII	0	0	10	10
Allocable BIE	30	10	0	40

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. Because A's allocable business interest expense exceeds its allocable business interest income by $30 ($30 − $0), A has an allocable business interest income deficit of $30. Because B's allocable business interest expense exceeds its allocable business interest income by $10 ($10 − $0), B has an allocable business interest income deficit of $10. C does not have any allocable business interest income deficit. Thus, the total allocable business interest income deficit is $40 ($30 + $10 + $0). A and B do not have any allocable business interest income excess. Because C's allocable business interest income exceeds its allocable business interest expense by $10 ($10 − $0), C has an allocable business interest income excess of $10. Thus, the total allocable business interest income excess is $10 ($0 + $0 + $10).

TABLE 12 TO PARAGRAPH (o)(18)(iii)

	A	B	C	Total
Allocable BII	$0	$0	$10	N/A
Allocable BIE	30	10	0	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	0	0	10	$10
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	30	10	0	40

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because A and B do not have any allocable business interest income excess, each partner has final allocable business interest income excess of $0. PRS determines C's final allocable business interest income excess by reducing, but not below $0, C's allocable business interest income excess ($10) by the product of the total allocable business interest income deficit ($40) and the ratio of C's allocable business interest income excess to the total allocable business interest income excess ($10/$10). Therefore, C's allocable business interest income excess of $10 is reduced by $10 ($40 × 100 percent). As a result, C's allocable business interest income excess is $0.

TABLE 13 TO PARAGRAPH (o)(18)(iv)

	A	B	C	Total
Allocable BII excess	$0	$0	$10	N/A
Less: (Total allocable BII deficit) × (Allocable BII excess/ Total allocable BII excess)	0	0	40	N/A
= Final Allocable BII Excess	0	0	0	$10

(v) Fifth, PRS determines each partner's remaining business interest expense. PRS determines A's remaining business interest expense by reducing, but not below $0, A's allocable business interest income deficit ($30) by the product of the total allocable business interest income excess ($10) and the ratio of A's allocable business interest income deficit to the total business interest income deficit ($30/$40). Therefore, A's allocable business interest income deficit of $30 is reduced by $7.50 ($10 × 75 percent). As a result, A's remaining business interest expense is $22.50. PRS determines B's remaining business interest expense by reducing, but not below $0, B's allocable business interest income deficit ($10) by the product of the total allocable business interest income excess ($10) and the ratio of B's allocable business interest income deficit to the total business interest income deficit ($10/$40). Therefore, B's allocable business interest income deficit of $10 is reduced by $2.50 ($10 × 25 percent). As a result, B's remaining business interest expense is $7.50. Because C does not have any allocable business interest income deficit, C's remaining business interest expense is $0.

TABLE 14 TO PARAGRAPH (o)(18)(v)

	A	B	C	Total
Allocable BII deficit	$30	$10	$0	$40
Less: (Total allocable BII excess) × (Allocable BII deficit/ Total allocable BII deficit)	7.50	2.50	0	N/A
= Remaining BIE	22.50	7.50	0	N/A

(vi) Sixth, PRS determines each partner's final allocable ATI. Because A's allocable ATI is comprised of $50 of items of deduction and loss and $0 of income and gain, A has negative allocable ATI of $50. A is the only partner with negative allocable ATI. Thus, the total negative allocable ATI amount is $50. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, A and C have a positive allocable ATI of $0. Because B's allocable ATI is comprised of $200 of items of income and gain and $0 of deduction and loss, B has positive allocable ATI of $200. Thus, the total positive allocable ATI is $200 ($0 + $200 + $0). PRS determines B's final allocable ATI by reducing, but not below $0, B's positive allocable ATI ($200) by the product of total negative allocable ATI ($50) and the ratio of B's positive allocable ATI to the total positive allocable ATI ($200/ $200). Therefore, B's positive allocable ATI is reduced by $50 ($50 × 100 percent). As a result, B's final allocable ATI is $150.

TABLE 15 TO PARAGRAPH (o)(18)(vi)

	A	B	C	Total
Allocable ATI	($50)	$200	$0	$150
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	50	0	0	50
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	0	200	0	200

TABLE 16 TO PARAGRAPH (o)(18)(vi)

	A	B	C	Total
Positive allocable ATI	$0	$200	$0	$200
Less: (Total negative allocable ATI) × (Positive allocable ATI/Total positive allocable ATI)	0	50	0	N/A
= Final allocable ATI	0	150	0	150

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $0 ($0 × 30 percent), B's ATIC amount is $45 ($150 × 30 percent), and C's ATIC amount is $0 ($0 × 30 percent). A does not have any ATIC excess. Because B's ATIC amount exceeds its remaining business interest expense by $37.50 ($45 − $7.50), B has an ATIC excess amount of $37.50. C does not have any ATIC excess. Thus, the total ATIC excess amount is $37.50 ($0 + $37.50 + $0). Because A's remaining business interest expense exceeds its ATIC amount by $22.50 ($22.50 − $0), A has an ATIC deficit of $22.50. B and C do not have any ATIC deficit. Thus, the total ATIC deficit is $22.50 ($22.50 + $0 + $0).

TABLE 17 TO PARAGRAPH (o)(18)(vii)

	A	B	C	Total
ATIC (Final allocable ATI × 30 percent)	$0	$45	$0	N/A
Remaining BIE	22.50	7.50	0	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	0	37.50	0	$37.50
If remaining BIE exceeds ATIC, then such excess = ATIC deficit	22.50	0	0	22.50

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has—

(*1*) An excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATIC excess amount greater than $0 under paragraph (f)(2)(vii) of this section.

(B) Because PRS does not meet all three requirements in paragraph (o)(18)(viii)(A) of this section, PRS does not perform the calculations or adjustments described in paragraph (f)(2)(viii) of this section. In sum, the correct amounts to be used in paragraphs (o)(18)(ix) and (x) of this section are as follows.

TABLE 18 TO PARAGRAPH (o)(18)(viii)(B)

	A	B	C	Total
ATIC excess	$0	$37.50	$0	$37.50
ATIC deficit	22.50	0	0	22.50

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Because B has ATIC excess, PRS must determine B's final ATIC excess amount. B's final ATIC excess amount is B's ATIC excess ($37.50), reduced, but not below $0, by the product of the total ATIC deficit ($22.50) and the ratio of B's ATIC excess to the total ATIC excess ($37.50/$37.50). Therefore, B has $15 of final ATIC excess ($37.50 − ($22.50 × 100 percent)).

TABLE 19 TO PARAGRAPH (o)(18)(ix)

	A	B	C	Total
ATIC excess	$0	$37.50	$0	N/A
Less: (Total ATIC deficit) × (ATIC excess/Total ATIC excess)	0	22.50	0	N/A
= Final ATIC excess	0	15	0	$15

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because A has an ATIC deficit, PRS must determine A's final ATIC deficit amount. A's final ATIC deficit amount is A's ATIC deficit ($22.50), reduced, but not below $0, by the product of the total ATIC excess ($37.50) and the ratio of A's ATIC deficit to the total ATIC deficit ($22.50/$22.50). Therefore, A has $0 of final ATIC deficit ($22.50 − ($37.50 × 100 percent)).

TABLE 20 TO PARAGRAPH (o)(18)(x)

	A	B	C	Total
ATIC deficit	$22.50	$0	$0	N/A
Less: (Total ATIC excess) × (ATIC deficit/Total ATIC deficit)	37.50	0	0	N/A
= Final ATIC deficit	0	0	0	0

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $50 of excess taxable income and $40 of deductible business interest expense. After grossing up each partner's final ATIC excess amounts by ten-thirds, excess taxable income is allocated dollar for dollar to partners with final ATIC excess amounts. Thus, PRS allocates its excess taxable income $50 to B. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. Therefore, A has deductible business interest expense of $30 ($30 − $0), B has deductible business interest expense of $10 ($10 − $0), and C has deductible business interest expense of $0 ($0 − $0).

TABLE 21 TO PARAGRAPH (o)(18)(xi)

	A	B	C	Total
Deductible BIE	$30	$10	$0	$40
EBIE allocated	0	0	0	0
ETI allocated	0	50	0	50
EBII allocated	0	0	0	0

(19) *Example 19: Facts*. A, B, and C own all of the interests in partnership PRS. In Year 1, PRS has $100 of ATI, $0 of business interest income, and $50 of business interest expense. PRS's ATI consists of $200 of gross income and $100 of gross deductions. PRS allocates its items comprising ATI $100 to A, $100 to B, and ($100) to C. PRS allocates its business interest expense $0 to A, $25 to B, and $25 to C.

(i) First, PRS determines its limitation pursuant to §1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $30 ($100 × 30 percent). Thus, PRS has $30 of deductible business interest expense and $20 of excess business interest expense.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation.

TABLE 22 TO PARAGRAPH (o)(19)(ii)

	A	B	C	Total
Allocable ATI	$100	$100	($100)	$100
Allocable BII	0	0	0	0
Allocable BIE	0	25	25	50

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. No partner has allocable business interest income. Consequently, each partner's allocable business interest income deficit is equal to such partner's allocable business interest expense. Thus, A's allocable business interest income deficit is $0, B's allocable business interest income deficit is $25, and C's allocable business interest income deficit is $25. The total allocable business interest income deficit is $50 ($0 + $25 + $25). No partner has allocable business interest income excess because no partner has allocable business interest income in excess of its allocable business interest expense. Thus, the total allocable business interest income excess is $0.

TABLE 23 TO PARAGRAPH (o)(19)(iii)

	A	B	C	Total
Allocable BII	$0	$0	$0	N/A
Allocable BIE	0	25	25	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	0	0	0	$0
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	0	25	25	50

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because no partner had any allocable business interest income excess, each partner has final allocable business interest income excess of $0.

(v) Fifth, PRS determines each partner's remaining business interest expense. Because no partner has any allocable business interest income excess, each partner's remaining business interest expense equals its allocable business interest income deficit. Thus, A's remaining business interest expense is $0, B's remaining business interest expense is $25, and C's remaining business interest expense is $25.

TABLE 24 TO PARAGRAPH (o)(19)(v)

	A	B	C	Total
Allocable BII deficit	$0	$25	$25	$50
Less: (Total allocable BII excess) × (Allocable BII deficit/ Total allocable BII deficit)	0	0	0	N/A
= Remaining BIE	0	25	25	N/A

(vi) Sixth, PRS determines each partner's final allocable ATI. Because C's allocable ATI is comprised of $100 of items of deduction and loss and $0 of income and gain, C has negative allocable ATI of $100. C is the only partner with negative allocable ATI. Thus, the total negative allocable ATI amount is $100. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, C has a positive allocable ATI of $0. Because A's allocable ATI is comprised of $100 of items of income and gain and $0 of deduction and loss, A has positive allocable ATI of $100. Because B's allocable ATI is comprised of $100 of items of income and gain and $0 of deduction and loss, B has positive allocable ATI of $100. Thus, the total positive allocable ATI is $200 ($100 + $100 + $0). PRS determines A's final allocable ATI by reducing, but not below $0, A's positive allocable ATI ($100) by the product of total negative allocable ATI ($100) and the ratio of A's positive allocable ATI to the total positive allocable ATI ($100/$200). Therefore, A's positive allocable ATI is reduced by $50 ($100 × 50 percent). As a result, A's final allocable ATI is $50. PRS determines B's final allocable ATI by reducing, but not below $0, B's positive allocable ATI ($100) by the product of total negative allocable ATI ($100) and the ratio of B's positive allocable ATI to the total positive allocable ATI ($100/$200). Therefore, B's positive allocable ATI is reduced by $50 ($100 × 50 percent). As a result, B's final allocable ATI is $50. Because C has a positive allocable ATI of $0, C's final allocable ATI is $0.

TABLE 25 TO PARAGRAPH (o)(19)(vi)

	A	B	C	Total
Allocable ATI	$100	$100	($100)	$100
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	0	0	100	100
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	100	100	0	200

TABLE 26 TO PARAGRAPH (o)(19)(vi)

	A	B	C	Total
Positive allocable ATI	$100	$100	$0	$200
Less: (Total negative allocable ATI) × (Positive allocable ATI/Total positive allocable ATI)	50	50	0	N/A
= Final allocable ATI	50	50	0	100

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $15 ($50 × 30 percent), B's ATIC amount is $15 ($50 × 30 percent), and C's ATIC amount is $0 ($0 × 30 percent). Because A's ATIC amount exceeds its remaining business interest expense by $15 ($15 − $0), A has an ATIC excess of $15. B and C do not have any ATIC excess. Thus, the total ATIC excess is $15 ($15 + $0 + $0). A does not have any ATIC deficit. Because B's remaining business interest expense exceeds its ATIC amount by $10 ($25 − $15), B has an ATIC deficit of $10. Because C's remaining business interest expense exceeds its ATIC amount by $25 ($25 − $0), C has an ATIC deficit of $25. Thus, the total ATIC deficit is $35 ($0 + $10 + $25).

TABLE 27 TO PARAGRAPH (o)(19)(vii)

	A	B	C	Total
ATIC (Final allocable ATI × 30 percent)	$15	$15	$0	N/A
Remaining BIE	0	25	25	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	15	0	0	$15
If remaining BIE exceeds ATIC, then such excess = ATIC deficit	0	10	25	35

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has—

(*1*) An excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATIC excess greater than $0 under paragraph (f)(2)(vii) of this section. Because PRS satisfies each of these three requirements, PRS must perform the calculations and make the necessary adjustments described under paragraphs (f)(2)(viii)(B) and (C) or (D) of this section.

(B) PRS must determine each partner's priority amount and usable priority amount. Only partners with an ATIC deficit under paragraph (f)(2)(vii) of this section can have a priority amount greater than $0. Thus, only partners B and C can have a priority amount greater than $0. PRS determines a partner's priority amount as 30 percent of the amount by which such partner's allocable positive ATI exceeds its final allocable ATI. Therefore, A's priority amount is $0, B's priority amount is $15 (($100 − $50) × 30 percent), and C's priority amount is $0 (($0 − $0) × 30 percent). Thus, the total priority amount is $15 ($0 + $15 + $0). Next, PRS must determine each partner's usable priority amount. Each partner's usable priority amount is the lesser of such partner's priority amount or ATIC deficit. Thus, A has a usable priority amount of $0, B has a usable priority amount of $10, and C has a usable priority amount of $0. As a result, the total usable priority amount is $10 ($0 + $10 + $0). Because the total ATIC excess under paragraph (f)(2)(vii) of this section ($15) is greater than the total usable priority amount ($10), PRS must perform the adjustments described in paragraph (f)(2)(viii)(C) of this section.

TABLE 28 TO PARAGRAPH (o)(19)(viii)(B)

	A	B	C	Total
(Positive allocable ATI—Final allocable ATI)	$0	$50	$0	N/A
Multiplied by 30 percent	30%	30%	30%	N/A
= Priority amount	$0	$15	$0	$15

TABLE 29 TO PARAGRAPH (o)(19)(viii)(B)

	A	B	C	Total
Priority amount	$0	$15	$0	N/A
ATIC deficit	0	10	25	N/A
Lesser of priority amount or ATIC deficit = Usable priority amount	0	10	0	$10

(C) For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATIC excess is $0. For purposes of paragraph (f)(2)(x) of this section, the following terms have the following meanings. Each partner's ATIC deficit is such partner's ATIC deficit as determined pursuant to paragraph (f)(2)(vii) of this section reduced by such partner's usable priority amount. Thus, A's ATIC deficit is $0 ($0 − $0), B's ATIC deficit is $0 ($10 − $10), and C's ATIC deficit is $25 ($25 − $0). The total ATIC deficit is the total ATIC deficit determined pursuant to paragraph (f)(2)(vii) ($35) reduced by the total usable priority amount ($10). Thus, the total ATIC deficit is $25 ($35 − $10). The total ATIC excess is the total ATIC excess determined pursuant to paragraph (f)(2)(vii) of this section ($15) reduced by the total usable priority amount ($10). Thus, the total ATIC excess is $5 ($15 − $5).

TABLE 30 TO PARAGRAPH (o)(19)(viii)(C)

	A	B	C	Total
ATIC deficit	$0	$10	$25	N/A

TABLE 30 TO PARAGRAPH (o)(19)(viii)(C)—Continued

	A	B	C	Total
Less: Usable priority amount	0	10	0	N/A
= ATIC deficit for purposes of paragraph (f)(2)(x) of this section	0	0	25	$25

(D)(1) In light of the fact that the total ATIC excess was greater than the total usable priority amount under paragraph (f)(2)(viii)(B) of this section, paragraph (f)(2)(viii)(D) of this section does not apply.

(2) In sum, the correct amounts to be used in paragraphs (o)(19)(ix) and (x) of this section are as follows.

TABLE 31 TO PARAGRAPH (o)(19)(viii)(D)(2)

	A	B	C	Total
ATIC excess	$5	$0	$0	$5
ATIC deficit	0	0	25	25

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Pursuant to paragraph (f)(2)(viii)(C) of this section, each partner's final ATIC excess amount is $0.

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because C has an ATIC deficit, PRS must determine C's final ATIC deficit amount. C's final ATIC deficit amount is C's ATIC deficit ($25), reduced, but not below $0, by the product of the total ATIC excess ($5) and the ratio of C's ATIC deficit to the total ATIC deficit ($25/$25). Therefore, C has $20 of final ATIC deficit ($25 − ($5 × 100 percent)).

TABLE 32 TO PARAGRAPH (o)(19)(x)

	A	B	C	Total
ATIC deficit	$0	$0	$25	N/A
Less: (Total ATIC excess) × (ATIC deficit/Total ATIC deficit)	0	0	5	N/A
= Final ATIC deficit	0	0	20	$20

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $20 of excess business interest expense. PRS allocates the excess business interest expense dollar for dollar to the partners with final ATIC deficits. Thus, PRS allocates its excess business interest expense $20 to C. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. Therefore, A has deductible business interest expense of $0 ($0 − $0), B has deductible business interest expense of $25 ($25 − $0), and C has deductible business interest expense of $5 ($25 − $20).

TABLE 33 TO PARAGRAPH (o)(19)(xi)

	A	B	C	Total
Deductible BIE	$0	$25	$5	$30
EBIE allocated	0	0	20	20
ETI allocated	0	0	0	0
EBII allocated	0	0	0	0

(20) *Example 20: Facts*. A, B, C, and D own all of the interests in partnership PRS. In Year 1, PRS has $200 of ATI, $0 of business interest income, and $140 of business interest expense. PRS's ATI consists of $600 of gross income and $400 of gross deductions. PRS allocates its items comprising ATI $100 to A, $100 to B, $400 to C, and ($400) to D. PRS allocates its business interest expense $0 to A, $40 to B, $60 to C, and $40 to D.

(i) First, PRS determines its limitation pursuant to §1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $60 ($200 × 30 percent). Thus, PRS has $60 of deductible business interest expense and $80 of excess business interest expense.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation.

TABLE 34 TO PARAGRAPH (o)(20)(ii)

	A	B	C	D	Total
Allocable ATI	$100	$100	$400	($400)	$200
Allocable BII	0	0	0	0	0
Allocable BIE	0	40	60	40	140

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. No partner has allocable business interest income. Consequently, each partner's allocable business interest income deficit is equal to such partner's allocable business interest expense. Thus, A's allocable business interest income deficit is $0, B's allocable business interest income deficit is $40, C's allocable business interest income deficit is $60, and D's allocable business interest income deficit is $40. The total allocable business interest income deficit is $140 ($0 + $40 + $60 + $40). No partner has allocable business interest income excess because no partner has allocable business interest income in excess of its allocable business interest expense. Thus, the total allocable business interest income excess is $0.

TABLE 35 TO PARAGRAPH (o)(20)(iii)

	A	B	C	D	Total
Allocable BII	$0	$0	$0	$0	N/A
Allocable BIE	0	40	60	40	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	0	0	0	0	$0
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	0	40	60	40	140

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because no partner has any allocable business interest income excess, each partner has final allocable business interest income excess of $0.

(v) Fifth, PRS determines each partner's remaining business interest expense. Because no partner has any allocable business interest income excess, each partner's remaining business interest expense equals its allocable business interest income deficit. Thus, A's remaining business interest expense is $0, B's remaining business interest expense is $40, C's remaining business interest expense is $60, and D's remaining business interest expense is $40.

TABLE 36 TO PARAGRAPH (o)(20)(v)

	A	B	C	D	Total
Allocable BII deficit	$0	$40	$60	$40	$140

TABLE 36 TO PARAGRAPH (o)(20)(v)—Continued

	A	B	C	D	Total
Less: (Total allocable BII excess) × (Allocable BII deficit/Total allocable BII deficit)	0	0	0	0	N/A
= Remaining BIE	0	40	60	40	N/A

(vi) Sixth, PRS determines each partner's final allocable ATI. Because D's allocable ATI is comprised of $400 of items of deduction and loss and $0 of income and gain, D has negative allocable ATI of $400. D is the only partner with negative allocable ATI. Thus, the total negative allocable ATI amount is $400. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, D has a positive allocable ATI of $0. PRS determines A's final allocable ATI by reducing, but not below $0, A's positive allocable ATI ($100) by the product of total negative allocable ATI ($400) and the ratio of A's positive allocable ATI to the total positive allocable ATI ($100/$600). Therefore, A's positive allocable ATI is reduced by $66.67 ($400 × 16.67 percent). As a result, A's final allocable ATI is $33.33. PRS determines B's final allocable ATI by reducing, but not below $0, B's positive allocable ATI ($100) by the product of total negative allocable ATI ($400) and the ratio of B's positive allocable ATI to the total positive allocable ATI ($100/$600). Therefore, B's positive allocable ATI is reduced by $66.67 ($400 × 16.67 percent). As a result, B's final allocable ATI is $33.33. PRS determines C's final allocable ATI by reducing, but not below $0, C's positive allocable ATI ($400) by the product of total negative allocable ATI ($400) and the ratio of C's positive allocable ATI to the total positive allocable ATI ($400/$600). Therefore, C's positive allocable ATI is reduced by $266.67 ($400 × 66.67 percent). As a result, C's final allocable ATI is $133.33. Because D has a positive allocable ATI of $0, D's final allocable ATI is $0.

TABLE 37 TO PARAGRAPH (o)(20)(vi)

	A	B	C	D	Total
Allocable ATI	$100	$100	$400	($400)	$200
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	0	0	0	400	400
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	100	100	400	0	600

TABLE 38 TO PARAGRAPH (o)(20)(vi)

	A	B	C	D	Total
Positive allocable ATI	$100	$100	$400	$0	$600
Less: (Total negative allocable ATI) × (Positive allocable ATI/Total positive allocable ATI)	66.67	66.67	266.67	0	N/A
= Final allocable ATI	33.33	33.33	133.33	0	200

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $10 ($33.33 × 30 percent), B's ATIC amount is $10 ($33.33 × 30 percent), C's ATIC amount is $40 ($133.33 × 30 percent), and D's ATIC amount is $0 ($0 × 30 percent). Because A's ATIC amount exceeds its remaining business interest expense by $10 ($10 − $0), A has an ATIC excess of $10. B, C, and D do not have any ATIC excess. Thus, the total ATIC excess is $10 ($10 + $0 + $0 + $0). A does not have any ATIC deficit. Because B's remaining business interest expense exceeds its ATIC amount by $30 ($40 − $10), B has an ATIC deficit of $30. Because C's remaining business interest expense exceeds its ATIC amount by $20 ($60 − $40), C has an ATIC deficit of $20. Because D's remaining business interest expense exceeds its ATIC amount by $40 ($40 − $0), D has an ATIC deficit of $40. Thus, the total ATIC deficit is $90 ($0 + $30 + $20 + $40).

TABLE 39 TO PARAGRAPH (o)(20)(vii)

—	A	B	C	D	Total
ATIC (Final allocable ATI × 30 percent)	$10	$10	$40	$0	N/A
Remaining BIE	0	40	60	40	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	10	0	0	0	$10
If remaining BIE exceeds ATIC, then such excess = ATIC deficit	0	30	20	40	90

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has (1) an excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section, (2) a total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section, and (3) a total ATIC excess amount greater than $0 under paragraph (f)(2)(vii) of this section. Because PRS satisfies each of these three requirements, PRS must perform the calculations and make the necessary adjustments described under paragraphs (f)(2)(viii)(B) and (C) or paragraph (f)(2)(viii)(D) of this section.

(B) PRS must determine each partner's priority amount and usable priority amount. Only partners with an ATIC deficit under paragraph (f)(2)(vii) of this section can have a priority amount greater than $0. Thus, only partners B, C, and D can have a priority amount greater than $0. PRS determines a partner's priority amount as 30 percent of the amount by which such partner's allocable positive ATI exceeds its final allocable ATI. Therefore, B's priority amount is $20 (($100 − $33.33) × 30 percent), C's priority amount is $80 (($400 − $133.33) × 30 percent), and D's priority amount is $0 (($0 − $0) × 30 percent). Thus, the total priority amount is $100 ($0 + $20 + $80 + $0). Next, PRS must determine each partner's usable priority amount. Each partner's usable priority amount is the lesser of such partner's priority amount or ATIC deficit. Thus, A has a usable priority amount of $0, B has a usable priority amount of $20, C has a usable priority amount of $20, and D has a usable priority amount of $0. As a result, the total usable priority amount is $40 ($0 + $20 + $20 + $0). Because the total usable priority amount ($40) is greater than the total ATIC excess under paragraph (f)(2)(vii) of this section ($10), PRS must perform the adjustments described in paragraph (f)(2)(viii)(D) of this section.

TABLE 40 TO PARAGRAPH (o)(20)(viii)(B)

	A	B	C	D	Total
(Positive allocable ATI—Final allocable ATI)	$0	$66.67	$266.67	$0	N/A
Multiplied by 30 percent	30%	30%	30%	30%	N/A
= Priority amount	0	20	80	0	$100

TABLE 41 TO PARAGRAPH (o)(20)(viii)(B)

	A	B	C	D	Total
Priority amount	$0	$20	$80	$0	N/A
ATIC deficit	0	30	20	40	N/A

TABLE 41 TO PARAGRAPH (o)(20)(viii)(B)—Continued

	A	B	C	D	Total
Lesser of priority amount or ATIC deficit = Usable priority amount	0	20	20	0	$40

(C) In light of the fact that the total usable priority amount is greater than the total ATIC excess under paragraph (f)(2)(viii)(B) of this section, paragraph (f)(2)(viii)(C) of this section does not apply.

(D)(*1*) Because B and C are the only partners with priority amounts greater than $0, B and C are priority partners, while A and D are non-priority partners. For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATIC excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, each non-priority partner's final ATIC deficit amount is such partner's ATIC deficit determined pursuant to paragraph (f)(2)(vii) of this section. Therefore, A has a final ATIC deficit of $0 and D has a final ATIC deficit of $40. Additionally, for purposes of paragraph (f)(2)(x) of this section, PRS must determine each priority partner's step eight excess share. A priority partner's step eight excess share is the product of the total ATIC excess and the ratio of the partner's priority amount to the total priority amount. Thus, B's step eight excess share is $2 ($10 × ($20/$100)) and C's step eight excess share is $8 ($10 × ($80/$100)). To the extent a priority partner's step eight excess share exceeds its ATIC deficit, the excess will be the partner's ATIC excess for purposes of paragraph (f)(2)(x) of this section. Thus, B and C each have an ATIC excess of $0, resulting in a total ATIC excess is $0. To the extent a priority partner's ATIC deficit exceeds its step eight excess share, the excess will be the partner's ATIC deficit for purposes of paragraph (f)(2)(x) of this section. Because B's ATIC deficit ($30) exceeds its step eight excess share ($2), B's ATIC deficit for purposes of paragraph (f)(2)(x) of this section is $28 ($30 − $2). Because C's ATIC deficit ($20) exceeds its step eight excess share ($8), C's ATIC deficit for purposes of paragraph (f)(2)(x) of this section is $12 ($20 − $8). Thus, the total ATIC deficit is $40 ($28 + $12).

TABLE 42 TO PARAGRAPH (o)(20)(viii)(D)(*1*)

	A	B	C	D	Total
Non-priority partners ATIC deficit in paragraph (f)(2)(vii) = Final ATIC deficit for purposes of paragraph (f)(2)(x) of this section	$0	N/A	N/A	$40	N/A

TABLE 43 TO PARAGRAPH (o)(20)(viii)(D)(*1*)

	A	B	C	D	Total
Priority partners step eight excess share = (Total ATIC excess) × (Priority/Total priority)	N/A	$2	$8	N/A	N/A
ATIC deficit	N/A	30	20	N/A	N/A
If step eight excess share exceeds ATIC deficit, then such excess = ATIC excess for purposes of paragraph (f)(2)(x) of this section	N/A	0	0	N/A	0
If ATIC deficit exceeds step eight excess share, then such excess = ATIC deficit for purposes of paragraph (f)(2)(x) of this section	N/A	28	12	N/A	40

(*2*) In sum, the correct amounts to be used in paragraphs (o)(20)(ix) and (x) of this section are as follows.

TABLE 44 TO PARAGRAPH (o)(20)(viii)(D)(2)

	A	B	C	D	Total
ATIC excess	$0	$0	$0	$0	$0
ATIC deficit	0	28	12	0	40
Non-priority partner final ATIC deficit	0	0	0	0	N/A

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Pursuant to paragraph (f)(2)(viii)(D) of this section, each priority and non-priority partner's final ATIC excess amount is $0.

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because B has an ATIC deficit, PRS must determine B's final ATIC deficit amount. B's final ATIC deficit amount is B's ATIC deficit ($28), reduced, but not below $0, by the product of the total ATIC excess ($0) and the ratio of B's ATIC deficit to the total ATIC deficit ($28/$40). Therefore, B has $28 of final ATIC deficit ($28 − ($0 × 70 percent)). Because C has an ATIC deficit, PRS must determine C's final ATIC deficit amount. C's final ATIC deficit amount is C's ATIC deficit ($12), reduced, but not below $0, by the product of the total ATIC excess ($0) and the ratio of C's ATIC deficit to the total ATIC deficit ($12/$40). Therefore, C has $12 of final ATIC deficit ($12 − ($0 × 30 percent)). Pursuant to paragraph (f)(2)(viii)(D) of this section, D's final ATIC deficit amount is $40.

TABLE 45 TO PARAGRAPH (o)(20)(x)

	A	B	C	D	Total
ATIC deficit	N/A	$28	$12	N/A	N/A
Less: (Total ATIC excess) × (ATIC deficit/ Total ATIC deficit)	N/A	0	0	N/A	N/A
= Final ATIC deficit	$0	28	12	$40	$80

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $80 of excess business interest expense. PRS allocates the excess business interest expense dollar for dollar to the partners with final ATIC deficits. Thus, PRS allocates its excess business interest expense $28 to B, $12 to C, and $40 to D. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. Therefore, A has deductible business interest expense of $0 ($0 − $0), B has deductible business interest expense of $12 ($40 − $28), C has deductible business interest expense of $48 ($60 − $12), and D has deductible business interest expense of $0 ($40 − $40).

TABLE 46 TO PARAGRAPH (o)(20)(xi)

	A	B	C	D	Total
Deductible BIE	$0	$12	$48	$0	$60
EBIE allocated	0	28	12	40	80
ETI allocated	0	0	0	0	0
EBII allocated	0	0	0	0	0

(21) *Example 21: Facts*. A, B, C, and D own all of the interests in partnership PRS. In Year 1, PRS has $200 of ATI, $0 of business interest income, and $150 of

business interest expense. PRS's ATI consists of $500 of gross income and $300 of gross deductions. PRS allocates its items comprising ATI $50 to A, $50 to B, $400 to C, and ($300) to D. PRS allocates its business interest expense $0 to A, $50 to B, $50 to C, and $50 to D.

(i) First, PRS determines its limitation pursuant to § 1.163(j)–2. PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $60 ($200 × 30 percent). Thus, PRS has $60 of deductible business interest expense, and $90 of excess business interest expense.

(ii) Second, PRS determines each partner's allocable share of section 163(j) items used in its own section 163(j) calculation.

TABLE 47 TO PARAGRAPH (o)(21)(ii)

	A	B	C	D	Total
Allocable ATI	$50	$50	$400	($300)	$200
Allocable BII	0	0	0	0	0
Allocable BIE	0	50	50	50	150

(iii) Third, PRS compares each partner's allocable business interest income to such partner's allocable business interest expense. No partner has allocable business interest income. Consequently, each partner's allocable business interest income deficit is equal to such partner's allocable business interest expense. Thus, A's allocable business interest income deficit is $0, B's allocable business interest income deficit is $50, C's allocable business interest income deficit is $50, and D's allocable business interest income deficit is $50. The total allocable business interest income deficit is $150 ($0 + $50 + $50 + $50). No partner has allocable business interest income excess because no partner has allocable business interest income in excess of its allocable business interest expense. Thus, the total allocable business interest income excess is $0.

TABLE 48 TO PARAGRAPH (o)(21)(iii)

	A	B	C	D	Total
Allocable BII	$0	$0	$0	$0	N/A
Allocable BIE	0	50	50	50	N/A
If allocable BII exceeds allocable BIE, then such amount = Allocable BII excess	0	0	0	0	0
If allocable BIE exceeds allocable BII, then such amount = Allocable BII deficit	0	50	50	50	150

(iv) Fourth, PRS determines each partner's final allocable business interest income excess. Because no partner has any allocable business interest income excess, each partner has final allocable business interest income excess of $0.

(v) Fifth, PRS determines each partner's remaining business interest expense. Because no partner has any allocable business interest income excess, each partner's remaining business interest expense equals its allocable business interest income deficit. Thus, A's remaining business interest expense is $0, B's remaining business interest expense is $50, C's remaining business interest expense is $50, and D's remaining business interest expense is $50.

TABLE 49 TO PARAGRAPH (o)(21)(v)

	A	B	C	D	Total
Allocable BII deficit	$0	$50	$50	$50	$150
Less: (Total allocable BII excess) × (Allocable BII deficit/Total allocable BII deficit)	0	0	0	0	N/A

TABLE 49 TO PARAGRAPH (o)(21)(v)—Continued

	A	B	C	D	Total
= Remaining BIE	0	50	50	50	N/A

(vi) Sixth, PRS determines each partner's final allocable ATI. Because D's allocable ATI is comprised of $300 of items of deduction and loss and $0 of income and gain, D has negative allocable ATI of $300. D is the only partner with negative allocable ATI. Thus, the total negative allocable ATI amount is $300. Any partner with a negative allocable ATI, or an allocable ATI of $0, has a positive allocable ATI of $0. Therefore, D has a positive allocable ATI of $0. PRS determines A's final allocable ATI by reducing, but not below $0, A's positive allocable ATI ($50) by the product of total negative allocable ATI ($300) and the ratio of A's positive allocable ATI to the total positive allocable ATI ($50/$500). Therefore, A's positive allocable ATI is reduced by $30 ($300 × 10 percent). As a result, A's final allocable ATI is $20. PRS determines B's final allocable ATI by reducing, but not below $0, B's positive allocable ATI ($50) by the product of total negative allocable ATI ($300) and the ratio of B's positive allocable ATI to the total positive allocable ATI ($50/$500). Therefore, B's positive allocable ATI is reduced by $30 ($300 × 10 percent). As a result, B's final allocable ATI is $20. PRS determines C's final allocable ATI by reducing, but not below $0, C's positive allocable ATI ($400) by the product of total negative allocable ATI ($300) and the ratio of C's positive allocable ATI to the total positive allocable ATI ($400/$500). Therefore, C's positive allocable ATI is reduced by $240 ($300 × 80 percent). As a result, C's final allocable ATI is $160. Because D has a positive allocable ATI of $0, D's final allocable ATI is $0.

TABLE 50 TO PARAGRAPH (o)(21)(vi)

	A	B	C	D	Total
Allocable ATI	$50	$50	$400	($300)	$200
If deduction and loss items comprising allocable ATI exceed income and gain items comprising allocable ATI, then such excess amount = Negative allocable ATI	0	0	0	300	300
If income and gain items comprising allocable ATI equal or exceed deduction and loss items comprising allocable ATI, then such amount = Positive allocable ATI	50	50	400	0	500

TABLE 51 TO PARAGRAPH (o)(21)(vi)

	A	B	C	D	Total
Positive allocable ATI	$50	$50	$400	$0	$500
Less: (Total negative allocable ATI) × (Positive allocable ATI/Total positive allocable ATI)	30	30	240	0	N/A
= Final allocable ATI	20	20	160	0	200

(vii) Seventh, PRS compares each partner's ATI capacity (ATIC) amount to such partner's remaining business interest expense. A's ATIC amount is $6 ($20 × 30 percent), B's ATIC amount is $6 ($20 × 30 percent), C's ATIC amount is $48 ($160 × 30 percent), and D's ATIC amount is $0 ($0 × 30 percent). Because A's ATIC amount exceeds its remaining business interest expense by $6 ($6 − $0), A has an ATIC excess of $6. B, C, and D do not have any ATIC excess. Thus, the total ATIC excess amount is $6 ($6 + $0 + $0 + $0). A does not have any ATIC deficit. Because B's remaining business interest expense exceeds its ATIC amount by $44 ($50 − $6), B has an ATIC deficit of $44. Because C's remaining business interest expense exceeds its ATIC amount by $2 ($50 − $48), C has an ATIC deficit of $2. Because D's remaining business interest expense exceeds its ATIC amount by $50 ($50 − $0), D has an ATIC deficit of $50. Thus, the total ATIC deficit is $96 ($0 + $44 + $2 + $50).

TABLE 52 TO PARAGRAPH (o)(21)(vii)

	A	B	C	D	Total
ATIC (Final allocable ATI × 30 percent)	$6	$6	$48	$0	N/A
Remaining BIE	0	50	50	50	N/A
If ATIC exceeds remaining BIE, then such excess = ATIC excess	6	0	0	0	$6
If remaining BIE exceeds ATIC, then such excess = ATIC deficit	0	44	2	50	96

(viii)(A) Eighth, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section if, and only if, PRS has—

(*1*) An excess business interest expense greater than $0 under paragraph (f)(2)(i) of this section;

(*2*) A total negative allocable ATI greater than $0 under paragraph (f)(2)(vi) of this section; and

(*3*) A total ATIC excess amount greater than $0 under paragraph (f)(2)(vii) of this section. Because PRS satisfies each of these three requirements, PRS must perform the calculations and make the necessary adjustments described under paragraph (f)(2)(viii) of this section.

(B) PRS must determine each partner's priority amount and usable priority amount. Only partners with an ATIC deficit under paragraph (f)(2)(vii) of this section of this section can have a priority amount greater than $0. Thus, only partners B, C, and D can have a priority amount greater than $0. PRS determines a partner's priority amount as 30 percent of the amount by which such partner's allocable positive ATI exceeds its final allocable ATI. Therefore, B's priority amount is $9 (($50 − $20) × 30 percent), C's priority amount is $72 (($400 − $160) × 30 percent), and D's priority amount is $0 (($0 − $0) × 30 percent). Thus, the total priority amount is $81 ($0 + $9 + $72 + $0). Next, PRS must determine each partner's usable priority amount. Each partner's usable priority amount is the lesser of such partner's priority amount or ATIC deficit. Thus, B has a usable priority amount of $9, C has a usable priority amount of $2, and D has a usable priority amount of $0. As a result, the total usable priority amount is $11 ($0 + $9 + $2 + $0). Because the total usable priority amount ($11) is greater than the total ATIC excess ($6) under paragraph (f)(2)(vii) of this section, PRS must perform the adjustments described in paragraph (f)(2)(viii)(D) of this section.

TABLE 53 TO PARAGRAPH (o)(21)(viii)(B)

	A	B	C	D	Total
(Positive allocable ATI − Final allocable ATI)	$0	$30	$240	$0	N/A
Multiplied by 30 percent	30%	30%	30%	30%	N/A
= Priority amount	$0	$9	$72	$0	$81

TABLE 54 TO PARAGRAPH (o)(21)(viii)(B)

	A	B	C	D	Total
Priority amount	$0	$9	$72	$0	N/A
ATIC deficit	0	44	2	50	N/A
Lesser of priority amount or ATIC deficit = Usable priority amount	0	9	2	0	$11

(C) In light of the fact that the total usable priority amount is greater than the total ATIC excess under paragraph (f)(2)(viii)(B) of this section, paragraph (f)(2)(viii)(C) of this section does not apply.

(D)(*1*) Because B and C are the only partners with priority amounts greater than $0, B and C are priority partners, while A and D are non-priority partners. For purposes of paragraph (f)(2)(ix) of this section, each partner's final ATIC excess amount is $0. For purposes of paragraph (f)(2)(x) of this section, each non-priority partner's final ATIC deficit amount is such partner's ATIC deficit determined pursuant to paragraph (f)(2)(vii) of this section. Therefore, A has a final ATIC deficit of $0 and D has a final ATIC deficit of $50. Additionally, for purposes of paragraph (f)(2)(x) of this section, PRS must determine each priority partner's step eight excess share. A priority partner's step eight excess share is the product of the total ATIC excess and the ratio of the partner's priority amount to the total priority amount. Thus, B's step eight excess share is $0.67 ($6 × ($9/$81)) and C's step eight excess share is $5.33 ($6 × ($72/$81)). To the extent a priority partner's step eight excess share exceeds its ATIC deficit, the excess will be the partner's ATIC excess for purposes of paragraph (f)(2)(x) of this section. B's step eight excess share does not exceed its ATIC deficit. Because C's step eight excess share ($5.33) exceeds its ATIC deficit ($2), C's ATIC excess for purposes of paragraph (f)(2)(x) of this section is $3.33 ($5.33 − $2). Thus, the total ATIC excess for purposes of paragraph (f)(2)(x) of this section is $3.33 ($0 + $3.33). To the extent a priority partner's ATIC deficit exceeds its step eight excess share, the excess will be the partner's ATIC deficit for purposes of paragraph (f)(2)(x) of this section. Because B's ATIC deficit ($44) exceeds its step eight excess share ($0.67), B's ATIC deficit for purposes of paragraph (f)(2)(x) of this section is $43.33 ($44 − $0.67). C's ATIC deficit does not exceed its step eight excess share. Thus, the total ATIC deficit for purposes of paragraph (f)(2)(x) of this section is $43.33 ($43.33 + $0).

TABLE 55 TO PARAGRAPH (o)(21)(viii)(D)(1)

	A	B	C	D	Total
Non-priority partners ATIC deficit in paragraph (f)(2)(vii) = Final ATIC deficit for purposes of paragraph (f)(2)(x) of this section	$0	N/A	N/A	$50	N/A

TABLE 56 TO PARAGRAPH (o)(21)(viii)(D)(1)

	A	B	C	D	Total
Priority partners step eight excess share = (Total ATIC excess) × (Priority/Total priority)	N/A	$0.67	$5.33	N/A	N/A
ATIC deficit	N/A	44	2	N/A	N/A
If step eight excess share exceeds ATIC deficit, then such excess = ATIC excess for purposes of paragraph (f)(2)(x) of this section	N/A	0	3.33	N/A	$3.33
If ATIC deficit exceeds step eight excess share, then such excess = ATIC deficit for purposes of paragraph (f)(2)(x) of this section	N/A	43.33	0	N/A	43.33

(*2*) In sum, the correct amounts to be used in paragraphs (o)(21)(ix) and (x) of this section are as follows.

TABLE 57 TO PARAGRAPH (o)(21)(viii)(D)(2)

	A	B	C	D	Total
ATIC excess	$0	$0	$3.33	$0	$3.33
ATIC deficit	0	43.33	0	0	43.33
Non-priority partner final ATIC deficit	0	0	0	50	N/A

(ix) Ninth, PRS determines each partner's final ATIC excess amount. Pursuant to paragraph (f)(2)(viii)(D) of this section, each priority and non-priority partner's final ATIC excess amount is $0.

(x) Tenth, PRS determines each partner's final ATIC deficit amount. Because B has an ATIC deficit, PRS must determine B's final ATIC deficit amount. B's final ATIC deficit amount is B's ATIC deficit ($43.33), reduced, but not below $0, by the product of the total ATIC excess ($3.33) and the ratio of B's ATIC deficit to the total ATIC deficit ($43.33/$43.33). Therefore, B has $40 of final ATIC deficit ($43.33 − ($3.33 × 100 percent)). Pursuant to paragraph (f)(2)(viii)(D) of this section, D's final ATIC deficit amount is $40.

TABLE 58 TO PARAGRAPH (o)(21)(x)

	A	B	C	D	Total
ATIC deficit	$0	$43.33	$0	N/A	N/A
Less: (Total ATIC excess) × (ATIC deficit/ Total ATIC deficit)	0	3.33	0	N/A	N/A
= Final ATIC deficit	0	40	0	$50	$90

(xi) Eleventh, PRS allocates deductible business interest expense and section 163(j) excess items to the partners. Pursuant to paragraph (f)(2)(i) of this section, PRS has $90 of excess business interest expense. PRS allocates the excess business interest expense dollar for dollar to the partners with final ATIC deficits. Thus, PRS allocates its excess business interest expense $40 to B and $50 to D. A partner's allocable business interest expense is deductible business interest expense to the extent it exceeds such partner's share of excess business interest expense. Therefore, A has deductible business interest expense of $0 ($0 − $0), B has deductible business interest expense of $10 ($50 − $40), C has deductible business interest expense of $50 ($50 − $0), and D has deductible business interest expense of $0 ($50 − $50).

TABLE 59 TO PARAGRAPH (o)(21)(xi)

	A	B	C	D	Total
Deductible BIE	$0	$10	$50	$0	$60
EBIE allocated	0	40	0	50	90
ETI allocated	0	0	0	0	0
EBII allocated	0	0	0	0	0

(22) *Example 22*—(i) *Facts*. A and B are equal shareholders in X, a subchapter S corporation. In Year 1, X has $100 of ATI and $40 of business interest expense. A has $100 of ATI and $20 of business interest expense from its sole proprietorship. B has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *S corporation-level*. In Year 1, X's section 163(j) limit is 30 percent of its ATI, or $30 ($100 × 30 percent). Thus, X has $30 of deductible business interest expense and $10 of disallowed business interest expense. Such $30 of deductible business interest expense is includable in X's nonseparately stated income or loss, and is not subject to further limitation under section 163(j). X carries forward the $10 of disallowed business interest expense to Year 2 as a disallowed business interest expense carryforward under §1.163(j)–2(c). X may not currently deduct all $40 of its business interest expense in Year 1. X only reduces its accumulated adjustments account in Year 1 by the $30 of deductible business interest expense in Year 1 under §1.163(j)–6(l)(7).

(iii) *Shareholder allocations.* A and B are each allocated $35 of nonseparately stated taxable income ($50 items of income or gain, less $15 of deductible business interest expense) from X. A and B do not reduce their basis in X by the $10 of disallowed business interest expense.

(iv) *Shareholder-level computations.* A, in computing its limit under section 163(j), has $100 of ATI and $20 of business interest expense from its sole proprietorship. A's section 163(j) limit is $30 ($100 × 30 percent). Thus, A's $20 of business interest expense is deductible business interest expense. B, in computing its limit under section 163(j), has $20 of business interest expense from its sole proprietorship. B's section 163(j) limit is $0 ($0 × 30 percent). Thus, B's $20 of business interest expense is not allowed as a deduction and is treated as business interest expense paid or accrued by B in Year 2.

(23) *Example 23*—(i) *Facts.* The facts are the same as in *Example 22* in paragraph (o)(22)(i) of this section. In Year 2, X has $233.33 of ATI, $0 of business interest income, and $30 of business interest expense. A has $100 of ATI and $20 of business interest expense from its sole proprietorship. B has $0 of ATI and $20 of business interest expense from its sole proprietorship.

(ii) *S corporation-level.* In Year 2, X's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $70 ($233.33 × 30 percent). Because X's section 163(j) limit exceeds X's $40 of business interest expense ($30 from Year 2, plus the $10 disallowed business interest expense carryforwards from Year 1), X may deduct all $40 of business interest expense in Year 2. Such $40 of deductible business interest expense is includable in X's nonseparately stated income or loss, and is not subject to further limitation under section 163(j). Pursuant to §1.163(j)–6(l)(7), X must reduce its accumulated adjustments account by $40. Additionally, X has $100 of excess taxable income under §1.163(j)–1(b)(17).

(iii) *Shareholder allocations.* A and B are each allocated $96.67 of nonseparately stated taxable income ($116.67 items of income or gain, less $20 of deductible business interest expense) from X. Additionally, A and B are each allocated $50 of excess taxable income under §1.163(j)–6(l)(4). As a result, A and B each increase their ATI by $50.

(iv) *Shareholder-level computations.* A, in computing its limit under section 163(j), has $150 of ATI ($100 from its sole proprietorship, plus $50 excess taxable income) and $20 of business interest expense (from its sole proprietorship). A's section 163(j) limit is $45 ($150 × 30 percent). Thus, A's $20 of business interest expense is deductible business interest expense. B, in computing its limit under section 163(j), has $50 of ATI ($0 from its sole proprietorship, plus $50 excess taxable income) and $40 of business interest expense ($20 from its sole proprietorship, plus $20 disallowed business interest expense from its sole proprietorship in Year 1). B's section 163(j) limit is $15 ($50 × 30 percent). Thus, $15 of B's business interest expense is deductible business interest expense. The $25 of B's business interest expense not allowed as a deduction ($40 business interest expense, less $15 section 163(j) limit) is treated as business interest expense paid or accrued by B in Year 3.

(24) *Example 24*—(i) *Facts.* On January 1, 2020, L and M form LM, a publicly traded partnership (as defined in §1.7704–1), and agree that each will be allocated a 50 percent share of all LM items. The partnership agreement provides that LM will make allocations under section 704(c) using the remedial allocation method under §1.704–3(d). L contributes depreciable property with an adjusted tax basis of $4,000 and a fair market value of $10,000. The property is depreciated using the straight-line method with a 10-year recovery period and has 4 years remaining on its recovery period. M contributes $10,000 in cash, which LM uses to purchase land. Except for the depreciation deductions, LM's expenses equal its income in each year of the 10 years commencing with the year LM is formed.

LM has a valid section 754 election in effect.

(ii) *Section 163(j) remedial items and partner basis items.* LM sells the asset contributed by L in a fully taxable transaction at a time when the adjusted basis of the property is $4,000. Under §1.163(j)–6(e)(2)(ii), solely for purposes of §1.163(j)–6, the tax gain of $6,000 is allocated equally between L and M ($3,000 each). To avoid shifting built-in gain to the non-contributing partner (M) in a manner consistent with the rule in section 704(c), a remedial deduction of $3,000 is allocated to M (leaving M with no net tax gain), and remedial income of $3,000 is allocated to L (leaving L with total tax gain of $6,000).

(25) *Example 25*—(i) *Facts.* The facts are the same as *Example 24* in paragraph (o)(24) of this section except the property contributed by L had an adjusted tax basis of zero. For each of the 10 years following the contribution, there would be $500 of section 704(c) remedial income allocated to L and $500 of remedial deductions allocated to M with respect to the contributed asset. A buyer of M's units would step into M's shoes with respect to the $500 of annual remedial deductions. A buyer of L's units would step into L's shoes with respect to the $500 of annual remedial income and would have an annual section 743(b) deduction of $1,000 (net $500 of deductions).

(ii) *Analysis.* Pursuant to §1.163(j)–6(d)(2)(ii), solely for purposes of §1.163(j)–6, a buyer of L's units immediately after formation of LM would offset its $500 annual section 704(c) remedial income allocation with $500 of annual section 743(b) adjustment (leaving the buyer with net $500 of section 743(b) deduction). As a result, such buyer would be in the same position as a buyer of M's units. Each buyer would have net deductions of $500 per year, which would not affect ATI before 2022.

(26) *Example 26*—(i) *Facts.* X and Y are partners in partnership PRS. In Year 1, PRS had $200 of excess business interest expense. Pursuant to §1.163(j)–6(f)(2), PRS allocated $100 of such excess business interest expense to each of its partners. In Year 2, X lends $10,000 to PRS and receives $1,000 of interest income for the taxable year (self-charged lending transaction). X is not in the trade or business of lending money. The $1,000 of interest expense resulting from this loan is allocable to PRS's trade or business assets. As a result, such $1,000 of interest expense is business interest expense of PRS. X and Y are each allocated $500 of such business interest expense as their distributive share of PRS's business interest expense for the taxable year. Additionally, in Year 2, PRS has $3,000 of ATI. PRS allocates the items comprising its $3,000 of ATI $0 to X and $3,000 to Y.

(ii) *Partnership-level.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or $900 ($3,000 × 30 percent). Thus, PRS has $900 of deductible business interest expense, $100 of excess business interest expense, $0 of excess taxable income, and $0 of excess business interest income. Pursuant to §1.163(j)–6(f)(2), $400 of X's allocation of business interest expense is treated as deductible business interest expense, $100 of X's allocation of business interest expense is treated as excess business interest expense, and $500 of Y's allocation of business interest expense is treated as deductible business interest expense.

(iii) *Lending partner.* Pursuant to §1.163(j)–6(n), X treats $100 of its $1,000 of interest income as excess business interest income allocated from PRS in Year 2. Because X is deemed to have been allocated $100 of excess business interest income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess business interest income is allocated from such partnership to a partner, X treats its $100 allocation of excess business interest expense from PRS in Year 2 as business interest expense paid or accrued in Year 2. X, in computing its limit under section 163(j), has $100 of business interest income ($100 deemed allocation of excess business interest income from PRS in Year 2) and $100 of business interest expense ($100 allocation of excess business interest expense treated as paid or accrued in Year 2). Thus, X's $100 of business interest expense is deductible business interest expense. At the end of Year 2, X has $100 of excess business interest expense from PRS

($100 from Year 1). X treats $900 of its $1,000 of interest income as investment income for purposes of section 163(d).

(27)–(33) [Reserved]

(34) *Example 34*—(i) *Facts*. X and Y are equal partners in partnership PRS. Further, X and Y share the profits of PRS equally. In 2019, PRS had ATI of $100. Additionally, in 2019, PRS had $100 of section 704(b) income which was allocated $50 to X and $50 to Y (PRS did not have any section 704(c) income in 2019). In 2020, PRS's only items of income, gain, loss or deduction was $1 of trade or business income, which it allocated to X pursuant to section 704(c).

(ii) *Partnership-level*. In 2020, PRS makes the election described in §1.163(j)–6(d)(5) to use its 2019 ATI in 2020. As a result, PRS has $100 of ATI in 2020. PRS does not have any business interest expense. Therefore, PRS has $100 of excess taxable income in 2020.

(iii) *Partner-level allocations*. PRS allocates its $100 of excess taxable income to X and Y pursuant to §1.163(j)–6(f)(2). To determine each partner's share of the $100 of excess taxable income, PRS must determine each partner's allocable ATI (as defined in §1.163(j)–6(f)(2)(ii)). Because PRS made the election described in §1.163(j)–6(d)(5), PRS must determine the allocable ATI of each of its partners pursuant to paragraph (d)(5). Specifically, PRS determines each partner's share of allocable ATI based on PRS's 2019 section 704 income, gain, loss, and deduction. PRS had $100 of section 704(b) income in 2019 which was allocated $50 to X and $50 to Y. Therefore, in 2020, X and Y are both allocated $50 of excess taxable income (50% × $100).

(35) *Example 35*—(i) *Facts*. X, a partner in partnership PRS, was allocated $20 of excess business interest expense from PRS in 2018 and $10 of excess business interest expense from PRS in 2019. In 2020, PRS allocated $16 of excess taxable income to X.

(ii) *Analysis*. X treats 50 percent of its $10 of excess business interest expense allocated from PRS in 2019 as §1.163(j)–6(g)(4) business interest expense. Thus, $5 of §1.163(j)–6(g)(4) business interest expense is treated as paid or accrued by X in 2020 and is not subject to the section 163(j) limitation at X's level. Because X was allocated $16 of excess taxable income from PRS in 2020, X treats $16 of its $25 of excess business interest expense as business interest expense paid or accrued pursuant to §1.163(j)–6(g)(2). X, in computing its limit under section 163(j) in 2020, has $16 of ATI (as a result of its allocation of $16 of excess taxable income from PRS), $0 of business interest income, and $16 of business interest expense ($16 of excess business interest expense treated as paid or accrued in 2020). Pursuant to §1.163(j)–2(b)(2)(i), X's section 163(j) limit in 2020 is $8 ($16 × 50 percent). Thus, X has $8 of business interest expense that is deductible under section 163(j). The $8 of X's business interest expense not allowed as a deduction ($16 business interest expense subject to section 163(j), less $8 section 163(j) limit) is treated as business interest expense paid or accrued by X in 2021. At the end of 2020, X has $9 of excess business interest expense from PRS ($20 from 2018, plus $10 from 2019, less $5 treated as paid or accrued pursuant to §1.163(j)–6(g)(4), less $16 treated as paid or accrued pursuant to §1.163(j)–6(g)(2)).

(36) *Example 36*—(i) *Facts*. X is a partner in partnership PRS. At the beginning of 2018, X's outside basis in PRS was $100. X was allocated $20 of excess business interest expense from PRS in 2018 and $10 of excess business interest expense from PRS in 2019. X sold its PRS interest in 2019 for $70.

(ii) *Analysis*. X treats 50 percent of its $10 of excess business interest expense allocated from PRS in 2019 as §1.163(j)–6(g)(4) business interest expense. Thus, $5 of §1.163(j)–6(g)(4) business interest expense is treated as paid or accrued by X in 2020 and is not subject to the section 163(j) limitation at X's level. Pursuant to paragraph (h)(3) of this section, immediately before the disposition, X increases the basis of its PRS interest from $70 to $95 (add back of $20 of EBIE from 2018 and $5 of remaining EBIE from 2019). Thus, X has a $25 section 741 loss recognized on the sale ($70 − $95).

(p) *Applicability dates*. (1)*In general*. This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year.

(2) *Paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5), (f)(1)(iii), (g)(4), (n), and (o)(24) through (29), and (34) through (36).* Paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5), (f)(1)(iii), (g)(4), (n), and (o)(24) through (29), and (34) through (36) of this section apply 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 paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5), (f)(1)(iii), (g)(4), (n), and (o)(24) through (29), and (34) through (36) to 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 in T.D. 9905 (§§1.163(j)–0 through 1.163(j)–11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4 contained in T.D. 9905 as modified by T.D. 9943, for that taxable year and for each subsequent taxable year.

[T.D. 9905, 85 FR 56760, Sept. 14, 2020, as amended by T.D. 9943, 86 FR 5529, Jan. 19, 2021]

§ 1.163(j)–7 Application of the section 163(j) limitation to foreign corporations and United States shareholders.

(a) *Overview.* This section provides rules for the application of section 163(j) to relevant foreign corporations and United States shareholders of relevant foreign corporations. Paragraph (b) of this section provides the general rule regarding the application of section 163(j) to a relevant foreign corporation. Paragraph (c) of this section provides rules for applying section 163(j) to CFC group members of a CFC group. Paragraph (d) of this section provides rules for determining a specified group and specified group members. Paragraph (e) of this section provides rules and procedures for treating a specified group member as a CFC group member and for determining a CFC group. Paragraph (f) of this section provides rules regarding the treatment of a CFC group member that has ECI. Paragraph (g) of this section provides rules concerning the computation of ATI of an applicable CFC. Paragraph (h) of this section provides a safe harbor that exempts certain stand-alone applicable CFCs and CFC groups from the application of section 163(j) for a taxable year. Paragraphs (i) and (j) of this section are reserved. Paragraph (k) of this section provides definitions that apply for purposes of this section (see also §1.163(j)–1 for additional definitions). Paragraph (l) of this section provides examples illustrating the application of this section.

(b) *General rule regarding the application of section 163(j) to relevant foreign corporations.* Except as otherwise provided in this section, section 163(j) and the section 163(j) regulations apply to determine the deductibility of a relevant foreign corporation's business interest expense for purposes of computing its taxable income for U.S. income tax purposes (if any) in the same manner as those provisions apply to determine the deductibility of a domestic C corporation's business interest expense for purposes of computing its taxable income. See also §1.952–2. If a relevant foreign corporation is a direct or indirect partner in a partnership, see §1.163(j)–6 (concerning the application of section 163(j) to partnerships).

(c) *Application of section 163(j) to CFC group members of a CFC group*—(1) *Scope*. This paragraph (c) provides rules for applying section 163(j) to a CFC group and a CFC group member. Paragraph (c)(2) of this section provides rules for computing a single section 163(j) limitation for a specified period of a CFC group. Paragraph (c)(3) of this section provides rules for allocating a CFC group's section 163(j) limitation to CFC group members for specified taxable years. Paragraph (c)(4) of this section provides currency translation rules. Paragraph (c)(5) of this section provides special rules for specified periods beginning in 2019 or 2020.

(2) *Calculation of section 163(j) limitation for a CFC group for a specified period*—(i) *In general*. A single section 163(j) limitation is computed for a specified period of a CFC group. For purposes of applying section 163(j) and the section 163(j) regulations, the current-year business interest expense, disallowed business interest expense carryforwards, business interest income, floor plan financing interest expense, and ATI of a CFC group for a specified period equal the sums of each CFC group member's respective amounts for its specified taxable year with respect to the specified period. A CFC group member's current-year business interest expense, business interest income, floor plan financing interest expense, and ATI for a specified taxable year are generally determined on a separate-company basis. For purposes of determining the ATI of a CFC group, §1.163(j)–1(b)(1)(vii) (providing that ATI cannot be less than zero) applies with respect to the ATI of the CFC group but not the ATI of any CFC group member.

(ii) *Certain transactions between CFC group members disregarded*. Any transaction between CFC group members of a CFC group that is entered into with a principal purpose of affecting a CFC group or a CFC group member's section 163(j) limitation by increasing or decreasing a CFC group or a CFC group member's ATI or business interest income for a specified taxable year is disregarded for purposes of applying section 163(j) and the section 163(j) regulations.

(3) *Deduction of business interest expense*—(i) *CFC group business interest expense*—(A) *In general*. The extent to which a CFC group member's current-year business interest expense and disallowed business interest expense carryforwards for a specified taxable year that ends with or within a specified period may be deducted under section 163(j) is determined under the rules and principles of §1.163(j)–5(a)(2) and (b)(3)(ii), subject to the modifications described in paragraph (c)(3)(i)(B) of this section.

(B) *Modifications to relevant terms*. For purposes of paragraph (c)(3)(i)(A) of this section, the rules and principles of §1.163(j)–5(b)(3)(ii) are applied by—

(*1*) Replacing ''§1.163(j)–4(d)(2)'' in §1.163(j)–5(a)(2)(ii) with ''§1.163(j)–7(c)(2)(i)'';

(*2*) Replacing the term ''allocable share of the consolidated group's remaining section 163(j) limitation'' with ''allocable share of the CFC group's remaining section 163(j) limitation'';

(*3*) Replacing the terms ''consolidated group'' and ''group'' with ''CFC group'';

(*4*) Replacing the term ''consolidated group's remaining section 163(j) limitation'' with ''CFC group's remaining section 163(j) limitation'';

(*5*) Replacing the term ''consolidated return year'' with ''specified period'';

(*6*) Replacing the term ''current year'' or ''current-year'' with ''current specified period'' or ''specified taxable year with respect to the current specified period,'' as the context requires;

(*7*) Replacing the term ''member'' with ''CFC group member''; and

(*8*) Replacing the term ''taxable year'' with ''specified taxable year with respect to a specified period.''

(ii) *Carryforwards treated as attributable to the same taxable year*. For purposes of applying the principles of §1.163(j)–5(b)(3)(ii), as required under paragraph (c)(3)(i) of this section, CFC group members' disallowed business interest expense carryforwards that arose in specified taxable years with respect to the same specified period are treated as disallowed business interest expense carryforwards from taxable years ending on the same date and are deducted on a pro rata basis, under the principles of §1.163(j)–5(b)(3)(ii)(C)(*3*), pursuant to paragraph (c)(3)(i) of this section.

(iii) *Multiple specified taxable years of a CFC group member with respect to a specified period.* If a CFC group member has more than one specified taxable year (each year, an *applicable specified taxable year*) with respect to a single specified period of a CFC group, then all the applicable specified taxable years are taken into account for purposes of applying the principles of §1.163(j)–5(b)(3)(ii), as required under paragraph (c)(3)(i) of this section, with respect to the specified period. The portion of the section 163(j) limitation allocable to disallowed business interest expense carryforwards of the CFC group member that arose in taxable years before the first applicable specified taxable year is prorated among the applicable specified taxable years in proportion to the number of days in each applicable specified taxable year.

(iv) *Limitation on pre-group disallowed business interest expense carryforward*—(A) *General rule*—(*1*) *CFC group member pre-group disallowed business interest expense carryforward.* This paragraph (c)(3)(iv) applies to pre-group disallowed business interest expense carryforwards of a CFC group member. The amount of the pre-group disallowed business interest expense carryforwards described in the preceding sentence that may be included in any CFC group member's business interest expense deduction for any specified taxable year under this paragraph (c)(3) may not exceed the aggregate section 163(j) limitation for all specified periods of the CFC group, determined by reference only to the CFC group member's items of income, gain, deduction, and loss, and reduced (including below zero) by the CFC group member's business interest expense (including disallowed business interest expense carryforwards) taken into account as a deduction by the CFC group member in all specified taxable years in which the CFC group member has continuously been a CFC group member of the CFC group (*cumulative section 163(j) pre-group carryforward limitation*).

(*2*) *Subgrouping.* In the case of a pre-group disallowed business interest expense carryforward, a pre-group subgroup is composed of the CFC group member with the pre-group disallowed business interest expense carryforward (the *loss member*) and each other CFC group member of the loss member's CFC group (the *current group*) that was a member of the CFC group in which the pre-group disallowed business interest expense carryforward arose and joined the specified group of the current group at the same time as the loss member. A CFC group member that is a member of a pre-group subgroup remains a member of the pre-group subgroup until its first taxable year during which it ceases to be a member of the same specified group as the loss member. For purposes of this paragraph (c), the rules and principles of §1.163(j)–5(d)(1)(B) apply to a pre-group subgroup as if the pre-group subgroup were a SRLY subgroup.

(*3*) *Transition rule.* Solely for purposes of paragraph (c)(3)(iv)(A)(*2*) of this section, a CFC group includes a group of applicable CFCs for which a CFC group election was made under guidance under section 163(j) published on December 28, 2018. Therefore, if the requirements of paragraph (c)(3)(iv)(A)(*2*) of this section are satisfied, a group of applicable CFCs described in the preceding sentence may be treated as a pre-group subgroup.

(B) *Deduction of pre-group disallowed business interest expense carryforwards.* Notwithstanding paragraph (c)(3)(iv)(A)(*1*) of this section, pre-group disallowed business interest expense carryforwards are available for deduction by a CFC group member in its specified taxable year only to the extent the CFC group has remaining section 163(j) limitation for the specified period after the deduction of current-year business interest expense and disallowed business interest expense carryforwards from earlier taxable years that are permitted to be deducted in specified taxable years of CFC group members with respect to the specified period. See paragraph (c)(3)(i) of this section and §1.163(j)–5(b)(3)(ii)(A). Pre-group disallowed business interest expense carryforwards are deducted on a pro rata basis (under the principles of paragraph (c)(3)(i) of this section and §1.163(j)–5(b)(3)(ii)(C)(*4*)) with other disallowed business interest expense carryforwards from taxable years ending on the same date.

(4) *Currency translation.* For purposes of applying this paragraph (c), items of a CFC group member are translated into a single currency for the CFC group and back to the functional currency of the CFC group member using the average exchange rate for the CFC group member's specified taxable year. The single currency for the CFC group may be the U.S. dollar or the functional currency of a plurality of the CFC group members.

(5) *Special rule for specified periods beginning in 2019 or 2020*—(i) *50 percent ATI limitation applies to a specified period of a CFC group.* In the case of a CFC group, §1.163(j)–2(b)(2) (including the election under §1.163(j)–2(b)(2)(ii)) applies to a specified period of the CFC group beginning in 2019 or 2020, rather than to a specified taxable year of a CFC group member. An election under §1.163(j)–2(b)(2)(ii) for a specified period of a CFC group is not effective unless made by each designated U.S. person. Except as otherwise provided in this paragraph (c)(5)(i), the election is made in accordance with Revenue Procedure 2020–22, 2020–18 I.R.B. 745. For purposes of applying §1.964–1(c), the election is treated as if made for each CFC group member.

(ii) *Election to use 2019 ATI applies to a specified period of a CFC group*—(A) *In general.* In the case of a CFC group, for purposes of applying paragraph (c)(2) of this section, an election under §1.163(j)–2(b)(3)(i) is made for a specified period of a CFC group beginning in 2020 and applies to the specified taxable years of each CFC group member with respect to such specified period, taking into account the application of paragraph (c)(5)(ii)(B) of this section. The election under §1.163(j)–2(b)(3)(i) does not apply to any specified taxable year of a CFC group member other than those described in the preceding sentence. An election under §1.163(j)–2(b)(3)(i) for a specified period of a CFC group is not effective unless made by each designated U.S. person. Except as otherwise provided in this paragraph (c)(5)(ii)(A), the election is made in accordance with Revenue Procedure 2020–22, 2020–18 I.R.B. 745. For purposes of applying §1.964–1(c), the election is treated as if made for each CFC group member.

(B) *Specified taxable years that do not begin in 2020.* If a specified taxable year of a CFC group member with respect to the specified period described in paragraph (c)(5)(ii)(A) of this section begins in 2019, then, for purposes of applying paragraph (c)(2) of this section, §1.163(j)–2(b)(3) is applied to such specified taxable year by substituting "2018" for "2019" and "2019" for "2020." If a specified taxable year of a CFC group member with respect to the specified period described in paragraph (c)(5)(ii)(A) of this section begins in 2021, then, for purposes of applying paragraph (c)(2) of this section, §1.163(j)–2(b)(3) is applied to such specified taxable year by substituting "2020" for "2019" and "2021" for "2020."

(d) *Determination of a specified group and specified group members*—(1) *Scope.* This paragraph (d) provides rules for determining a specified group and specified group members. Paragraph (d)(2) of this section provides rules for determining a specified group. Paragraph (d)(3) of this section provides rules for determining specified group members.

(2) *Rules for determining a specified group*—(i) *Definition of a specified group.* Subject to paragraph (d)(2)(ii) of this section, the term *specified group* means one or more applicable CFCs or chains of applicable CFCs connected through stock ownership with a specified group parent (which is included in the specified group only if it is an applicable CFC), but only if—

(A) The specified group parent owns directly or indirectly stock meeting the requirements of section 1504(a)(2)(B) in at least one applicable CFC; and

(B) Stock meeting the requirements of section 1504(a)(2)(B) in each of the applicable CFCs (except the specified group parent) is owned directly or indirectly by one or more of the other applicable CFCs or the specified group parent.

(ii) *Indirect ownership.* For purposes of applying paragraph (d)(2)(i) of this section, stock is owned indirectly only if it is owned under section 318(a)(2)(A) through a partnership or under section 318(a)(2)(A) or (B) through an estate or trust not described in section 7701(a)(30).

(iii) *Specified group parent.* The term *specified group parent* means a qualified U.S. person or an applicable CFC.

(iv) *Qualified U.S. person.* The term *qualified U.S. person* means a United States person described in section 7701(a)(30)(A) or (C). For purposes of this paragraph (d), members of a consolidated group that file (or that are required to file) a consolidated U.S. Federal income tax return are treated as a single qualified U.S person and individuals described in section 7701(a)(30)(A) whose filing status is married filing jointly are treated as a single qualified U.S. person.

(v) *Stock.* For purposes of this paragraph (d)(2), the term *stock* has the same meaning as ''stock'' in section 1504 (without regard to §1.1504–4, except as provided in paragraph (d)(2)(vi) of this section) and all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(vi) *Options treated as exercised.* For purposes of this paragraph (d)(2), options that are reasonably certain to be exercised, as determined under §1.1504–4(g), are treated as exercised. For purposes of this paragraph (d)(2)(vi), options include call options, warrants, convertible obligations, put options, and any other instrument treated as an option under §1.1504–4(d), determined by replacing the term ''a principal purpose of avoiding the application of section 1504 and this section'' with ''a principal purpose of avoiding the application of section 163(j).''

(vii) *When a specified group ceases to exist.* The principles of §1.1502–75(d)(1), (d)(2)(i) and (ii), and (d)(3)(i) through (iv) apply for purposes of determining when a specified group ceases to exist. Solely for purposes of applying these principles, references to the common parent are treated as references to the specified group parent and each applicable CFC that is treated as a specified group member for a taxable year with respect to a specified period is treated as affiliated with the specified group parent from the beginning to the end of the specified period, without regard to the beginning or end of its taxable year.

(3) *Rules for determining a specified group member.* If two or more applicable CFCs are included in a specified group on the last day of a taxable year of each applicable CFC that ends with or within a specified period, then each applicable CFC is a *specified group member* with respect to the specified period for its entire taxable year ending with or within the specified period. If only one applicable CFC is included in a specified group on the last day of its taxable year that ends with or within the specified period, it is not a specified group member. If an applicable CFC has multiple taxable years that end with or within a specified period, this paragraph (d)(3) is applied separately to each taxable year to determine if the applicable CFC is a specified group member for such taxable year.

(e) *Rules and procedures for treating a specified group as a CFC group*—(1) *Scope.* This paragraph (e) provides rules and procedures for treating a specified group member as a CFC group member and for determining a CFC group for purposes of applying section 163(j) and the section 163(j) regulations.

(2) *CFC group and CFC group member*—(i) *CFC group.* The term *CFC group* means, with respect to a specified period, all CFC group members for their specified taxable years.

(ii) *CFC group member.* The term *CFC group member* means, with respect to a specified taxable year and a specified period, a specified group member of a specified group for which a CFC group election is in effect. However, notwithstanding the prior sentence, a specified group member is not treated as a CFC group member for a taxable year of the specified group member beginning before January 1, 2018.

(3) *Duration of a CFC group.* A CFC group continues until the CFC group election is revoked, or there is no longer a specified period with respect to the specified group. A failure to provide the information described in paragraph (e)(6) of this section does not terminate a CFC group election.

(4) *Joining or leaving a CFC group.* If an applicable CFC becomes a specified group member for a specified taxable year with respect to a specified period

of a specified group for which a CFC group election is in effect, the CFC group election applies to the applicable CFC and the applicable CFC becomes a CFC group member. If an applicable CFC ceases to be a specified group member for a specified taxable year with respect to a specified period of a specified group for which a CFC group election is in effect, the CFC group election terminates solely with respect to the applicable CFC.

(5) *Manner of making or revoking a CFC group election*—(i) *In general.* An election is made or revoked under this paragraph (e)(5) (*CFC group election*) with respect to a specified period of a specified group. A CFC group election remains in effect for each specified period of the specified group until revoked. A CFC group election that is in effect with respect to a specified period of a specified group applies to each specified group member for its specified taxable year that ends with or within the specified period. The making or revoking of a CFC group election is not effective unless made or revoked by each designated U.S. person.

(ii) *Revocation by election.* A CFC group election cannot be revoked with respect to any specified period beginning before 60 months following the last day of the specified period for which the election was made. Once a CFC group election has been revoked, a new CFC group election cannot be made with respect to any specified period beginning before 60 months following the last day of the specified period for which the election was revoked.

(iii) *Timing.* A CFC group election must be made or revoked with respect to a specified period of a specified group no later than the due date (taking into account extensions, if any) of the original Federal income tax return for the taxable year of each designated U.S. person in which or with which the specified period ends.

(iv) *Election statement.* To make or revoke a CFC group election for a specified period of a specified group, each designated U.S. person must attach a statement to its relevant Federal income tax or information return in accordance with publications, forms, instructions, or other guidance. The statement must include the name and taxpayer identification number of all designated U.S. persons, a statement that the CFC group election is being made or revoked, as applicable, the specified period for which the CFC group election is being made or revoked, and the name of each CFC group member and its specified taxable year with respect to the specified period. The statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance.

(v) *Effect of prior CFC group election.* A CFC group election is made solely pursuant to the provisions of this paragraph (e)(5), without regard to whether a CFC group election described in guidance under section 163(j) published on December 28, 2018, was in effect.

(6) *Annual information reporting.* Each designated U.S. person must attach a statement to its relevant Federal income tax or information return for each taxable year in which a CFC group election is in effect that contains information concerning the computation of the CFC group's section 163(j) limitation and the application of paragraph (c)(3) of this section to the CFC group in accordance with publications, forms, instructions, or other guidance.

(f) *Treatment of a CFC group member that has ECI*—(1) *In general.* If a CFC group member has ECI in its specified taxable year, then for purposes of section 163(j) and the section 163(j) regulations—

(i) The items, disallowed business interest expense carryforwards, and other attributes of the CFC group member that are ECI are treated as items, disallowed business interest expense carryforwards, and attributes of a separate applicable CFC (such deemed corporation, an *ECI deemed corporation*) that has the same taxable year and shareholders as the applicable CFC; and

(ii) The ECI deemed corporation is not treated as a specified group member for the specified taxable year.

(2) [Reserved]

(g) *Rules concerning the computation of adjusted taxable income of a relevant foreign corporation*—(1) *Tentative taxable income.* For purposes of computing the tentative taxable income of a relevant foreign corporation for a taxable year, the relevant foreign corporation's gross income and allowable deductions are determined under the principles of §1.952–2 or under the rules of section 882 for determining income that is, or deductions that are allocable to, effectively connected income, as applicable.

(2) *Treatment of certain dividends.* For purposes of computing the ATI of a relevant foreign corporation for a taxable year, any dividend included in gross income that is received from a related person, within the meaning of section 954(d)(3), with respect to the distributee is subtracted from tentative taxable income.

(3) *Treatment of certain foreign income taxes.* For purposes of computing the ATI of a relevant foreign corporation for a taxable year, no deduction is taken into account for any foreign income tax (as defined in §1.960–1(b), but substituting the phrase ''relevant foreign corporation'' for the phrase ''controlled foreign corporation'').

(4) *Anti-abuse rule*—(i) *In general.* If a specified group member of a specified group or an applicable partnership (*specified lender*) includes an amount (*payment amount*) in income and such amount is attributable to business interest expense incurred by another specified group member or an applicable partnership of the specified group (*specified borrower*) during its taxable year, then the ATI of the specified borrower for the taxable year is increased by the ATI adjustment amount if—

(A) The business interest expense is incurred with a principal purpose of reducing the Federal income tax liability of any United States shareholder of a specified group member (including over other taxable years);

(B) Absent the application of this paragraph (g)(4), the effect of the specified borrower treating all or part of the payment amount as disallowed business interest expense would be to reduce the Federal income tax liability of any United States shareholder of a specified group member; and

(C) Either no CFC group election is in effect with respect to the specified group or the specified borrower is an applicable partnership.

(ii) *ATI adjustment amount*—(A) *In general.* For purposes of this paragraph (g)(4), the term *ATI adjustment amount* means, with respect to a specified borrower and a taxable year, the product of 3⅓ and the lesser of the payment amount or the disallowed business interest expense, computed without regard to this paragraph (g)(4).

(B) *Special rule for taxable years or specified periods beginning in 2019 or 2020.* For any taxable year of an applicable CFC or specified taxable year of a CFC group member with respect to a specified period for which the section 163(j) limitation is determined based, in part, on 50 percent of ATI, in accordance with §1.163(j)–2(b)(2), paragraph (g)(4)(ii)(A) of this section is applied by substituting ''2'' for ''3⅓.''

(iii) *Applicable partnership.* For purposes of this paragraph (g)(4), the term *applicable partnership* means, with respect to a specified group, a partnership in which at least 80 percent of the interests in profits or capital is owned, directly or indirectly through one or more other partnerships, by specified group members of the specified group. For purposes of this paragraph (g)(4)(iii), a partner's interest in the profits of a partnership is determined in accordance with the rules and principles of §1.706–1(b)(4)(ii) and a partner's interest in the capital of a partnership is determined in accordance with the rules and principles of §1.706–1(b)(4)(iii).

(h) *Election to apply safe-harbor*—(1) *In general.* If an election to apply this paragraph (h)(1) (*safe-harbor election*) is in effect with respect to a taxable year of a stand-alone applicable CFC or a specified taxable year of a CFC group member, as applicable, then, for such year, no portion of the applicable CFC's business interest expense is disallowed under the section 163(j) limitation. This paragraph (h) does not apply to excess business interest expense, as described in §1.163(j)–6(f)(2), until the taxable year in which it is treated as paid or accrued by an applicable CFC under §1.163(j)–6(g)(2)(i). Furthermore, excess business interest expense is not taken into account for purposes of determining whether the safe-harbor election is available for a stand-alone applicable CFC or a CFC group until the taxable year in which it is treated as paid or accrued by an applicable CFC under §1.163(j)–6(g)(2)(i).

(2) *Eligibility for safe-harbor election*—(i) *Stand-alone applicable CFC*. The safe-harbor election may be made for the taxable year of a stand-alone applicable CFC only if, for the taxable year, the business interest expense of the applicable CFC is less than or equal to either—

(A) The business interest income of the applicable CFC; or

(B) 30 percent of the lesser of the eligible amount or the qualified tentative taxable income of the applicable CFC.

(ii) *CFC group*. The safe-harbor election may be made for the specified period of a CFC group only if, for the specified period, no CFC group member has any pre-group disallowed business interest expense carryforward and the business interest expense of the CFC group for the specified period is less than or equal to either—

(A) The business interest income of the CFC group; or

(B) 30 percent of the lesser of the eligible amount or the qualified tentative taxable income of the CFC group.

(iii) *Currency translation*. For purposes of applying this paragraph (h), BII, BIE, and qualified tentative taxable income of a stand-alone applicable CFC or a CFC group must be determined using the U.S. dollar. If BII, BIE, or any items of income, gain, deduction, or loss that are taken into account in computing qualified tentative taxable income are maintained in a currency other than the U.S. dollar, then those items must be translated into the U.S. dollar using the average exchange rate for the taxable year or the specified taxable year, as applicable.

(3) *Eligible amount*—(i) *Stand-alone applicable CFC*. The *eligible amount* of a stand-alone applicable CFC for a taxable year is the sum of the amounts a domestic corporation would include in gross income under sections 951(a)(1)(A) and 951A(a), reduced by any deductions that would be allowed under section 245A (by reason of section 964(e)(4)) or section 250(a)(1)(B)(i), determined as if the domestic corporation has a taxable year that ends on the last date of the taxable year of the stand-alone applicable CFC, it wholly owns the stand-alone applicable CFC throughout the CFC's taxable year, it does not own any assets other than stock in the stand-alone applicable CFC, and it has no other items of income, gain, deduction, or loss.

(ii) *CFC group*. The *eligible amount* of a CFC group for a specified period is the sum of the amounts a domestic corporation would include in gross income under sections 951(a)(1)(A) and 951A(a), reduced by any deductions that would be allowed under section 245A (by reason of section 964(e)(4)) or section 250(a)(1)(B)(i), determined as if the domestic corporation has a taxable year that is the specified period, it wholly owns each CFC group member throughout the CFC group member's specified taxable year, it does not own any assets other than stock in the CFC group members, and it has no other items of income, gain, deduction, or loss.

(iii) *Additional rules for determining an eligible amount*. For purposes of paragraphs (h)(3)(i) and (ii) of this section, the amounts that would be included in gross income of a United States shareholder under sections 951(a)(1)(A) and 951A(a), and any corresponding deductions that would be allowed under section 245A (by reason of section 964(e)(4)) or section 250(a)(1)(B)(i), are determined by taking into account any elections that are made with respect to the applicable CFC(s), including under §1.954–1(d)(5) (relating to the subpart F high-tax exception) and §1.951A–2(c)(7)(viii) (relating to the GILTI high-tax exclusion). These amounts are also determined without regard to any section 163(j) limitation on business interest expense and without regard to any disallowed business interest expense carryovers. In addition, those amounts are determined by only taking in account items of the applicable CFC(s) that are properly allocable to a non-excepted trade or business under §1.163(j)–10.

(4) *Qualified tentative taxable income*. The term *qualified tentative taxable income* means, with respect to a taxable year of a stand-alone applicable CFC, the applicable CFC's tentative taxable income, and with respect to a specified period of a CFC group, the sum of each CFC group member's tentative taxable income for the specified taxable year; provided that for purposes of this paragraph (h)(4), tentative taxable income

is determined by taking into account only items properly allocable to a non-excepted trade or business under §1.163(j)–10.

(5) *Manner of making a safe-harbor election*—(i) *In general.* A safe-harbor election is an annual election made under this paragraph (h)(5) with respect to a taxable year of a stand-alone applicable CFC or with respect to a specified period of a CFC group. A safe-harbor election that is made with respect to a specified period of a CFC group is effective with respect to each CFC group member for its specified taxable year. A safe-harbor election is only effective if made by each designated U.S. person with respect to a stand-alone applicable CFC or a CFC group. A safe-harbor election is made with respect to a taxable year of a stand-alone applicable CFC, or a specified period of a CFC group, no later than the due date (taking into account extensions, if any) of the original Federal income tax return for the taxable year of each designated U.S. person, respectively, in which or with which the taxable year of the stand-alone applicable CFC ends or the specified period of the CFC group ends.

(ii) *Election statement.* To make a safe-harbor election, each designated U.S. person must attach to its relevant Federal income tax return or information return a statement that includes the name and taxpayer identification number of all designated U.S. persons, a statement that a safe-harbor election is being made pursuant to §1.163(j)–7(h) and a calculation that substantiates that the requirements for making the election are satisfied, and the taxable year of the stand-alone applicable CFC or the specified period of the CFC group, as applicable, for which the safe-harbor election is being made in accordance with publications, forms, instructions, or other guidance. In the case of a CFC group, the statement must also include the name of each CFC group member and its specified taxable year that ends with or within the specified period for which the safe-harbor election is being made. The statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance.

(6) *Special rule for taxable years or specified periods beginning in 2019 or 2020.* In the case of a stand-alone applicable CFC, for any taxable year beginning in 2019 or 2020, paragraph (h)(2)(i) of this section is applied by substituting ''50 percent'' for ''30 percent.'' In the case of a CFC group, for any specified period beginning in 2019 or 2020, paragraph (h)(2)(ii)(A) of this section is applied by substituting ''50 percent'' for ''30 percent.''

(k) *Definitions.* The following definitions apply for purposes of this section.

(1) *Applicable partnership.* The term *applicable partnership* has the meaning provided in paragraph (g)(4)(iii) of this section.

(2) *Applicable specified taxable year.* The term *applicable specified taxable year* has the meaning provided in paragraph (c)(3)(iii) of this section.

(3) *ATI adjustment amount.* The term *ATI adjustment amount* has the meaning provided in paragraph (g)(4)(ii) of this section.

(4)–(5) [Reserved].

(6) *CFC group.* The term *CFC group* has the meaning provided in paragraph (e)(2)(i) of this section.

(7) *CFC group election.* The term *CFC group election* means the election described in paragraph (e)(5) of this section.

(8) *CFC group member.* The term *CFC group member* has the meaning provided in paragraph (e)(2)(ii) of this section.

(9) [Reserved].

(10) *Cumulative section 163(j) pre-group carryforward limitation.* The term *cumulative section 163(j) pre-group carryforward limitation* has the meaning provided in paragraph (c)(3)(iv)(A)(*1*) of this section.

(11) *Current group.* The term *current group* has the meaning provided in paragraph (c)(3)(iv)(A)(*2*) of this section.

(12) *Designated U.S. person.* The term *designated U.S. person* means—

(i) With respect to a stand-alone applicable CFC, each controlling domestic shareholder, as defined in §1.964–1(c)(5)(i) of the applicable CFC; or

(ii) With respect to a specified group, the specified group parent, if the specified group parent is a qualified U.S. person, or each controlling domestic shareholder, as defined in §1.964–

1(c)(5)(i), of the specified group parent, if the specified group parent is an applicable CFC.

(13) *ECI deemed corporation.* The term *ECI deemed corporation* has the meaning provided in paragraph (f)(1)(i) of this section.

(14) *Effectively connected income.* The term *effectively connected income* (or *ECI*) means income or gain that is ECI, as defined in §1.884–1(d)(1)(iii), and deduction or loss that is allocable to, ECI, as defined in §1.884–1(d)(1)(iii).

(15) *Eligible amount.* The term *eligible amount* has the meaning provided in paragraph (h)(3)(i) of this section.

(16) *Former group.* The term *former group* has the meaning provided in paragraph (c)(3)(iv)(A)(*2*) of this section.

(17) *Loss member.* The term *loss member* has the meaning provided in paragraph (c)(3)(iv)(A)(*2*) of this section.

(18) *Payment amount.* The term *payment amount* has the meaning provided in paragraph (g)(4)(i) of this section.

(19) *Pre-group disallowed business interest expense carryforward.* The term *pre-group disallowed business interest expense carryforward* means, with respect to a CFC group member and a specified taxable year, any disallowed business interest expense carryforward of the CFC group member that arose in a taxable year during which the CFC group member (or its predecessor) was not a CFC group member of the CFC group.

(20) *Qualified tentative taxable income.* The term *qualified tentative taxable income* has the meaning provided in paragraph (h)(4) of this section.

(21) *Qualified U.S. person.* The term *qualified U.S. person* has the meaning provided in paragraph (d)(2)(iv) of this section.

(22) *Relevant period.* The term *relevant period* has the meaning provided in paragraph (c)(3)(iv)(A)(*2*) of this section.

(23) *Safe-harbor election.* The term *safe-harbor election* has the meaning provided in paragraph (h)(1) of this section.

(24) *Specified borrower.* The term *specified borrower* has the meaning provided in paragraph (g)(4)(i) of this section.

(25) *Specified group.* The term *specified group* has the meaning provided in paragraph (d)(2)(i) of this section.

(26) *Specified group member.* The term *specified group member* has the meaning provided in paragraph (d)(3) of this section.

(27) *Specified group parent.* The term *specified group parent* has the meaning provided in paragraph (d)(2)(iii) of this section.

(28) *Specified lender.* The term *specified lender* has the meaning provided in paragraph (g)(4)(i) of this section.

(29) *Specified period*—(i) *In general.* Except as otherwise provided in paragraph (k)(29)(ii) of this section, the term *specified period* means, with respect to a specified group—

(A) If the specified group parent is a qualified U.S. person, the period ending on the last day of the taxable year of the specified group parent and beginning on the first day after the last day of the specified group's immediately preceding specified period; or

(B) If the specified group parent is an applicable CFC, the period ending on the last day of the specified group parent's required year described in section 898(c)(1), without regard to section 898(c)(2), and beginning on the first day after the last day of the specified group's immediately preceding specified period.

(ii) *Short specified period.* A specified period begins no earlier than the first date on which a specified group exists. A specified period ends on the date a specified group ceases to exist under paragraph (d)(2)(vii) of this section. If the last day of a specified period, as determined under paragraph (k)(29)(i) of this section, changes, and, but for this paragraph (k)(29)(ii), the change in the last day of the specified period would result in the specified period being longer than 12 months, the specified period ends on the date on which the specified period would have ended had the change not occurred.

(30) *Specified taxable year.* The term *specified taxable year* means, with respect to an applicable CFC that is a specified group member of a specified group and a specified period, a taxable year of the applicable CFC that ends with or within the specified period.

(31) *Stand-alone applicable CFC.* The term *stand-alone applicable CFC* means any applicable CFC that is not a specified group member.

(32) *Stock.* The term *stock* has the meaning provided in paragraph (d)(2)(v) of this section.

(l) *Examples.* The following examples illustrate the application of this section. For each example, unless otherwise stated, no exemptions from the application of section 163(j) are available, no foreign corporation has ECI, and all relevant taxable years and specified periods begin after December 31, 2020.

(1) *Example 1. Specified taxable years included in specified period of a specified group*—(i) *Facts.* As of June 30, Year 1, USP, a domestic corporation, owns 60 percent of the common stock of FP, which owns all of the stock of FC1, FC2, and FC3. The remaining 40 percent of the common stock of FP is owned by an unrelated foreign corporation. FP has a single class of stock. FP acquired the stock of FC3 from an unrelated person on March 22, Year 1. The acquisition did not result in a change in FC3's taxable year or a close of its taxable year. USP's interest in FP and FP's interest in FC1 and FC2 has been the same for several years. USP has a taxable year ending June 30, Year 1, which is not a short taxable year. Each of FP, FC1, FC2, and FC3 are applicable CFCs. Pursuant to section 898(c)(2), FP and FC1 have taxable years ending May 31, Year 1. Pursuant to section 898(c)(1), FC2 and FC3 have taxable years ending June 30, Year 1.

(ii) *Analysis*—(A) *Determining a specified group and specified period of the specified group.* Pursuant to paragraph (d) of this section, FP, FC1, FC2, and FC3 are members of a specified group, and FP is the specified group parent. Because the specified group parent, FP, is an applicable CFC, the specified period of the specified group is the period ending on June 30, Year 1, which is the last day of FP's required year described in section 898(c)(1), without regard to section 898(c)(2), and beginning on July 1, Year 0, which is the first day following the last day of the specified group's immediately preceding specified period (June 30, Year 0). See paragraph (k)(29)(i)(B) of this section.

(B) *Determining the specified taxable years with respect to the specified period.* Pursuant to paragraph (d)(3) of this section, because each of FP and FC1 are included in the specified group on the last day of their taxable years ending May 31, Year 1, and such taxable years end with or within the specified period ending June 30, Year 1, FP and FC1 are specified group members with respect to the specified period ending June 30, Year 1, for their entire taxable years ending May 31, Year 1, and those taxable years are specified taxable years. Similarly, because each of FC2 and FC3 are included in the specified group on the last day of their taxable years ending June 30, Year 1, and such taxable years end with or within the specified period ending June 30, Year 1, FC2 and FC3 are specified group members with respect to the specified period ending June 30, Year 1, for their entire taxable years ending June 30, Year 1, and those taxable years are specified taxable years. The fact that FC3 was acquired on March 22, Year 1, does not prevent FC3 from being a specified group member with respect to the specified period for the portion of its specified taxable year before March 22, Year 1.

(2) *Example 2. CFC groups*—(i) *Facts.* The facts are the same as in *Example 1* in paragraph (l)(1)(i) of this section except that, in addition, a CFC group election is in place with respect to the specified period ending June 30, Year 1.

(ii) *Analysis.* Because a CFC group election is in place for the specified period ending June 30, Year 1, pursuant to paragraph (e)(2)(ii) of this section, each specified group member is a CFC group member with respect to its specified taxable year ending with or within the specified period. Accordingly, FP, FC1, FC2, and FC3 are CFC group members with respect to the specified period ending June 30, Year 1, for their specified taxable years ending May 31, Year 1, and June 30, Year 1, respectively. Pursuant to paragraph (e)(2)(i) of this section, the CFC group for the specified period ending June 30, Year 1, consists of FP, FC1, FC2, and FC3 for their specified taxable years ending May 31, Year 1, and June 30, Year 1, respectively. Pursuant to paragraph (c)(2) of this section, a single section 163(j) limitation is computed for the specified period ending June 30, Year 1. That section 163(j) calculation will include FP and FC1's specified taxable years ending May 31, Year 1, and FC2 and FC3's specified taxable years ending June 30, Year 1.

(3) *Example 3. Application of anti-abuse rule*—(i) *Facts*. USP, a domestic corporation, owns all of the stock of CFC1 and CFC2. Thus, USP is the specified group parent of a specified group, the specified group members of which are CFC1 and CFC2. USP has a calendar year taxable year. All specified group members also have a calendar year taxable year and a functional currency of the U.S. dollar. CFC1 is organized in, and a tax resident of, a jurisdiction that imposes no tax on certain types of income, including interest income. With respect to Year 1, USP expects to pay no residual U.S. tax on its income inclusion under section 951A(a) (GILTI inclusion amount) and expects to have unused foreign tax credits in the category described in section 904(d)(1)(A). A CFC group election is not in effect for Year 1. With a principal purpose of reducing USP's Federal income tax liability in subsequent taxable years, on January 1, Year 1, CFC1 loans $100x to CFC2. On December 31, Year 1, CFC2 pays interest of $10x to CFC1 and repays the principal of $100x. Absent the application of paragraph (g)(4)(i) of this section, all $10x of CFC2's interest expense would be disallowed business interest expense and, therefore, CFC2 would have $10x of disallowed business interest expense carryforward to Year 2. In Year 2, CFC2 disposes of one of its businesses at a substantial gain that gives rise to tested income (within the meaning of section 951A(c)(2)(A) and §1.951A–2(b)(1)). As a result of the gain being included in the ATI of CFC2, absent the application of paragraph (g)(4)(i) of this section, CFC2 would be allowed to deduct the entire $10x of disallowed business interest expense carryforward and therefore reduce the amount of its tested income. Also, USP would pay residual U.S. tax on its GILTI inclusion amount in Year 2, without regard to the application of paragraph (g)(4)(i) of this section.

(ii) *Analysis*. The $10x of business interest expense paid in Year 1 is a payment amount described in paragraph (g)(4)(i) of this section because it is between specified group members, CFC1 and CFC2. Furthermore, the requirements of paragraphs (g)(4)(i)(A), (B), and (C) of this section are satisfied because the $10x of business interest expense is incurred with a principal purpose of reducing USP's Federal income tax liability; absent the application of paragraph (g)(4)(i) of this section, the effect of CFC2 treating the $10x of business interest expense as disallowed business interest expense in Year 1 would be to reduce USP's Federal income tax liability in Year 2; and no CFC group election is in effect with respect to the specified group in Year 1. Because the requirements of paragraphs (g)(4)(i)(A), (B), and (C) of this section are satisfied, CFC2's ATI for Year 1 is increased by the ATI adjustment amount, or $33.33x, which is the amount equal to 3 ⅓ multiplied by $10x (the lesser of the payment amount of $10x and the disallowed business interest expense of $10x). As a result, the $10x of business interest expense is not disallowed business interest expense of CFC2 in Year 1, and therefore does not give rise to a disallowed business interest expense carryforward to Year 2.

(m) *Applicability dates*—(1) *General applicability date*. Except as provided in paragraph (m)(2) of this section, this section applies for a taxable year of a foreign corporation beginning on or after November 13, 2020.

(2) *Exception*. Paragraphs (a), (c)(1), (c)(2)(i) and (ii), and (c)(3) through (5), (d), (e), (f)(1), (g)(3) and (4), (h), and (k)(1) through (3), (6) through (8), and (10) through (32) of this section apply for a taxable year of a foreign corporation beginning on or after March 22, 2021.

(3) *Early application*—(i) *Rules for paragraphs (b) and (g)(1) and (2) of this section*. 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 paragraphs (b) and (g)(1) and (2) of this section for a taxable year beginning after December 31, 2017, and before November 13, 2020, provided that those taxpayers and their related parties consistently apply all of those rules and the rules described in paragraph (m)(4) of this section for that taxable year. If a taxpayer and its related parties apply the rules described in paragraph (m)(4) of

this section, as contained in T.D. 9905 (§§ 1.163(j)–0 through 1.163(j)–11, effective November 13, 2020), they will be considered as applying the rules described in paragraph (m)(4) of this section for purposes of this paragraph (m)(3)(i).

(ii) *Rules for certain other paragraphs in this section.* 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 paragraphs (a), (c)(1), (c)(2)(i) and (ii), and (c)(3) through (5), (d), (e), (f)(1), (g)(3) and (4), (h), and (k)(1) through (3), (6) through (8), and (10) through (32) of 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 those rules and the rules described in paragraph (m)(4) of this section for that taxable year and for each subsequent taxable year. If a taxpayer and its related parties apply the rules described in paragraph (m)(4) of this section, as contained in T.D. 9905 (§§ 1.163(j)–0 through 1.163(j)–11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021),they will be considered as applying the rules described in paragraph (m)(4) of this section for purposes of this paragraph (m)(3)(ii).

(4) *Additional rules that must be applied consistently.* The rules described in this paragraph (m)(4) are the section 163(j) regulations and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, and 1.383–1) and 1.1504–4.

(5) *Election for prior taxable years and specified periods.* Notwithstanding paragraph (e)(5)(iii) or (h)(5)(i) of this section, in the case of a specified period of a specified group or a taxable year of a stand-alone applicable CFC that ends with or within a taxable year of a designated U.S. person ending before November 13, 2020, a CFC group election or a safe-harbor election may be made on an amended Federal income tax return filed on or before the due date (taking into account extensions, if any) of the original Federal income tax return for the first taxable year of each designated U.S. person ending on or after November 13, 2020.

[T.D. 9905, 85 FR 56760, Sept. 14, 2020, as amended by T.D. 9943, 86 FR 5532, Jan. 19, 2021]

§ 1.163(j)–8 [Reserved]

§ 1.163(j)–9 Elections for excepted trades or businesses; safe harbor for certain REITs.

(a) *Overview.* The limitation in section 163(j) applies to business interest, which is defined under section 163(j)(5) as interest properly allocable to a trade or business. The term trade or business does not include any electing real property trade or business or any electing farming business. See section 163(j)(7). This section provides the rules and procedures for taxpayers to follow in making an election under section 163(j)(7)(B) for a trade or business to be an electing real property trade or business and an election under section 163(j)(7)(C) for a trade or business to be an electing farming business.

(b) *Availability of election*—(1) *In general.* An election under section 163(j)(7)(B) for a real property trade or business to be an electing real property trade or business is available to any trade or business that is described in § 1.163(j)–1(b)(14)(i), (ii), or (iii), and an election under section 163(j)(7)(C) for a farming business to be an electing farming business is available to any trade or business that is described in § 1.163(j)–1(b)(13)(i), (ii), or (iii).

(2) *Special rules*—(i) *Exempt small businesses.* An election described in paragraph (b)(1) of this section is available regardless of whether the real property trade or business or farming business making the election also meets the requirements of the small business exemption in section 163(j)(3) and § 1.163(j)–2(d). See paragraph (c)(2) of this section for the effect of the election relating to depreciation.

(ii) *Section 162 trade or business not required for electing real property trade or business.* An election described in paragraph (b)(1) of this section to be an electing real property trade or business is available regardless of whether the trade or business with respect to which the election is made is a trade or business under section 162. For example, a taxpayer engaged in activities described in section 469(c)(7)(C) and §1.469–9(b)(2), as required in §1.163(j)–1(b)(14)(i), may make an election for a trade or business to be an electing real property trade or business, regardless of whether its activities rise to the level of a section 162 trade or business.

(c) *Scope and effect of election*—(1) *In general*. An election under this section is made with respect to each eligible trade or business of the taxpayer and applies only to such trade or business for which the election is made. An election under this section applies to the taxable year in which the election is made and to all subsequent taxable years. See paragraph (e) of this section for terminations of elections.

(2) *Irrevocability*. An election under this section is irrevocable.

(3) *Depreciation*. Taxpayers making an election under this section are required to use the alternative depreciation system for certain types of property under section 163(j)(11) and cannot claim the additional first-year depreciation deduction under section 168(k) for those types of property.

(d) *Time and manner of making election*—(1) *In general*. Subject to paragraph (f) of this section, a taxpayer makes an election under this section by attaching an election statement to the taxpayer's timely filed original Federal income tax return, including extensions. A taxpayer may make elections for multiple trades or businesses on a single election statement.

(2) *Election statement contents*. The election statement should be titled ''Section 1.163(j)–9 Election'' and must contain the following information for each trade or business:

(i) The taxpayer's name;

(ii) The taxpayer's address;

(iii) The taxpayer's social security number (SSN) or employer identification number (EIN);

(iv) A description of the taxpayer's electing trade or business sufficient to demonstrate qualification for an election under this section, including the principal business activity code; and

(v) A statement that the taxpayer is making an election under section 163(j)(7)(B) or (C), as applicable.

(3) *Consolidated group's trade or business*. For a consolidated group's trade or business, the election under this section is made by the agent for the group, as defined in §1.1502–77, on behalf of itself and members of the consolidated group. Only the name and taxpayer identification number (TIN) of the agent for the group, as defined in §1.1502–77, must be provided on the election statement.

(4) *Partnership's trade or business*. An election for a partnership must be made on the partnership's return for a trade or business that the partnership conducts. An election by a partnership does not apply to a trade or business conducted by a partner outside the partnership.

(e) *Termination of election*—(1) *In general*. An election under this section automatically terminates if a taxpayer ceases to engage in the electing trade or business. A taxpayer is considered to cease to engage in an electing trade or business if the taxpayer sells or transfers substantially all of the assets of the electing trade or business to an acquirer that is not a related party in a taxable asset transfer. A taxpayer is also considered to cease to engage in an electing trade or business if the taxpayer terminates its existence for Federal income tax purposes or ceases operation of the electing trade or business, except to the extent that such termination or cessation results in the sale or transfer of substantially all of the assets of the electing trade or business to an acquirer that is a related party, or in a transaction that is not a taxable asset transfer.

(2) *Taxable asset transfer defined*. For purposes of this paragraph (e), the term *taxable asset transfer* means a transfer in which the acquirer's basis or adjusted basis in the assets is not determined, directly or indirectly, in whole or in part, by reference to the transferor's basis in the assets.

(3) *Related party defined*. For purposes of this paragraph (e), the term *related party* means any person who bears a relationship to the taxpayer which is described in section 267(b) or 707(b)(1).

(4) *Anti-abuse rule.* If, within 60 months of a sale or transfer of assets described in paragraph (e)(1) of this section, the taxpayer or a related party reacquires substantially all of the assets that were used in the taxpayer's prior electing trade or business, or substantially similar assets, and resumes conducting such prior electing trade or business, the taxpayer's previously terminated election under this section is reinstated and is effective on the date the prior electing trade or business is reacquired.

(f) *Additional guidance.* The rules and procedures regarding the time and manner of making an election under this section and the election statement contents in paragraph (d) of this section may be modified through other guidance (see §§ 601.601(d) and 601.602 of this chapter). Additional situations in which an election may terminate under paragraph (e) of this section may be provided through guidance published in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d) of this chapter).

(g) *Examples.* The examples in this paragraph (g) illustrate the application of this section. Unless otherwise indicated, X and Y are domestic C corporations; D and E are U.S. resident individuals not subject to any foreign income tax; and the exemption for certain small businesses in § 1.163(j)–2(d) does not apply.

(1) *Example 1: Scope of election*—(i) *Facts.* For the taxable year ending December 31, 2021, D, a sole proprietor, owned and operated a dairy farm and an orchard as separate farming businesses described in section 263A(e)(4). D filed an original Federal income tax return for the 2021 taxable year on August 1, 2022, and included with the return an election statement meeting the requirements of paragraph (d)(2) of this section. The election statement identified D's dairy farm business as an electing trade or business under this section. On March 1, 2023, D sold some but not all or substantially all of the assets from D's dairy farm business to D's neighbor, E, who is unrelated to D. After the sale, D continued to operate the dairy farm trade or business.

(ii) *Analysis.* D's election under this section was properly made and is effective for the 2021 taxable year and subsequent years. D's dairy farm business is an excepted trade or business because D made the election with D's timely filed Federal income tax return. D's orchard business is a non-excepted trade or business, because D did not make an election for the orchard business to be an excepted trade or business. The sale of some but not all or substantially all of the assets from D's dairy farm business does not affect D's election under this section.

(2) *Example 2: Availability of election*—(i) *Facts.* E, an individual, operates a dairy business that is a farming business under section 263A and also owns real property that is not part of E's dairy business that E leases to an unrelated party through a triple net lease. E's average gross receipts, excluding inherently personal amounts, for the three years prior to 2021 are approximately $25 million, but E is unsure of the exact amount.

(ii) *Analysis.* Under paragraph (b)(2)(i) of this section, E may make an election under this section for the dairy business to be an electing farming business, even though E is unsure whether the small business exemption of § 1.163(j)–2(d) applies. Additionally, under paragraph (b)(2)(ii) of this section, assuming the requirements of section 163(j)(7)(C) and this section are otherwise satisfied, E may make an election under this section for its triple net lease property to be an electing real property trade or business, even though E may not be engaged in a trade or business under section 162 with respect to the real property.

(3) *Example 3: Cessation of entire trade or business*—(i) *Facts.* X has a real property trade or business for which X made an election under this section by attaching an election statement to A's 2021 Federal income tax return. On March 1, 2022, X sold all of the assets used in its real property trade or business to Y, an unrelated party, and ceased to engage in the electing trade or business. On June 1, 2027, X started a new real property trade or business that was substantially similar to X's prior electing trade or business.

(ii) *Analysis.* X's election under this section terminated on March 1, 2022, under paragraph (e)(1) of this section.

X may choose whether to make an election under this section for X's new real property trade or business that A started in 2027.

(4) *Example 4: Anti-abuse rule*—(i) *Facts.* The facts are the same as in *Example 3* in paragraph (g)(3)(i) of this section, except that X re-started its previous real property trade or business on February 1, 2023, when X reacquired substantially all of the assets that X had sold on March 1, 2022.

(ii) *Analysis.* X's election under this section terminated on March, 1, 2022, under paragraph (e)(1) of this section. On February 1, 2023, X's election was reinstated under paragraph (e)(4) of this section. X's new real property trade or business is treated as a resumption of X's prior electing trade or business and is therefore treated as an electing real property trade or business.

(5) *Example 5: Trade or business continuing after acquisition*—(i) *Facts.* X has a farming business for which X made an election under this section by attaching an election statement to X's timely filed 2021 Federal income tax return. Y, unrelated to X, also has a farming business, but Y has not made an election under this section. On July 1, 2022, X transferred all of its assets to Y in a transaction described in section 368(a)(1)(D). After the transfer, Y continues to operate the farming trade or business acquired from X.

(ii) *Analysis.* Under paragraph (e)(1) of this section, Y is subject to X's election under this section for the trade or business that uses X's assets because the sale or transfer was not in a taxable transaction. Y cannot revoke X's election, but X's election has no effect on Y's existing farming business for which Y has not made an election under this section.

(6) *Example 6: Trade or business merged after acquisition*—(i) *Facts.* The facts are the same as in *Example 5* in paragraph (g)(5)(i) of this section, except that Y uses the assets acquired from X in a trade or business that is neither a farming business (as defined in section 263A(e)(4) or §1.263A–4(a)(4)) nor a trade or business of a specified agricultural or horticultural cooperative (as defined in section 199A(g)(4)).

(ii) *Analysis.* Y is not subject to X's election for Y's farming business because the farming trade or business ceased to exist after the acquisition.

(h) *Safe harbor for REITs*—(1) *In general.* If a REIT holds real property, as defined in §1.856–10, interests in one or more partnerships directly or indirectly holding real property (through interests in other partnerships or shares in other REITs), as defined in §1.856–10, or shares in one or more other REITs directly or indirectly holding real property (through interests in partnerships or shares in other REITs), as defined in §1.856–10, the REIT is eligible to make the election described in paragraph (b)(1) of this section to be an electing real property trade or business for purposes of sections 163(j)(7)(B) and 168(g)(1)(F) for all or part of its assets. The portion of the REIT's assets eligible for this election is determined under paragraph (h)(2) or (3) of this section.

(2) *REITs that do not significantly invest in real property financing assets.* If a REIT makes the election under paragraph (h)(1) of this section and the value of the REIT's real property financing assets, as defined in paragraphs (h)(5) and (6) of this section, at the close of the taxable year is 10 percent or less of the value of the REIT's total assets at the close of the taxable year, as determined under section 856(c)(4)(A), then all of the REIT's assets are treated as assets of an excepted trade or business.

(3) *REITs that significantly invest in real property financing assets.* If a REIT makes the election under paragraph (h)(1) of this section and the value of the REIT's real property financing assets, as defined in paragraphs (h)(5) and (6) of this section, at the close of the taxable year is more than 10 percent of the value of the REIT's total assets at the close of the taxable year, as determined under section 856(c)(4)(A), then for the allocation of interest expense, interest income, and other items of expense and gross income to excepted and non-excepted trades or businesses, the REIT must apply the rules set forth in §1.163(j)–10 as modified by paragraph (h)(4) of this section.

(4) *REIT real property assets, interests in partnerships, and shares in other*

REITs—(i) *Real property assets.* Assets held by a REIT described in paragraph (h)(3) of this section that meet the definition of real property under §1.856–10 are treated as assets of an excepted trade or business.

(ii) *Partnership interests.* If a REIT described in paragraph (h)(3) of this section holds an interest in a partnership, in applying the partnership look-through rule described in §1.163(j)–10(c)(5)(ii)(A)(*2*), the REIT treats assets of the partnership that meet the definition of real property under §1.856–10 as assets of an excepted trade or business. This application of the definition of real property under §1.856–10 does not affect the characterization of the partnership's assets at the partnership level or for any non-REIT partner. However, no portion of the adjusted basis of the REIT's interest in the partnership is allocated to a non-excepted trade or business if the partnership makes an election under paragraph (h)(7) of this section and if all of the partnership's assets are treated as assets of an excepted trade or business under paragraph (h)(2) of this section.

(iii) *Shares in other REITs*—(A) *In general.* If a REIT (shareholder REIT) described in paragraph (h)(3) of this section holds an interest in another REIT, then for purposes of applying the allocation rules in §1.163(j)–10, the partnership look-through rule described in §1.163(j)–10(c)(5)(ii)(A)(*2*), as modified by paragraph (h)(4)(ii) of this section, applies to the assets of the other REIT (as if the other REIT were a partnership) in determining the portion of shareholder REIT's adjusted basis in the shares of the other REIT that is allocable to an excepted or non-excepted trade or business of shareholder REIT. However, no portion of the adjusted basis of shareholder REIT's shares in the other REIT is allocated to a non-excepted trade or business if all of the other REIT's assets are treated as assets of an excepted trade or business under paragraph (h)(2) of this section.

(B) *Information necessary.* If shareholder REIT does not receive, either directly from the other REIT or indirectly through the analysis of an applicable financial statement (within the meaning of section 451(b)(3)) of the other REIT, the information necessary to determine whether and to what extent the assets of the other REIT are investments in real property financing assets, then shareholder REIT's shares in the other REIT are treated as assets of a non-excepted trade or business under §1.163(j)–10(c).

(iv) *Tiered entities.* In applying §1.163(j)–10(c)(5)(ii)(E), the rules in paragraphs (h)(4)(ii) and (h)(4)(iii)(A) and (B) of this section apply to any partnerships and other REITs within the tier.

(5) *Value of shares in other REITs*—(i) *In general.* If a REIT (shareholder REIT) holds shares in another REIT, then solely for purposes of applying the value tests under paragraphs (h)(2) and (3) of this section, the value of shareholder REIT's real property financing assets includes the portion of the value of shareholder REIT's shares in the other REIT that is attributable to the other REIT's investments in real property financing assets. However, no portion of the value of shareholder REIT's shares in the other REIT is included in the value of shareholder REIT's real property financing assets if all of the other REIT's assets are treated as assets of an excepted trade or business under paragraph (h)(2) of this section.

(ii) *Information necessary.* If shareholder REIT does not receive, either directly from the other REIT or indirectly through the analysis of an applicable financial statement (within the meaning of section 451(b)(3)) of the other REIT, the information necessary to determine whether and to what extent the assets of the other REIT are investments in real property financing assets, then shareholder REIT's shares in the other REIT are treated as real property financing assets for purposes of paragraphs (h)(2) and (3) of this section.

(iii) *Tiered REITs.* The rules in paragraphs (h)(5)(i) and (ii) of this section apply successively to the extent that the other REIT, and any other REIT in the tier, holds shares in another REIT.

(6) *Real property financing assets.* For purposes of this paragraph (h), *real property financing assets* include interests, including participation interests, in the following: Mortgages, deeds of trust, and installment land contracts; mortgage pass-through certificates

guaranteed by Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), or Canada Mortgage and Housing Corporation (CMHC); REMIC regular interests; other interests in investment trusts classified as trusts under §301.7701–4(c) of this chapter that represent undivided beneficial ownership in a pool of obligations principally secured by interests in real property and related assets that would be permitted investments if the investment trust were a REMIC; obligations secured by manufactured housing treated as single family residences under section 25(e)(10), without regard to the treatment of the obligations or the properties under state law; and debt instruments issued by publicly offered REITs.

(7) *Application of safe harbor for partnerships controlled by REITs.* A partnership is eligible to make the election under paragraph (h)(1) of this section if one or more REITs own directly or indirectly at least 50 percent of the partnership's capital and profits, the partnership meets the requirements of section 856(c)(2), (3), and (4) as if the partnership were a REIT, and the partnership satisfies the requirements described in paragraph (h)(1) of this section as if the partnership were a REIT. The portion of the partnership's assets eligible for this election is determined under paragraph (h)(2) or (3) of this section, treating the partnership as if it were a REIT.

(8) *REITs or partnerships controlled by REITs that do not apply the safe harbor.* A REIT or a partnership that is eligible but chooses not to apply the safe harbor provisions of paragraph (h)(1) or (7) of this section, respectively, may still elect, under paragraph (b)(1) of this section, for one or more of its trades or businesses to be an electing real property trade or business, provided that such trade or business is otherwise eligible to elect under paragraph (b)(1) of this section. A REIT or partnership that makes the election under paragraph (b)(1) of this section without utilizing the safe harbor provisions of paragraph (h) of this section may not rely on any portion of paragraphs (h)(1) through (7) of this section.

(i) [Reserved]

(j) *Special anti-abuse rule for certain real property trades or businesses*—(1) *In general.* Except as provided in paragraph (j)(2) of this section, a trade or business (lessor) does not constitute a trade or business eligible for an election described in paragraph (b)(1) of this section to be an electing real property trade or business if at least 80 percent, determined by fair market rental value, of the real property used in the business is leased to a trade or business (lessee) under common control with the lessor, regardless of whether the arrangement is pursuant to a written lease or pursuant to a service contract or another agreement that is not denominated as a lease. For purposes of this paragraph (j), fair market rental value is the amount of rent that a prospective lessee that is unrelated to the lessor would be willing to pay for a rental interest in real property, taking into account the geographic location, size, and type of the real property. For purposes of this paragraph (j), two trades or businesses are under common control if 50 percent of the direct and indirect ownership of both businesses are held by related parties within the meaning of sections 267(b) and 707(b).

(2) *Exceptions*—(i) *De minimis exception.* The limitation in paragraph (j)(1) of this section does not apply, and the lessor is eligible to make an election under paragraph (b)(1) of this section, if the lessor leases, regardless of whether the arrangement is pursuant to a written lease or pursuant to a service contract or another agreement that is not denominated as a lease, at least 90 percent of the lessor's real property, determined by fair market rental value, to one or more of the following:

(A) A party not under common control with the lessor or lessee;

(B) A party under common control with the lessor or lessee that has made an election described in paragraph (b)(1) of this section for a trade or business to be an electing real property trade or business or electing farming business, but only to the extent that the real property is used as part of its electing real property trade or business or electing farming business; or

(C) A party under common control with the lessor or lessee that is an excepted regulated utility trade or business, but only to the extent that the real property is used as part of its excepted regulated utility trade or business.

(ii) *Look-through exception*. If the de minimis exception in paragraph (j)(2)(i) of this section does not apply because less than 90 percent of the lessor's real property is leased to parties described in paragraphs (j)(2)(i)(A), (B), and (C), the lessor is eligible to make the election under paragraph (b)(1) of this section to the extent that the lessor leases the real property to parties described in paragraph (j)(2)(A), (B), or (C), and to the extent that the lessee subleases (or lessees ultimately sublease) the real property to:

(A) A party not under common control with the lessor or lessee;

(B) A party under common control with the lessor or lessee that has made an election described in paragraph (b)(1) of this section for a trade or business to be an electing real property trade or business or electing farming business to the extent that the real property is used as part of its electing real property trade or business or electing farming business; or

(C) A party under common control with the lessor or lessee that is an excepted regulated utility trade or business to the extent that the real property is used as part of its excepted regulated utility trade or business.

(iii) *Inapplicability of exceptions to consolidated groups*. The exceptions in paragraphs (j)(2)(i) and (ii) of this section do not apply when the lessor and lessee are members of the same consolidated group.

(iv) *Exception for certain REITs*. The special anti-abuse rule in paragraph (j)(1) of this section does not apply to REITs or to partnerships making an election under paragraph (h)(7) of this section that lease qualified lodging facilities, as defined in section 856(d)(9)(D), and qualified health care properties, as defined in section 856(e)(6)(D).

(3) *Allocations*. See §1.163(j)–10(c)(3)(iii)(D) for rules related to the allocation of the basis of assets used in lessor trades or businesses described in paragraphs (j)(1) and (j)(2)(i) of this section.

(4) *Examples*. The examples in this paragraph (j)(4) illustrate the application of paragraphs (j)(1), (2), and (3) of this section. Unless otherwise indicated, the parties are all domestic entities and are not members of a single consolidated group within the meaning of §1.1502–1(h).

(i) *Example 1: Related party lease of hotel*—(A) *Facts*. X and Y are under common control, as defined in paragraph (j)(1) of this section. X owns one piece of real property, a hotel, that X leases to Y. Y operates the hotel and provides hotel rooms and associated amenities to third party guests of the hotel. The form of the arrangement with third party hotel guests is a license to use rooms in the hotel and associated amenities. Y is a real property trade or business that has made an election under paragraph (b)(1) of this section.

(B) *Analysis*. Because X leases at least 80 percent of X's real property to a party under common control, X is subject to the anti-abuse rule in paragraph (j)(1) of this section. However, under the de minimis exception under paragraph (j)(2)(i) of this section, 100 percent of the fair market rental value of the building is leased to a party under common control that has made an election to be an electing real property trade or business. Accordingly, X is eligible to make the election described in paragraph (b)(1) of this section for its entire trade or business.

(ii) *Example 2*—(A) *Facts*. The facts are the same as in *Example 1* in paragraph (j)(4)(i)(A) of this section, except that Y has not made an election under paragraph (b)(1) of this section, and is not otherwise using the real property in an excepted trade or business.

(B) *Analysis*. Because X leases at least 80 percent of X's real property, determined by fair market rental value, to Y, a party under common control, X is subject to the anti-abuse rule in paragraph (j)(1) of this section. X is not eligible for the de minimis exception under paragraph (j)(2)(i) of this section because X does not lease at least 90 percent of its real property to a party under common control, as defined in paragraph (j)(1) of this section, such as Y, and Y is not using the property in an otherwise excepted trade or business. However, X is eligible for the look-through exception under paragraph (j)(2)(ii) of this section because X leases 100 percent of its real property to Y, a party that is under common control, and Y subleases 100 percent of the real property to parties that are not under common control with X or Y. The fact that the license provided to hotel guests is not denominated as a lease does not prevent these licenses from being treated as a lease for purposes of paragraph (j) of this section. Accordingly, under the look-through exception under paragraph (j)(2)(ii) of this section, X is eligible to make the election described in paragraph (b)(1) of this section with regard to its entire trade or business.

(iii) *Example 3: Sublease to related party and unrelated third party*—(A) *Facts*. X owns one piece of real property that X leases to Y, a party under common control, as defined in paragraph (j)(1) of this section. Y does not operate an excepted trade or business. Y subleases 80 percent of the real property, determined by the fair market rental value, to a party under common control with Y that does not operate an excepted trade or business and 20 percent of the real property, determined by the fair market rental value, to an unrelated third party.

(B) *Analysis*. Because X leases at least 80 percent of X's real property, determined by fair market rental value, to a party under common control, X is subject to the anti-abuse rule in paragraph (j)(1) of this section. X is not eligible for the de minimis exception in paragraph (j)(2)(i) of this section because X is not leasing at least 90 percent of the real property, determined by fair market rental value, to a party under common control that operates an excepted trade or business and/or unrelated parties. Under the look-through exception under paragraph (j)(2)(ii) of this section, X is eligible to make the election described in paragraph (b)(1) of this section with respect to the 20 percent of the fair market rental value of the real property subleased to an unrelated party because X is treated as directly leasing this portion to an unrelated party. X is not eligible to make the election described in paragraph (b)(1) of this section with respect to the 80 percent of the building subleased to a party under common control because X is still treated as directly leasing this portion to a related party. Under § 1.163(j)–10(c)(3)(iii)(D), X must allocate 80 percent of the basis in the real property as a non-excepted trade or business and 20 percent of the basis in the real property as an excepted trade or business.

(iv) *Example 4: Multiple subleases*—(A) *Facts*. X owns a building that X leases to Y, a party under common control as defined in paragraph (j)(1) of this section. Y does not operate an excepted trade or business. Y subleases 80 percent of the building, determined by fair market rental value, to Z, a party under common control with both X and Y. Y subleases the remaining 20 percent of the building, determined by fair market rental value, to unrelated parties. Z subleases 50 percent of its leasehold interest, determined by fair market rental value, to parties unrelated to X, Y and Z, and uses the remaining leasehold interest in its retail business. Z does not operate an excepted trade or business.

(B) *Analysis*. Because X leases at least 80 percent of X's real property, determined by fair market rental value, to a party under common control, X is subject to the anti-abuse rule in paragraph (j)(1) of this section. X is not eligible for the de minimis exception in paragraph (j)(2)(i) because X is not leasing at least 90 percent of the building, determined by fair market rental value, to a party under common control that operates an excepted trade or business and/or unrelated parties. Under the look-through exception under paragraph (j)(2)(ii) of this section, X is eligible to make the election described in paragraph (b)(1) of this section with respect to the 60 percent of the building that is subleased to unrelated parties, determined by adding 40 percent (50 percent of the 80 percent leasehold interest) from Z's sublease to an unrelated party and 20 percent from Y's sublease to unrelated parties (40 + 20). X is not eligible to make the election described in paragraph (b)(1) of this section with respect to the 40 percent of the building subleased to Z, because Z is a related party that does not operate an excepted trade or business.

(v) *Example 5: Lessee's Trade or Business*—(A) *Facts*. X owns a building that X leases to W, a party under common control as defined in paragraph (j)(1) of this section. W operates the building as a widget manufacturing plant and does not sublease any portion of the building.

(B) *Analysis*. X is not eligible to make the election described in paragraph (b)(1) of this section because X leases the entire building to a party under common control. X is not eligible for the de minimis exception in paragraph (j)(2)(i) of this section because X is not leasing at least 90 percent of the real property to a party under common control that operates an excepted trade or business and/or unrelated parties. W's trade or business cannot be an electing real property trade or business. X is not eligible for the look-through exception under paragraph (j)(2)(ii) of this section because W is not subleasing any part of the building.

(k) *Applicability date*. This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year.

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§ 1.163(j)–10 Allocation of interest expense, interest income, and other items of expense and gross income to an excepted trade or business.

(a) *Overview*—(1) *In general*—(i) *Purposes*. Except as provided in §1.163(j)–6(m) or §1.163(j)–9(h), this section provides the exclusive rules for allocating tax items that are properly allocable to a trade or business between excepted trades or businesses and non-excepted trades or businesses for purposes of section 163(j). The amount of a taxpayer's interest expense that is properly allocable to excepted trades or businesses is not subject to the section 163(j) limitation. The amount of a taxpayer's other items of income, gain, deduction, or loss, including interest income, that is properly allocable to excepted trades or businesses is excluded from the calculation of the taxpayer's section 163(j) limitation. See section 163(j)(6) and (j)(8)(A)(i); see also §1.163(j)–1(b)(1)(i)(H), (b)(1)(ii)(F), and (b)(3). The general method of allocation set forth in paragraph (c) of this section is based on the approach that money is fungible and that interest expense is attributable to all activities and property, regardless of any specific purpose for incurring an obligation on which interest is paid. In no event may the amount of interest expense allocated under this section exceed the amount of interest paid or accrued, or treated as paid or accrued, by the taxpayer within the taxable year.

(ii) *Application of section*. The amount of a taxpayer's tax items properly allocable to a trade or business, other than interest expense and interest income, that is properly allocable to excepted trades or businesses for purposes of section 163(j) is determined as set forth in paragraph (b) of this section. The amount of a taxpayer's interest expense and interest income that is properly allocable to excepted trades or businesses for purposes of section 163(j) generally is determined as set forth in paragraph (c) of this section, except as otherwise provided in paragraph (d) of this section. For purposes of this section, a taxpayer's activities are not treated as a separate trade or business to the extent those activities involve the provision of real property, goods, or services to a trade or business of the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group). For example, if a taxpayer engaged in a manufacturing trade or business has in-house legal personnel that provide legal services solely with respect to the taxpayer's manufacturing business, the taxpayer is not treated as also engaged in the trade or business of providing legal services. Similarly, if the taxpayer described in the previous sentence constructs or acquires real property solely for use by the taxpayer's manufacturing business, the taxpayer is not treated as also engaged in a real property trade or business.

(2) *Coordination with other rules*—(i) *In general*. The rules of this section apply after a taxpayer has determined whether any interest expense or interest income paid, received, or accrued is properly allocable to a trade or business. Similarly, the rules of this section apply to other tax items after a taxpayer has determined whether those items are properly allocable to a trade or business. For instance, a taxpayer must apply §1.163–8T, if applicable, to determine which items of interest expense are investment interest under section 163(d) before applying the rules in paragraph (c) of this section to allocate interest expense between excepted and non-excepted trades or businesses. After determining whether its tax items are properly allocable to a trade or business, a taxpayer that is engaged in both excepted and non-excepted trades or businesses must apply the rules of this section to determine the amount of interest expense that is business interest expense subject to the section 163(j) limitation and to determine which items are included or excluded in computing its section 163(j) limitation.

(ii) *Treatment of investment interest, investment income, investment expenses, and certain other tax items of a partnership with a C corporation or tax-exempt corporation as a partner*. For rules governing the treatment of investment interest, investment income, investment expenses, and certain other separately stated tax items of a partnership with a C corporation or tax-exempt corporation as a partner, see §§1.163(j)–4(b)(3) and 1.163(j)–6(k).

(3) *Application of allocation rules to foreign corporations and foreign partnerships*. The rules of this section apply to foreign corporations and foreign partnerships.

(4) *Application of allocation rules to members of a consolidated group*—(i) *In general*. As provided in §1.163(j)–4(d), the computations required by section 163(j) and the regulations in this part under section 163(j) of the Code generally are made for a consolidated group on a consolidated basis. In this regard, for purposes of applying the allocation rules of this section, all members of a consolidated group are treated as one corporation. Therefore, the rules of this section apply to the activities conducted by the group as if those activities were conducted by a single corporation. For example, the group (rather than a particular member) is treated as engaged in excepted or non-excepted trades or businesses. In the case of intercompany obligations, within the meaning of §1.1502–13(g)(2)(ii), for purposes of allocating asset basis between excepted and non-excepted trades or businesses, the obligation of the member borrower is not considered an asset of the creditor member. Similarly, intercompany transactions, within the meaning of §1.1502–13(b)(1)(i), are disregarded for purposes of this section, as are the resulting offsetting items, and property is allocated to a trade or business based on the activities of the group as if the members of the group were divisions of a single corporation. Further, stock of a group member that is owned by another member of the same group is not treated as an asset for purposes of this section, and the transfer of any amount of member stock to a non-member is treated by the group as a transfer of the member's assets proportionate to the amount of member stock transferred. Additionally, stock of a corporation that is not a group member is treated as owned by the group.

(ii) *Application of excepted business percentage to members of a consolidated group*. After a consolidated group has determined the percentage of the group's interest expense allocable to excepted trades or businesses for the taxable year (and thus not subject to the section 163(j) limitation), this exempt percentage is applied to the interest paid or accrued by each member during the taxable year to any lender that is not a group member. Therefore, except to the extent paragraph (d) of this section (providing rules for certain qualified nonrecourse indebtedness) applies, an identical percentage of the interest paid or accrued by each member of the group to any lender that is not a group member is treated as allocable to excepted trades or businesses, regardless of whether any particular member actually engaged in an excepted trade or business.

(iii) *Basis in assets transferred in an intercompany transaction*. For purposes of allocating interest expense and interest income under paragraph (c) of this section, the basis of property does not include any gain or loss realized with respect to the property by another member in an intercompany transaction, as defined in §1.1502–13(b), whether or not the gain or loss is deferred.

(5) *Tax-exempt organizations*. For tax-exempt organizations, section 512 and the regulations in this part under section 512 of the Code determine the rules for allocating all income and expenses among multiple trades or businesses.

(6) *Application of allocation rules to disallowed disqualified interest*. A taxpayer may apply the allocation rules of this section to disallowed disqualified interest by either:

(i) Applying the allocation rules of this section to all of the taxpayer's disallowed disqualified interest in the taxable year(s) in which the disallowed disqualified interest was paid or accrued (the historical approach); or

(ii) Treating all of the taxpayer's disallowed disqualified interest as if it were paid or accrued in the taxpayer's first taxable year beginning after December 31, 2017 (the effective date approach).

(7) *Examples*. The following examples illustrate the principles of this paragraph (a).

(i) *Example 1: Items properly allocable to a trade or business*—(A) *Facts*. Individual T operates Business X, a non-excepted trade or business, as a sole proprietor. In Year 1, T pays or accrues $40x of interest expense and receives $100x of gross income with respect to Business X that is not eligible for a section 199A deduction. T borrows money to buy a car for personal use, and T pays or accrues $20x of interest expense with respect to the car loan. T also invests in corporate bonds, and, in Year 1, T receives $50x of interest income on those bonds.

(B) *Analysis*. Under paragraphs (a)(1) and (2) of this section, T must determine which items of income and expense, including items of interest income and interest expense, are properly allocable to a trade or business. T's $100x of gross income and T's $40x of interest expense with respect to Business X are properly allocable to a trade or business. However, the interest expense on T's car loan is personal interest within the meaning of section 163(h)(2) rather than interest properly allocable to a trade or business. Similarly, T's interest income from corporate bonds is not properly allocable to a trade or business because it is interest from investment activity. See section 163(d)(4)(B).

(ii) *Example 2: Intercompany transaction*—(A) *Facts*. S is a member of a consolidated group of which P is the common parent. P conducts an electing real property trade or business (Business X), and S conducts a non-excepted trade or business (Business Y). P leases Building V (which P owns) to S for use in Business Y.

(B) *Analysis*. Under paragraph (a)(4)(i) of this section, a consolidated group is treated as a single corporation for purposes of applying the allocation rules of this section, and the consolidated group (rather than a particular member of the group) is treated as engaged in excepted and non-excepted trades or businesses. Thus, intercompany transactions are disregarded for purposes of this section. As a result, the lease of Building V by P to S is disregarded. Moreover, because Building V is used in Business Y, basis in this asset is allocated to Business Y rather than Business X for purposes of these allocation rules, regardless of which member (P or S) owns the building.

(iii) *Example 3: Intercompany sale of natural gas*—(A) *Facts*. S is a member of a consolidated group of which P is the common parent. S drills for natural gas and is not an excepted regulated utility trade or business. S sells most of its natural gas production to P, which produces electricity at its natural gas-fired power plants, and S sells the rest of its natural gas production to third parties at market rates. P is an excepted regulated utility trade or business to the extent that it is engaged in a trade or business described in § 1.163(j)–1(b)(15)(i).

(B) *Analysis.* Intercompany transactions are disregarded for purposes of this section. As a result, the intercompany sales of natural gas by S to P are disregarded. Moreover, the assets of S and P are allocated between the excepted and non-excepted trades or businesses of the P group based on the assets used in each trade or business. Assets of S may be allocated to the P group's excepted trade or business to the extent those assets are used in the trade or business of the furnishing or sale of electrical energy. Likewise, assets of P may be allocated to the P group's non-excepted trade or business to the extent those assets are used in the trade or business of natural gas production.

(iv) *Example 4: Disallowed disqualified interest*—(A) *Facts.* S is a member of a consolidated group of which P is the common parent. P and S are the only members of an affiliated group under old section 163(j)(6)(C). S operates a farm equipment leasing business (Business X) that is not an excepted trade or business. P is engaged in an electing farming business (Business Y). Entering its first taxable year beginning after December 31, 2017, the P group has disallowed disqualified interest of $120x, all of which the P group paid or accrued in earlier taxable years in which it only operated Business X. The P group also incurs $100x of interest expense during its 2018 taxable year, of which $25x (25 percent of $100x) is business interest expense properly allocable to Business X and $75x (75 percent of $100x) is properly allocable to Business Y under paragraph (c) of this section.

(B) *Analysis.* Under paragraph (a)(6) of this section, the P group may allocate disallowed disqualified interest to Business X and Business Y by either applying the allocation rules of this section in the taxable years in which the disallowed disqualified interest was paid or accrued (the historical approach) or by treating such interest as though it were paid or accrued in the P group's first taxable year beginning after December 31, 2017 (the effective date approach). Accordingly, if the P group chooses to rely on the historical approach, it allocates all $120x of disallowed disqualified interest to Business X (a non-excepted trade or business), and all $120x of disallowed disqualified interest is subject to the section 163(j) limitation. If, instead, the P group chooses to rely on the effective date approach, it allocates its $120x of disallowed disqualified interest in the same proportion as its $100x of business interest expense that was paid or accrued in its 2018 taxable year. Of the $120x of disallowed disqualified interest, $30x (25 percent of $120x) is allocated to Business X and $90x (75 percent of $120x) is allocated to Business Y. The $90x of disallowed disqualified interest that is properly allocable to Business Y (an excepted trade or business) is not subject to the section 163(j) limitation.

(b) *Allocation of tax items other than interest expense and interest income*—(1) *In general.* Except as otherwise provided in § 1.163(j)–6(m) or § 1.163(j)–9(h), for purposes of calculating ATI, tax items other than interest expense and interest income are allocated to a particular trade or business in the manner described in this paragraph (b). It is not necessary to allocate items under this paragraph (b) for purposes of calculating ATI if all of the taxpayer's items subject to allocation under this paragraph (b) are allocable to excepted trades or businesses, or if all of those items are allocable to non-excepted trades or businesses.

(2) *Gross income other than dividends and interest income.* A taxpayer's gross income other than dividends and interest income is allocated to the trade or business that generated the gross income.

(3) *Dividends*—(i) *Look-through rule.* If a taxpayer receives a dividend, within the meaning of section 316, that is not investment income, within the meaning of section 163(d), and if the taxpayer satisfies the minimum ownership threshold in paragraph (c)(7) of this section, then, solely for purposes of allocating amounts received as a dividend during the taxable year to excepted or non-excepted trades or businesses under this paragraph (b), the

dividend income is treated as allocable to excepted or non-excepted trades or businesses based upon the relative amounts of the payor corporation's adjusted basis in the assets used in its trades or businesses, determined pursuant to paragraph (c) of this section. If at least 90 percent of the payor corporation's adjusted basis in its assets during the taxable year, determined pursuant to paragraph (c) of this section, is allocable to either excepted trades or businesses or to non-excepted trades or businesses, all of the taxpayer's dividend income from the payor corporation for the taxable year is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(ii) *Inapplicability of the look-through rule.* If a taxpayer receives a dividend that is not investment income, within the meaning of section 163(d), and if the taxpayer does not satisfy the minimum ownership threshold in paragraph (c)(7) of this section, then the taxpayer must treat the dividend as allocable to a non-excepted trade or business.

(4) *Gain or loss from the disposition of non-consolidated C corporation stock, partnership interests, or S corporation stock*—(i) *Non-consolidated C corporations.* (A) If a taxpayer recognizes gain or loss upon the disposition of stock in a non-consolidated C corporation that is not property held for investment, within the meaning of section 163(d)(5), and if the taxpayer looks through to the assets of the C corporation under paragraph (c)(5)(ii) of this section for the taxable year, then the taxpayer must allocate gain or loss from the disposition of stock to excepted or non-excepted trades or businesses based upon the relative amounts of the C corporation's adjusted basis in the assets used in its trades or businesses, determined pursuant to paragraph (c) of this section. If at least 90 percent of the C corporation's adjusted basis in its assets during the taxable year, determined pursuant to paragraph (c) of this section, is allocable to either excepted trades or businesses or to non-excepted trades or businesses, all of the taxpayer's gain or loss from the disposition is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(B) If a taxpayer recognizes gain or loss upon the disposition of stock in a non-consolidated C corporation that is not property held for investment, within the meaning of section 163(d)(5), and if the taxpayer does not look through to the assets of the C corporation under paragraph (c)(5)(ii) of this section for the taxable year, then the taxpayer must treat the gain or loss from the disposition of stock as allocable to a non-excepted trade or business.

(C) For rules governing the transfer of stock of a member of a consolidated group, see paragraph (a)(4)(i) of this section.

(ii) *Partnerships and S corporations.* (A) If a taxpayer recognizes gain or loss upon the disposition of interests in a partnership or stock in an S corporation that owns—

(*1*) Non-excepted assets and excepted assets;

(*2*) Investment assets; or

(*3*) Both;

(B) The taxpayer determines a proportionate share of the amount properly allocable to a non-excepted trade or business in accordance with the allocation rules set forth in paragraph (c)(5)(ii)(A) or (c)(5)(ii)(B)(*3*) of this section, as appropriate, and includes such proportionate share of gain or loss in the taxpayer's ATI. However, if at least 90 percent of the partnership's or S corporation's adjusted basis in its assets during the taxable year, determined pursuant to paragraph (c) of this section, is allocable to either excepted trades or businesses or to non-excepted trades or businesses, all of the taxpayer's gain or loss from the disposition is treated as allocable to either excepted or non-excepted trades or businesses, respectively. This rule also applies to tiered passthrough entities by looking through each passthrough entity tier (for example, an S corporation that is the partner of the highest-tier partnership would look through each lower-tier partnership), subject to paragraph (c)(5)(ii)(D) of this section. With respect to a partner that is a C corporation or tax-exempt corporation, a partnership's investment assets are taken into account and treated as non-excepted trade or business assets. For purposes of this paragraph, a pass-through entity means a partnership, S corporation, or any other entity (domestic or foreign) that is not a corporation if all items of income and deduction of the entity are included in the income of its owners or beneficiaries.

(5) *Expenses, losses, and other deductions*—(i) *Expenses, losses, and other deductions that are definitely related to a trade or business*. Expenses (other than interest expense), losses, and other deductions (collectively, *deductions* for purposes of this paragraph (b)(5)) that are definitely related to a trade or business are allocable to the trade or business to which they relate. A deduction is considered definitely related to a trade or business if the item giving rise to the deduction is incurred as a result of, or incident to, an activity of the trade or business or in connection with property used in the trade or business (see §1.861–8(b)(2)). If a deduction is definitely related to one or more excepted trades or businesses and one or more non-excepted trades or businesses, the deduction is apportioned between the excepted and non-excepted trades or businesses based upon the relative amounts of the taxpayer's adjusted basis in the assets used in those trades or businesses, as determined under paragraph (c) of this section.

(ii) *Other deductions*. Deductions that are not described in paragraph (b)(5)(i) of this section are ratably apportioned based on the gross income of each trade or business.

(6) *Treatment of investment items and certain other items of a partnership with a C corporation partner*. Any investment income, investment expense, or other item that a partnership receives, pays, or accrues and that is treated as properly allocable to a trade or business of a C corporation partner under §1.163(j)–4(b)(3)(i) is treated as properly allocable to a non-excepted trade or business of the C corporation partner, except that any item with respect to property or activities for which an election has been made by the partnership under §1.163(j)–9(b) is treated as properly allocable to an excepted trade or business. See, for example, an election for activities described in §1.163(j)–9(b)(2)(ii) or an election under §1.163(j)–9(h).

(7) *Examples: Allocation of income and expense*. The following examples illustrate the principles of this paragraph (b):

(i) *Example 1: Allocation of income and expense between excepted and non-excepted trades or businesses*—(A) *Facts*. T conducts an electing real property trade or business (Business Y), which is an excepted trade or business. T also operates a lumber yard (Business Z), which is a non-excepted trade or business. In Year 1, T receives $100x of gross rental income from real property leasing activities. T also pays or accrues $60x of expenses in connection with its real property leasing activities and $20x of legal services performed on behalf of both Business Y and Business Z. T receives $60x of gross income from lumber yard customers and pays or accrues $50x of expenses related to the lumber yard business. For purposes of expense allocations under paragraphs (b) and (c) of this section, T has $240x of adjusted basis in its Business Y assets and $80x of adjusted basis in its Business Z assets.

(B) *Analysis*. Under paragraph (b)(2) of this section, for Year 1, $100x of rental income is allocated to Business Y, and $60x of income from lumber yard customers is allocated to Business Z. Under paragraph (b)(5)(i) of this section, $60x of expenses paid or accrued in connection with real property leasing activities are allocated to Business Y, and $50x of expenses related to the lumber yard are allocated to Business Z. The $20x of remaining expenses for legal services performed on behalf of both Business Y and Business Z are allocated according to the relative amounts of T's basis in the assets used in each business. The total amount of T's basis in the assets used in Businesses Y and Z is $320x, of which 75 percent ($240x/$320x) is used in Business Y and 25 percent ($80x/$320x) is used in Business Z. Accordingly, $15x of the expenses for legal services are allocated to Business Y and $5x are allocated to Business Z.

(ii) *Example 2: Allocation of partnership items from investment activity*—(A)

Facts. U, a domestic C corporation, directly conducts an electing real property trade or business. U also has an interest in PRS, a partnership that holds real property for investment. PRS's investment in real property is not a trade or business under section 162 or a real property trade or business under section 469. During the taxable year, PRS sells some of its real property to third parties and allocates $80x of income to U from these sales. In addition, PRS incurs deductible expenses related to its investment in real property and allocates $9x of these deductible expenses to U.

(B) *Analysis.* Under paragraph (b)(6) of this section, any investment income or investment expense that a partnership receives, pays, or accrues and that is treated as properly allocable to a trade or business of a C corporation partner is treated as properly allocable to a non-excepted trade or business of the C corporation partner. Because PRS generates its income and expense from investment activity that is not a trade or business under section 162 or a real property trade or business under section 469, U's allocation of $80x of income and $9x of deductible expense from PRS is treated as properly allocable to a non-excepted trade or business.

(c) *Allocating interest expense and interest income that is properly allocable to a trade or business*—(1) *General rule*—(i) *In general.* Except as otherwise provided in this section, § 1.163(j)–6(m), or § 1.163(j)–9(h), the amount of a taxpayer's interest expense and interest income that is properly allocable to a trade or business is allocated to the taxpayer's excepted or non-excepted trades or businesses for purposes of section 163(j) based upon the relative amounts of the taxpayer's adjusted basis in the assets, as determined under paragraph (c)(5) of this section, used in its excepted or non-excepted trades or businesses. The taxpayer must determine the adjusted basis in its assets as of the close of each determination date, as defined in paragraph (c)(6) of this section, in the taxable year and average those amounts to determine the relative amounts of asset basis for its excepted and non-excepted trades or businesses for that year. It is not necessary to allocate interest expense or interest income under this paragraph (c) for purposes of determining a taxpayer's business interest expense and business interest income if all of the taxpayer's interest income and expense is allocable to excepted trades or businesses (in which case the taxpayer is not subject to the section 163(j) limitation) or if all of the taxpayer's interest income and expense is allocable to non-excepted trades or businesses.

(ii) *De minimis exception.* If at least 90 percent of the taxpayer's basis in its assets for the taxable year is allocable to either excepted or non-excepted trades or businesses pursuant to this paragraph (c), then all of the taxpayer's interest expense and interest income for that year that is properly allocable to a trade or business is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(2) *Example.* The following example illustrates the principles of paragraph (c)(1) of this section:

(i) *Facts.* T is a calendar-year C corporation engaged in an electing real property trade or business, the business of selling wine, and the business of selling hand-carved wooden furniture. In Year 1, T has $100x of interest expense that is deductible except for the potential application of section 163(j). Based upon determinations made on the determination dates in Year 1, T's average adjusted basis in the assets used in the electing real property trade or business (an excepted trade or business) in Year 1 is $800x, and T's total average adjusted basis in the assets used in the other two businesses (which are non-excepted trades or businesses) in Year 1 is $200x.

(ii) *Analysis.* $80x (($800x/($800x + $200x)) × $100x) of T's interest expense for Year 1 is allocable to T's electing real property trade or business and is not business interest expense subject to the section 163(j) limitation. The remaining $20x of T's interest expense is business interest expense for Year 1 that is subject to the section 163(j) limitation.

(3) *Asset used in more than one trade or business*—(i) *General rule.* If an asset is

used in more than one trade or business during a determination period, as defined in paragraph (c)(6) of this section, the taxpayer's adjusted basis in the asset is allocated to each trade or business using the permissible methodology under this paragraph (c)(3) that most reasonably reflects the use of the asset in each trade or business during that determination period. An allocation methodology most reasonably reflects the use of the asset in each trade or business if it most properly reflects the proportionate benefit derived from the use of the asset in each trade or business. A taxpayer is not required to use the same allocation methodology for each type of asset used in a trade a business. Instead, a taxpayer may use different allocation methodologies for different types of assets used in a trade or business. If none of the permissible methodologies set forth in paragraph (c)(3)(ii) of this section reasonably reflects the use of the asset in each trade or business, the taxpayer's basis in the asset is not taken into account for purposes of this paragraph (c).

(ii) *Permissible methodologies for allocating asset basis between or among two or more trades or businesses.* Subject to the special rules in paragraphs (c)(3)(iii) and (c)(5) of this section, a taxpayer's basis in an asset used in two or more trades or businesses during a determination period may be allocated to those trades or businesses based upon—

(A) The relative amounts of gross income that an asset generates, has generated, or may reasonably be expected to generate, within the meaning of §1.861–9T(g)(3), with respect to the trades or businesses;

(B) If the asset is land or an inherently permanent structure, the relative amounts of physical space used by the trades or businesses; or

(C) If the trades or businesses generate the same unit of output, the relative amounts of output of those trades or businesses (for example, if an asset is used in two trades or businesses, one of which is an excepted regulated utility trade or business, and the other of which is a non-excepted regulated utility trade or business, the taxpayer may allocate basis in the asset based upon the relative amounts of kilowatt-hours generated by each trade or business).

(iii) *Special rules*—(A) *Consistent allocation methodologies*—(*1*) *In general.* Except as otherwise provided in paragraph (c)(3)(iii)(A)(*2*) of this section, a taxpayer must maintain the same allocation methodology for a period of at least five taxable years.

(*2*) *Consent to change allocation methodology.* If a taxpayer has used the same allocation methodology for at least five taxable years, the taxpayers may change its method of allocation under paragraphs (c)(3)(i) and (ii) of this section without the consent of the Commissioner. If a taxpayer has used the same allocation methodology for less than five taxable years, and if the taxpayer determines that a different allocation methodology properly reflects the proportionate benefit derived from the use of assets in its trades or businesses, the taxpayer may change its method of allocation under paragraphs (c)(3)(i) and (ii) of this section only with the consent of the Commissioner. To obtain consent, a taxpayer must submit a request for a letter ruling under the applicable administrative procedures, and consent will be granted only in extraordinary circumstances.

(B) *De minimis exception.* If at least 90 percent of the taxpayer's basis in an asset would be allocated to either excepted trades or businesses or non-excepted trades or businesses during a determination period pursuant to this paragraph (c)(3), the taxpayer's entire basis in the asset for the determination period must be allocated to either excepted or non-excepted trades or businesses, respectively. This rule applies before the application of paragraph (c)(1)(ii) of this section.

(C) *Allocations of excepted regulated utility trades or businesses*—(*1*) *In general.* Except as provided in the de minimis rule in paragraph (c)(3)(iii)(C)(*3*) of this section, a taxpayer is engaged in an excepted regulated utility trade or business only to the extent that the taxpayer is engaged in an excepted regulated utility trade or business described in §1.163(j)–1(b)(15)(i)(A), (B), or (C), and any remaining utility trade or business is a non-excepted trade or business. Thus, for example, electricity sold by a utility trade or business at rates not established or approved by an entity described in §1.163(j)–1(b)(15)(i)(A)(*2*) and not subject to an election under §1.163(j)–1(b)(15)(iii) must be treated as electricity sold by a non-excepted regulated utility trade or business. The taxpayer must allocate under this paragraph (c) the basis of assets used in the utility trade or business between its excepted and non-excepted trades or businesses.

(*2*) *Permissible method for allocating asset basis for utility trades or businesses.* In the case of a utility trade or business described in paragraph (c)(3)(iii)(C)(*1*) of this section, and except as provided in the de minimis rule in paragraph (c)(3)(iii)(C)(*3*) of this section, the method described in paragraph (c)(3)(ii)(C) of this section is the only permissible method under this paragraph (c)(3) for allocating the taxpayer's basis in assets used in both the excepted and non-excepted trades or businesses of selling or furnishing the items described in §1.163(j)–1(b)(15)(i)(A)(*1*).

(*3*) *De minimis rule for excepted utility trades or businesses.* If a taxpayer is engaged in a utility trade or business described in paragraph (c)(3)(iii)(C)(*1*) of this section, and if at least 90 percent of the items described in §1.163(j)–1(b)(15)(i)(A)(*1*) are furnished or sold by trades or businesses described in §1.163(j)–1(b)(15)(i)(A), (B) or (C), the taxpayer's entire trade or business is an excepted regulated utility trade or business, and paragraph (c)(3)(iii)(C)(*2*) of this section does not apply. This rule applies before the application of paragraph (c)(3)(iii)(B) of this section.

(*4*) *Example.* The following example illustrates the principles of this paragraph (c)(3)(iii)(C):

(*i*) *Facts.* X, a C corporation, is engaged in the trade or business of generating electrical energy. During each determination period in the taxable year, 80 percent of the megawatt-hours generated in the electricity generation trade or business is sold at rates negotiated with the purchaser, and with respect to which X filed a schedule of rates with a public utility commission. The public utility commission has the authority to take action on the filed schedule of rates, but if no action is taken, the rules governing the public utility commission explicitly state that the public utility commission is deemed to have approved the rates. The public utility has taken no action with respect to the negotiated rate. The remaining 20 percent of the megawatt-hours is sold on the wholesale market at rates not established or subject to approval by a regulator described in §1.163(j)–1(b)(15)(i)(A)(*2*). X has not made an election under §1.163(j)–1(b)(15)(iii). None of the assets used in X's utility generation trade or business are used in any other trade or business.

(*ii*) *Analysis.* For purposes of section 163(j), under paragraph (c)(3)(iii)(C)(*1*) of this section, 80 percent of X's electricity generation business is an excepted regulated utility trade or business, because the rate for the sale of the electricity was subject to approval by a regulator described in §1.163(j)–1(b)(15)(i)(A)(*2*). The remaining 20 percent of X's business is a non-excepted utility trade or business. Under paragraph (c)(3)(iii)(C)(*2*) of this section, X must allocate 80 percent of the basis of the assets used in its utility business to excepted trades or business and the remaining 20 percent of the basis in the assets to non-excepted trades or businesses.

(D) *Special allocation rule for real property trades or businesses subject to special anti-abuse rule*—(*1*) *In general.* In the case of a trade or business that leases real property subject to an arrangement described in §1.163(j)–9(j)(1), including trades or businesses to which the look-through exception in §1.163(j)–9(j)(2)(ii) applies, the taxpayer must allocate under this paragraph (c)(3) the basis of property used in both the excepted and non-excepted portions of its trade or business, as determined under §1.163(j)–9(j)(3).

(*2*) *Allocation methodology for real property.* For purposes of this paragraph (c)(3)(iii)(D), a taxpayer must allocate the basis of real property leased under an arrangement described in §1.163(j)–9(j)(1) or (j)(2)(i) between the excepted and non-excepted portions of the real property trade or business based on the relative fair market rental value of the real property that is attributable to the excepted and non-excepted portions of the trade or business, respectively.

(*3*) *Example*. The following example illustrates the principles of this paragraph (c)(3)(iii)(D):

(*i*) *Facts*. X and Y are domestic C corporations under common control within the meaning of section 267(b), but neither X nor Y are members of a consolidated group. The small business exemption in §1.163(j)–2(d) does not apply to X or Y. X owns an office building and leases the entire building to Y. Y subleases 80 percent of the office building, measured by fair market rental value, to a related party. Y subleases the remaining 20 percent of the building to unrelated third parties. X also owns depreciable scaffolding equipment, which it uses to clean all of the building's windows as part of its leasing arrangement with Y.

(*ii*) *Analysis*. Under §1.163(j)–9(j)(2)(ii), X is eligible to make an election for 20 percent of its business of leasing the office building to be an electing real property trade or business. Assuming X makes such an election, X must allocate the basis of assets used in both the excepted and non-excepted portions of its leasing trade or business under this paragraph (c). Under paragraph (c)(3)(iii)(D)(*2*) of this section, X must allocate the basis of the office building based on the relative fair market value attributable to the excepted and non-excepted portions of its leasing business. Therefore, X must allocate 20 percent of the basis of the building to the excepted portion of its leasing business, and it must allocate the remaining 80 percent of the building to the non-excepted portion of its leasing business. Under paragraph (c)(3)(iii)(D)(*2*) of this section, X may use one of the allocation methods described in paragraph (c)(3)(ii) of this section to allocate the basis of its scaffolding equipment between the excepted and non-excepted portions of its leasing trade or business.

(4) *Disallowed business interest expense carryforwards; floor plan financing interest expense*. Disallowed business interest expense carryforwards (which were treated as allocable to a non-excepted trade or business in a prior taxable year) are not re-allocated between non-excepted and excepted trades or businesses in a succeeding taxable year. Instead, the carryforwards continue to be treated as allocable to a non-excepted trade or business. Floor plan financing interest expense also is not subject to allocation between excepted and non-excepted trades or businesses (see §1.163(j)–1(b)(19)) and is always treated as allocable to non-excepted trades or businesses.

(5) *Additional rules relating to basis*—(i) *Calculation of adjusted basis*—(A) *Non-depreciable property other than land*. Except as otherwise provided in paragraph (c)(5)(i)(E) of this section, for purposes of this section, the adjusted basis of an asset other than land with respect to which no deduction is allowable under section 167, former section 168, or section 197, as applicable, is the adjusted basis of the asset for determining gain or loss from the sale or other disposition of that asset as provided in §1.1011–1. Self-created intangible assets are not taken into account for purposes of this paragraph (c).

(B) *Depreciable property other than inherently permanent structures*. For purposes of this section, the adjusted basis of any tangible asset with respect to which a deduction is allowable under section 167, other than inherently permanent structures, is determined by using the alternative depreciation system under section 168(g) before any application of the additional first-year depreciation deduction (for example, under section 168(k) or (m)), and the adjusted basis of any tangible asset with respect to which a deduction is allowable under former section 168, other than inherently permanent structures, is determined by using the taxpayer's method of computing depreciation for the asset under former section 168. The depreciation deduction with respect to the property described in this paragraph (c)(5)(i)(B) is allocated ratably to each day during the period in the taxable year to which the depreciation relates. A change to the alternative depreciation system should be determined in a manner similar to that in §1.168(i)–4(d)(4) or (d)(5)(ii)(B), as applicable.

(C) *Special rule for land and inherently permanent structures.* Except as otherwise provided in paragraph (c)(5)(i)(E) of this section, for purposes of this section, the adjusted basis of any asset that is land, including nondepreciable improvements to land, or an inherently permanent structure is its unadjusted basis.

(D) *Depreciable or amortizable intangible property and depreciable income forecast method property.* For purposes of this section, the adjusted basis of any intangible asset with respect to which a deduction is allowable under section 167 or 197, as applicable, is determined in accordance with section 167 or 197, as applicable, and the adjusted basis of any asset described in section 167(g)(6) for which a deduction is allowable under section 167 is determined in accordance with section 167(g). The adjusted basis of any intangible asset under this paragraph (c)(5)(i)(D) is determined before any application of the additional first-year depreciation deduction. The depreciation or amortization deduction with respect to the property described in this paragraph (c)(5)(i)(D) is allocated ratably to each day during the period in the taxable year to which the depreciation or amortization relates.

(E) *Assets not yet used in a trade or business.* Assets that have been acquired or that are under development but that are not yet used in a trade or business are not taken into account for purposes of this paragraph (c). For example, construction works in progress (such as buildings, airplanes, or ships) are not taken into account for purposes of this paragraph (c). Similarly, land acquired by a taxpayer for construction of a building by the taxpayer to be used in a trade or business is not taken into account for purposes of under this paragraph (c) until the building is placed in service. This rule does not apply to interests in a partnership or stock in a corporation.

(F) *Trusts established to fund specific liabilities.* Trusts required to fund specific liabilities (for example, pension trusts, and nuclear decommissioning funds (including, but not limited to, those funds for which an election is made under section 468A)) are not taken into account for purposes of this paragraph (c).

(G) *Inherently permanent structure.* For purposes of this section, the term *inherently permanent structure* has the meaning provided in §1.856–10(d)(2).

(ii) *Partnership interests; stock in nonconsolidated C corporations*—(A) *Partnership interests*—(*1*) *Calculation of asset basis.* For purposes of this section, a partner's interest in a partnership is treated as an asset of the partner. For these purposes, the partner's adjusted basis in a partnership interest is reduced, but not below zero, by the partner's share of partnership liabilities, as determined under section 752, and is further reduced as provided in paragraph (c)(5)(ii)(A)(*2*)(*iii*) of this section. If a partner elects or is required to apply the rules in this paragraph (c)(5)(ii)(A) to look through to a partnership's basis in the partnership's assets, the partner's basis in the partnership interest is adjusted to the extent of the partner's share of any adjustments to the basis of the partnership's assets required pursuant to the rules in paragraph (c)(5)(i) of this section.

(*2*) *Allocation of asset basis*—(*i*) *In general.* For purposes of determining the extent to which a partner's adjusted basis in its partnership interest is allocable to an excepted or non-excepted trade or business, the partner may look through to such partner's share of the partnership's basis in the partnership's assets, taking into account any adjustments under sections 734(b) and 743(b), and adjusted to the extent required under paragraph (d)(4) of this section, except as otherwise provided in paragraph (c)(5)(ii)(D) of this section. For purposes of the preceding sentence, such partner's share of partnership assets is determined using a reasonable method taking into account special allocations under section 704(b). Notwithstanding paragraph (c)(7) of this section, if a partner's direct and indirect interest in a partnership is greater than or equal to 80 percent of the partnership's capital or profits, the partner must apply the rules in this paragraph (c)(5)(ii)(A)(*2*) to look through to the partnership's basis in the partnership's assets. If a partner elects or is required to apply the rules in this paragraph (c)(5)(ii)(A)(*2*) to look through to a partnership's basis in the partnership's assets, the partner allocates the basis of its partnership interest between excepted and non-excepted trades or businesses based on the ratio in which the partner's share of the partnership's adjusted tax basis in its trade or business assets is allocated between excepted and non-excepted trade or business assets.

(*ii*) *De minimis rule.* If, after applying paragraph (c)(5)(ii)(A)(*2*)(*iii*) of this section, at least 90 percent of a partner's share of a partnership's basis in its assets (including adjustments under sections 734(b) and 743(b)) is allocable to either excepted trades or businesses or non-excepted trades or businesses, without regard to assets not properly allocable to a trade or business, the partner's entire basis in its partnership interest is treated as allocable to either excepted or non-excepted trades or businesses, respectively. For purposes of the preceding sentence, such partner's share of partnership assets is determined using a reasonable method taking into account special allocations under section 704(b).

(*iii*) *Partnership assets not properly allocable to a trade or business.* For purposes of applying paragraphs (c)(5)(ii)(A)(*2*)(*i*) and (*ii*) of this section to a partner that is a C corporation or tax-exempt corporation, such partner's share of a partnership's assets that are not properly allocable to a trade or business is treated as properly allocable to a non-excepted trade or business of such partner. However, if the partnership made an election under §1.163(j)–9(b) or §1.163(j)–9(h) with respect to an asset or activity, the assets (or assets related to such activities) are treated as properly allocable to an excepted trade or business of such partner. See, for example, an election under §1.163(j)–9(h) for an asset or an election under §1.163(j)–9(b) with respect to activities described in §1.163(j)–9(b)(2)(ii). For a partner other than a C corporation or tax-exempt corporation, a partnership's assets that are not properly allocable to a trade or business are treated as neither excepted nor non-excepted trade or business assets; instead, such partner's adjusted basis in its partnership interest is decreased by that partner's share of the excess of the partnership's basis in those assets over the partnership's debt that is traced to such assets in accordance with §1.163–8T, and it is increased by that partner's share of the excess of the partnership's debt that is traced to such assets in accordance with §1.163–8T over the partnership's basis in those assets. For purposes of the preceding sentence, the partnership's asset basis in property not allocable to a trade or business is adjusted pursuant to the rules in paragraph (c)(5)(i) of this section. For purposes of this paragraph (c)(5)(ii)(A)(*2*)(*iii*), such partner's share of a partnership's assets is determined under a reasonable method taking into account special allocations under section 704(b).

(*iv*) *Inapplicability of partnership look-through rule.* If a partner, other than a C corporation or a tax-exempt corporation, chooses not to look through to the partnership's basis in the partnership's assets under paragraph (c)(5)(ii)(A)(*2*)(*i*) of this section or is precluded by paragraph (c)(5)(ii)(D) of this section from applying such partnership look-through rule, the partner generally will treat its basis in the partnership interest as either an asset held for investment or a non-excepted trade or business asset as determined under section 163(d). If a partner that is a C corporation or a tax-exempt corporation chooses not to look through to the partnership's basis in the partnership's assets under paragraph (c)(5)(ii)(A)(*2*)(*i*) of this section or is precluded by paragraph (c)(5)(ii)(D) of this section from applying such partnership look-through rule, the taxpayer must treat its entire basis in the partnership interest as allocable to a non-excepted trade or business.

(B) *Stock in domestic non-consolidated corporations*—(*1*) *In general.* For purposes of this section, if a taxpayer owns stock in a domestic C corporation that is not a member of the taxpayer's consolidated group, or if the taxpayer owns stock in an S corporation, the stock is treated as an asset of the taxpayer.

(*2*) *Domestic non-consolidated C corporations*—(*i*) *Allocation of asset basis.* If a shareholder satisfies the minimum ownership threshold in paragraph (c)(7) of this section for stock in a domestic non-consolidated C corporation, and if dividends paid on such stock would not be included in the shareholder's investment income under section 163(d)(4)(B), then, for purposes of determining the extent to which the shareholder's basis in the stock is allocable to an excepted or non-excepted trade or business, the shareholder must look through to the corporation's basis in the corporation's assets, adjusted to the extent required under paragraph (d)(4) of this section, except as otherwise provided in paragraph (c)(5)(ii)(D) of this section. If a shareholder does not satisfy the minimum ownership threshold in paragraph (c)(7) of this section for stock in a domestic non-consolidated C corporation, but the shareholder's direct and indirect interest in such corporation is greater than or equal to 80 percent by value, and if dividends paid on such stock would not be included in the shareholder's investment income under section 163(d)(4)(B), then, for purposes of determining the extent to which the shareholder's basis in the stock is allocable to an excepted or non-excepted trade or business, the shareholder may look through to the corporation's basis in the corporation's assets, adjusted to the extent required under paragraph (d)(4) of this section, except as otherwise provided in paragraph (c)(5)(ii)(D) of this section. For purposes of the preceding sentence, indirect stock ownership is determined by applying the constructive ownership rules of section 318(a).

(*ii*) *De minimis rule.* If at least 90 percent of the domestic non-consolidated C corporation's basis in the corporation's assets is allocable to either excepted trades or businesses or non-excepted trades or businesses, the shareholder's entire interest in the corporation's stock is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(*iii*) *Inapplicability of corporate look-through rule.* If a shareholder other than a C corporation or a tax-exempt corporation is ineligible to look through or chooses not to look through to a corporation's basis in its assets under paragraph (c)(5)(ii)(B)(*2*)(*i*) of this section, the shareholder generally will treat its entire basis in the corporation's stock as an asset held for investment. If a shareholder that is a C corporation or a tax-exempt corporation is ineligible to look through or chooses not to look through to a corporation's basis in its assets under paragraph (c)(5)(ii)(B)(*2*)(*i*) of this section, the shareholder must treat its entire basis in the corporation's stock as allocable to a non-excepted trade or business.

(*iv*) *Use of inside basis for purposes of C corporation look-through rule.* This paragraph (c)(5)(ii)(B)(*2*)(*iv*) applies if a shareholder meets the requirements to look through the stock of a domestic non-consolidated C corporation under paragraph (c)(5)(ii)(B)(*2*)(*i*) of this section, determined without applying the constructive ownership rules of section 318(a). If this paragraph (c)(5)(ii)(B)(*2*)(*iv*) applies, then solely for purposes of allocating asset basis under paragraph (c)(5)(ii)(B)(*2*)(*i*) of this section, and except as otherwise provided in paragraph (c)(5)(ii)(D) of this section, the shareholder may look through to such shareholder's pro rata share of the C corporation's basis in its assets, taking into account the modifications in paragraph (c)(5)(i) of this section with respect to the C corporation's assets, and adjusted to the extent required under paragraph (d)(4) of this section (asset basis look-through approach). If a shareholder applies the asset basis look-through approach, it must do so for all domestic non-consolidated C corporations for which the shareholder is eligible to use this approach, and it must report its use of this approach on the information statement described in paragraph (c)(6)(iii) of this section. The shareholder also must continue to use the asset basis look-through approach in all future taxable years in which the shareholder is eligible to use this approach.

(*3*) *S corporations*—(*i*) *Calculation of asset basis.* For purposes of this section, a shareholder's share of stock in an S corporation is treated as an asset of the shareholder. Additionally, for these purposes, the shareholder's adjusted basis in a share of S corporation stock is adjusted to take into account the modifications in paragraph (c)(5)(i) of this section with respect to the assets of the S corporation (for example, a shareholder's adjusted basis in its S corporation stock is increased by the shareholder's share of depreciation with respect to an inherently permanent structure owned by the S corporation).

(*ii*) *Allocation of asset basis.* For purposes of determining the extent to which a shareholder's basis in its stock of an S corporation is allocable to an excepted or non-excepted trade or business, the shareholder may look through to such shareholder's share of the S corporation's basis in the S corporation's assets, allocated on a pro rata basis, adjusted to the extent required under paragraph (d)(4) of this section, except as otherwise provided in paragraph (c)(5)(ii)(D) of this section. Notwithstanding paragraph (c)(7) of this section, if a shareholder's direct and indirect interest in an S corporation is greater than or equal to 80 percent of the S corporation's stock by vote and value, the shareholder must apply the rules in this paragraph (c)(5)(ii)(B)(*3*) to look through to the S corporation's basis in the S corporation's assets. For these purposes, indirect stock ownership is determined by applying the constructive ownership rules of section 318(a).

(*iii*) *De minimis rule.* If at least 90 percent of a shareholder's share of an S corporation's basis in its assets is allocable to either excepted trades or businesses or non-excepted trades or businesses, the shareholder's entire basis in its S corporation stock is treated as allocable to either excepted or non-excepted trades or businesses, respectively.

(*iv*) *Inapplicability of S corporation look-through rule.* If a shareholder chooses not to look through to the S corporation's basis in the S corporation's assets under paragraph (c)(5)(ii)(B)(*3*)(*ii*) of this section or is precluded by paragraph (c)(5)(ii)(D) of this section from applying such S corporation look-through rule, the shareholder will treat its basis in the S corporation stock as either an asset held for investment or a non-excepted trade or business asset as determined under section 163(d).

(C) *Stock in relevant foreign corporations*—(*1*) *In general.* The rules applicable to domestic non-consolidated C corporations in paragraph (c)(5)(ii)(B) of this section also apply to relevant foreign corporations (as defined in §1.163(j)–1(b)(33)).

(*2*) *Special rule for CFC utilities.* Solely for purposes of applying the rules in paragraph (c)(5)(ii)(B) of this section, a utility trade or business conducted by an applicable CFC is treated as an excepted regulated utility trade or business, but only to the extent that the applicable CFC sells or furnishes the items described in §1.163(j)–1(b)(15)(i)(A)(*1*) pursuant to rates established or approved by an entity described in §1.163(j)–1(b)(15)(i)(A)(*2*), a foreign government, a public service or public utility commission or other similar body of any foreign government, or the governing or ratemaking body of a foreign electric cooperative. For purposes of this paragraph (c)(5)(ii)(C)(*2*), the term *foreign government* means any foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one of the foregoing within the meaning of §1.1471–6(b).

(D) *Limitations on application of look-through rules*—(*1*) *Inapplicability of look-through rule to partnerships or non-consolidated C corporations to which the small business exemption applies.* A taxpayer may not apply the look-through rules in paragraphs (b)(3) and (c)(5)(ii)(A), (B), and (C) of this section to a partnership, S corporation, or non-consolidated C corporation that is eligible for the small business exemption under section 163(j)(3) and §1.163(j)–2(d)(1), unless the partnership, S corporation, or non-consolidated C corporation elects under §1.163(j)–9 for a trade or business to be an electing real property trade or business or an electing farming business.

(E) *Tiered entities.* If a taxpayer applies the look-through rules of this paragraph (c)(5)(ii), the taxpayer must do so for all lower-tier entities with respect to which the taxpayer satisfies, directly or indirectly, the minimum ownership threshold in paragraph (c)(7) of this section, subject to the limitation in paragraph (c)(5)(ii)(D) of this section, beginning with the lowest-tier entity.

(*2*) *Limitation on application of look-through rule to C corporations.* Except as provided in §1.163(j)–9(h)(4)(iii) and (iv) (for a REIT or a partnership making the election under §1.163(j)–9(h)(1) or (7), respectively), for purposes of applying the look-through rules in paragraph (c)(5)(ii)(B) and (C) of this section to a non-consolidated C corporation (upper-tier entity), that upper-tier entity may not apply these look-through rules to a lower-tier non-consolidated C corporation if a principal purpose for borrowing funds at the upper-tier entity level or adding an upper-tier or lower-tier entity to the ownership structure is increasing the amount of the taxpayer's basis allocable to excepted trades or businesses. For example, P wholly and directly owns S1 (the upper-tier entity), which wholly and directly owns S2. Each of S1 and S2 is a non-consolidated C corporation to which the small business exemption does not apply, and S2 is engaged in an excepted trade or business. With a principal purpose of increasing the amount of basis allocable to its excepted trades or businesses, P has S1 (rather than S2) borrow funds from a third party. S1 may not look through the stock of S2 (and may not apply the asset basis look-through rule described in paragraph (c)(5)(ii)(B)(*2*)(*iv*) of this section) for purposes of P's allocation of its basis in its S1 stock between excepted and non-excepted trades or businesses; instead, S1 must treat its stock in S2 as an asset used in a non-excepted trade or business for that purpose. However, S1 may look through the stock of S2 for purposes of S1's allocation of its basis in its S2 stock between excepted and non-excepted trades or businesses.

(iii) *Cash and cash equivalents and customer receivables.* Except as otherwise provided in the last sentence of this paragraph (c)(5)(iii), a taxpayer's basis in its cash and cash equivalents and customer receivables is not taken into account for purposes of this paragraph (c). This rule also applies to a lower-tier entity if a taxpayer looks through to the assets of that entity under paragraph (c)(5)(ii) of this section. For purposes of this paragraph (c)(5)(iii), the term *cash and cash equivalents* includes cash, foreign currency, commercial paper, any interest in an investment company registered under the Investment Company Act of 1940 (1940 Act) and regulated as a money market fund under 17 CFR 270.2a–7 (Rule 2a–7 under the 1940 Act), any obligation of a government, and any derivative that is substantially secured by an obligation of a government, or any similar asset. For purposes of this paragraph (c)(5)(iii), a *derivative* is a derivative described in section 59A(h)(4)(A), without regard to section 59A(h)(4)(C). For purposes of this paragraph (c)(5)(iii), the term *government* means the United States or any agency or instrumentality of the United States; a State, a territory, a possession of the United States, the District of Columbia, or any political subdivision thereof within the meaning of section 103 and §1.103–1; or any foreign government, any political subdivision of a foreign government, or any wholly owned agency or instrumentality of any one of the foregoing within the meaning of §1.1471–6(b). This paragraph (c)(5)(iii) does not apply to an entity that qualifies as a financial services entity as described in §1.904–4(e)(3).

(iv) *Deemed asset sale.* Solely for purposes of determining the amount of basis allocable to excepted and non-excepted trades or businesses under this section, an election under section 336, 338, or 754, as applicable, is deemed to have been made for any acquisition of corporate stock or partnership interests with respect to which the taxpayer demonstrates, in the information statement required by paragraph (c)(6)(iii)(B) of this section, that the acquisition qualified for such an election and that, immediately before the acquisition, the acquired entity had a regulatory liability for deferred taxes recorded on its books with respect to property predominantly used in an excepted regulated utility trade or business. Any additional basis taken into account under this rule is reduced ratably over a 15-year period beginning with the month of the acquisition and is not subject to the anti-abuse rule in paragraph (c)(8) of this section.

(v) *Other adjustments.* The Commissioner may make appropriate adjustments to prevent a taxpayer from intentionally and artificially increasing its basis in assets attributable to an excepted trade or business.

(6) *Determination dates; determination periods; reporting requirements*—(i) *Determination dates and determination periods*—(A) *Quarterly determination periods.* For purposes of this section, and except as otherwise provided in paragraph (c)(6)(i)(B) of this section, the term *determination date* means the last day of each quarter of the taxpayer's taxable year (and the last day of the taxpayer's taxable year, if the taxpayer has a short taxable year), and the term *determination period* means the period beginning the day after one determination date and ending on the next determination date.

(B) *Annual determination periods.* If a taxpayer satisfies the requirements of the last sentence of this paragraph (c)(6)(i)(B), the taxpayer may allocate asset basis for a taxable year based on the average of adjusted asset basis at the beginning of the year and the end of the year (annual determination method). For these purposes, the term *determination date* means the last day of the taxpayer's taxable year, and the term *determination period* has the same meaning as provided in paragraph (c)(6)(i)(A) of this section. A taxpayer may use the annual determination method for a taxable year only if the taxpayer demonstrates that its total adjusted basis (as determined under paragraph (c)(5) of this section) at the end of the year in its assets used in its excepted trades or businesses, as a percentage of the taxpayer's total adjusted basis at the end of such year in all of its assets used in a trade or business, does not differ by more than 20 percent from such percentage at the beginning of the year.

(ii) *Application of look-through rules.* If a taxpayer that applies the look-through rules of paragraph (c)(5)(ii) of this section has a different taxable year than the partnership or non-consolidated C corporation to which the taxpayer is applying those rules, then, for purposes of this paragraph (c)(6), the taxpayer must use the most recent asset basis figures from the partnership or non-consolidated C corporation. For example, assume that PS1 is a partnership with a May 31 taxable year, and that C (a calendar-year C corporation that is ineligible to use the annual determination method for the taxable year) is a partner in PS1. PS1's determination dates are February 28, May 31, August 31, and November 30. In turn, C's determination dates are March 31, June 30, September 30, and December 31. If C looks through to PS1's basis in its assets under paragraph (c)(5)(ii) of this section, then, for purposes of determining the amount of C's asset basis that is attributable to its excepted and non-excepted businesses on March 31, C must use PS1's asset basis calculations for February 28.

(iii) *Reporting requirements*—(A) *Books and records.* A taxpayer must maintain books of account and other records and data as necessary to substantiate the taxpayer's use of an asset in an excepted trade or business and to substantiate any adjustments to asset basis for purposes of applying this paragraph (c). One indication that a particular asset is used in a particular trade or business is if the taxpayer maintains separate books and records for all of its excepted and non-excepted trades or businesses and can show the asset in the books and records of a particular excepted or non-excepted trade or business. For rules governing record retention, see §1.6001–1.

(B) *Information statement.* Except as otherwise provided in publications, forms, instructions, or other guidance, each taxpayer that is making an allocation under this paragraph (c), including any taxpayer that satisfies the de minimis rule in paragraph (c)(1)(ii) of this section, must prepare a statement titled ''Section 163(j) Asset Basis Calculations'' containing the information described in paragraphs (c)(6)(iii)(B)(*1*) through (*7*) of this section and must attach the statement to its timely filed Federal income tax return for the taxable year:

(*1*) The taxpayer's adjusted basis in the assets used in its excepted and non-excepted businesses, determined as set forth in this section, including detailed information for the different groups of assets identified in paragraphs (c)(5)(i) and (ii) and (d) of this section;

(*2*) The determination dates on which asset basis was measured during the taxable year;

(*3*) The names and taxpayer identification numbers (TINs) of all entities for which basis information is being provided, including partnerships and corporations if the taxpayer that owns an interest in a partnership or corporation looks through to the partnership's or corporation's basis in the partnership's or corporation's assets under paragraph (c)(5)(ii) of this section. If the taxpayer is a member of a consolidated group, the name and TIN of the agent for the group, as defined in §1.1502–77, must be provided, but the taxpayer need not provide the names and TINs of all other consolidated group members;

(*4*) Asset basis information for corporations or partnerships if the taxpayer looks through to the corporation's or partnership's basis in the corporation's or partnership's assets under paragraph (c)(5)(ii) of this section;

(*5*) A summary of the method or methods used to determine asset basis in property used in both excepted and non-excepted businesses, as well as information regarding any deemed sale under paragraph (c)(5)(iv) of this section;

(*6*) Whether the taxpayer used the historical approach or the effective date approach for all of its disallowed disqualified interest; and

(*7*) If the taxpayer changed its methodology for allocating asset basis between or among two or more trades or businesses under paragraph (c)(3)(ii) of this section, a statement that the taxpayer has changed the allocation methodology and a description of the new methodology or, if the taxpayer is required to request consent for the allocation methodology change under paragraph (c)(3)(iii)(A)(*2*) of this section, a statement that the request has been or will be filed and a description of the methodology change.

(iv) *Failure to file statement.* If a taxpayer fails to file the statement described in paragraph (c)(6)(iii) of this section or files a statement that does not comply with the requirements of paragraph (c)(6)(iii) of this section, the Commissioner may treat the taxpayer as if all of its interest expense is properly allocable to a non-excepted trade or business, unless the taxpayer shows that there was reasonable cause for failing to comply with, and the taxpayer acted in good faith with respect to, the requirements of paragraph (c)(6)(iii) of this section, taking into account all pertinent facts and circumstances.

(7) *Ownership threshold for look-through rules*—(i) *Corporations*—(A) *Asset basis.* For purposes of this section, a shareholder must look through to the assets of a domestic non-consolidated C corporation or a relevant foreign corporation under paragraph (c)(5)(ii) of this section if the shareholder's direct and indirect interest in the corporation satisfies the ownership requirements of section 1504(a)(2). For purposes of this paragraph (c)(7)(i)(A), indirect stock ownership is determined by applying the constructive ownership rules of section 318(a). A shareholder may look through to the assets of an S corporation under paragraph (c)(5)(ii) of this section for purposes of allocating the shareholder's basis in its stock in the S corporation between excepted and non-excepted trades or businesses regardless of the shareholder's direct and indirect interest in the S corporation.

(B) *Dividends.* A shareholder must look through to the activities of a domestic non-consolidated C corporation or a relevant foreign corporation under paragraph (b)(3) of this section if the shareholder's direct interest in the corporation satisfies the ownership requirements of section 1504(a)(2). A shareholder may look through to the activities of a domestic non-consolidated C corporation or an applicable CFC under paragraph (b)(3) of this section if the shareholder's direct interest in the corporation is greater than or equal to 80 percent by value. A shareholder may look through to the activities of an S corporation under paragraph (b)(3) of this section regardless of the shareholder's direct interest in the S corporation.

(ii) *Partnerships.* A partner may look through to the assets of a partnership under paragraph (c)(5)(ii) of this section for purposes of allocating the partner's basis in its partnership interest between excepted and non-excepted trades or businesses regardless of the partner's direct and indirect interest in the partnership.

(iii) *Inapplicability of look-through rule.* For circumstances in which a taxpayer that satisfies the ownership threshold in this paragraph (c)(7) may not apply the look-through rules in paragraphs (b)(3) and (c)(5)(ii) of this section, see paragraph (c)(5)(ii)(D) of this section.

(8) *Anti-abuse rule*. If a principal purpose for the acquisition, disposition, or change in use of an asset was to artificially shift the amount of basis allocable to excepted or non-excepted trades or businesses on a determination date, the additional basis or change in use will not be taken into account for purposes of this section. For example, if an asset is used in a non-excepted trade or business for most of the taxable year, and if the taxpayer begins using the asset in an excepted trade or business towards the end of the year with a principal purpose of shifting the amount of basis in the asset that is allocable to the excepted trade or business, the change in use is disregarded for purposes of this section. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately). In determining whether a taxpayer has a principal purpose described in this paragraph (c)(8), factors to be considered include, for example, the following: The business purpose for the acquisition, disposition, or change in use; the length of time the asset was used in a trade or business; whether the asset was acquired from a related person; and whether the taxpayer's aggregate basis in its assets increased or decreased temporarily on or around a determination date. A principal purpose is presumed to be present in any case in which the acquisition, disposition, or change in use lacks a substantial business purpose and increases the taxpayer's basis in assets used in its excepted trades or businesses by more than 10 percent during the taxable year.

(d) *Direct allocations*—(1) *In general*. It is not necessary to allocate interest expense under this paragraph (d) if all of the taxpayer's interest expense is allocable to excepted trades or businesses or if all of the taxpayer's interest expense is allocable to non-excepted trades or businesses.

(2) *Qualified nonrecourse indebtedness*. For purposes of this section, a taxpayer with qualified nonrecourse indebtedness must directly allocate interest expense from the indebtedness to the taxpayer's assets in the manner and to the extent provided in §1.861–10T(b). For purposes of this paragraph (d)(2), the term *qualified nonrecourse indebtedness* has the meaning provided in §1.861–10T(b), except that the term *cash flow from the property* (within the meaning of §1.861–10T(b)(3)(i)) includes revenue derived from the sale or lease of inventory or similar property with respect to an excepted regulated utility trade or business or a non-excepted regulated utility trade or business.

(3) *Assets used in more than one trade or business*. If an asset is used in more than one trade or business, the taxpayer must apply the rules in paragraph (c)(3) of this section to determine the extent to which interest that is directly allocated under this paragraph (d) is allocable to excepted or non-excepted trades or businesses.

(4) *Adjustments to basis of assets to account for direct allocations*. In determining the amount of a taxpayer's basis in the assets used in its excepted and non-excepted trades or businesses for purposes of paragraph (c) of this section, adjustments must be made to reflect direct allocations under this paragraph (d). These adjustments consist of reductions in the taxpayer's basis in its assets for purposes of paragraph (c) of this section to reflect assets to which interest expense is directly allocated under this paragraph (d). The amount of the taxpayer's basis in these assets must be reduced, but not below zero, by the amount of qualified nonrecourse indebtedness secured by these assets. These adjustments must be made before the taxpayer averages the adjusted basis in its assets as determined on each determination date during the taxable year.

(5) *Example: Direct allocation of interest expense*—(i) *Facts*. T conducts an electing real property trade or business (Business X) and operates a retail store that is a non-excepted trade or business (Business Y). In Year 1, T issues Note A to a third party in exchange for $1,000x for the purpose of acquiring Building B. Note A is qualified nonrecourse indebtedness (within the meaning of §1.861–10T(b)) secured by Building B. T then uses those funds to

acquire Building B for $1,200x, and T uses Building B in Business X. During Year 1, T pays $500x of interest, of which $100x is interest payments on Note A. For Year 1, T's basis in its assets used in Business X (as determined under paragraph (c) of this section) is $3,600x (excluding cash and cash equivalents), and T's basis in its assets used in Business Y (as determined under paragraph (c) of this section) is $800x (excluding cash and cash equivalents). Each of Business X and Business Y also has $100x of cash and cash equivalents.

(ii) *Analysis.* Because Note A is qualified nonrecourse indebtedness that is secured by Building B, in allocating interest expense between Businesses X and Y, T first must directly allocate the $100x of interest expense it paid with respect to Note A to Business X in accordance with paragraph (d)(2) of this section. Thereafter, T must allocate the remaining $400x of interest expense between Businesses X and Y under paragraph (c) of this section. After excluding $1,000x of T's basis in Building B to reflect the amount of Note A (see paragraph (d)(4) of this section), and without regard to T's $200x of cash and cash equivalents (see paragraph (c)(5)(iii) of this section), T's basis in its assets used in Businesses X and Y is $2,600x and $800x (76.5 percent and 23.5 percent), respectively. Thus, $306x of the remaining $400x of interest expense would be allocated to Business X, and $94x would be allocated to Business Y.

(e) *Examples.* The examples in this paragraph (e) illustrate the principles of this section. For purposes of these examples, no taxpayer is eligible for the small business exemption under section 163(j)(3) and §1.163(j)–2(d), no taxpayer has floor plan financing interest expense, and no taxpayer has qualified nonrecourse indebtedness within the meaning of §1.861–10T(b).

(1) *Example 1: Interest allocation within a consolidated group*—(i) *Facts.* S is a member of a consolidated group of which P is the common parent. P conducts an electing real property trade or business (Business X), and S conducts a non-excepted trade or business (Business Y). In Year 1, P pays or accrues (without regard to section 163(j)) $35x of interest expense and receives $10x of interest income, and S pays or accrues (without regard to section 163(j)) $115x of interest expense and receives $5x of interest income (for a total of $150x of interest expense and $15x of interest income). For purposes of this example, assume that, pursuant to paragraph (c) of this section, $30x of the P group's interest expense and $3x of the P group's interest income is allocable to Business X, and the remaining $120x of interest expense and $12x of interest income is allocable to Business Y.

(ii) *Analysis.* Under paragraph (a)(4) of this section, 20 percent of the P group's Year 1 interest expense ($30x/$150x) and interest income ($3x/$15x) is allocable to an excepted trade or business. Thus, $7x ($35x × 20 percent) of P's interest expense and $2x ($10x × 20 percent) of P's interest income is allocable to an excepted trade or business. The remaining $28x of P's interest expense is business interest expense subject to the section 163(j) limitation, and the remaining $8x of P's interest income is business interest income that increases the group's section 163(j) limitation. In turn, $23x ($115x × 20 percent) of S's interest expense and $1x ($5x × 20 percent) of S's interest income is allocable to an excepted trade or business. The remaining $92x of S's interest expense is business interest expense subject to the section 163(j) limitation, and the remaining $4x of S's interest income is business interest income that increases the group's section 163(j) limitation.

(2) *Example 2: Interest allocation within a consolidated group with assets used in more than one trade or business*—(i) *Facts.* S is a member of a consolidated group of which P is the common parent. P conducts an electing real property trade or business (Business X), and S conducts a non-excepted trade or business (Business Y). In Year 1, P pays or accrues (without regard to section 163(j)) $50x of interest expense, and S pays or accrues $100x of interest expense (without regard to section 163(j)). P leases 40 percent of space in Building V (which P owns) to S for use in Business Y, and P leases the remaining 60 percent of space in Building V to third parties. For purposes of allocating interest expense under paragraph (c) of this section, the P group's basis in its

assets (excluding Building V) used in Businesses X and Y is $180x and $620x, respectively. The P group's basis in Building V for purposes of allocating interest expense under paragraph (c) of this section is $200x.

(ii) *Analysis*. Under paragraph (c)(3)(ii) of this section, the P group's basis in Building V ($200x) is allocated to excepted and non-excepted trades or businesses in accordance with the use of space by Business Y (40 percent) and Business X (the remainder, or 60 percent). Accordingly, $120x of the basis in Building V is allocated to excepted trades or businesses (60 percent × $200x), and $80x is allocated to non-excepted trades or businesses (40 percent × $200x). After allocating the basis in Building V, the P group's total basis in the assets used in excepted and non-excepted trades or businesses is $300x and $700x, respectively. Under paragraphs (a)(4) and (c) of this section, 30 percent ($300x/$1,000x) of the P group's Year 1 interest expense is properly allocable to an excepted trade or business. Thus, $15x ($50x × 30 percent) of P's interest expense is properly allocable to an excepted trade or business, and the remaining $35x of P's interest expense is business interest expense subject to the section 163(j) limitation. In turn, $30x ($100x × 30 percent) of S's interest expense is properly allocable to an excepted trade or business, and the remaining $70x of S's interest expense is business interest expense subject to the section 163(j) limitation.

(3) *Example 3: Application of look-through rules*—(i) *Facts*. (A) Each of Corp A, Corp B, Corp C, and Corp D is a domestic calendar-year corporation that is not a member of a consolidated group. Corp A owns 100 percent of the stock of Corp C; the basis of Corp A's stock in Corp C is $500x. Corp C owns 10 percent of the interests in PS1 (a domestic partnership), and Corp B owns the remaining 90 percent. Corp C's basis in its PS1 interests is $25x; Corp B's basis in its PS1 interests is $225x. PS1 owns 100 percent of the stock of Corp D; the basis of PS1's stock in Corp D is $1,000x. Corp A and Corp B are owned by unrelated, non-overlapping shareholders.

(B) In 2021, Corp C was engaged solely in a non-excepted trade or business. That same year, PS1's only activity was holding Corp D stock. In turn, Corp D was engaged in both an electing farming business and a non-excepted trade or business. Under the allocation rules in paragraph (c) of this section, 50 percent of Corp D's asset basis in 2021 was allocable to the electing farming business, and the remaining 50 percent was allocable to the non-excepted trade or business.

(C) Corp A and Corp B each paid or accrued (without regard to section 163(j)) $150x of interest expense allocable to a trade or business. Corp A's trade or business was an excepted trade or business, and Corp B's trade or business was a non-excepted trade or business. Corp A's basis in the assets used in its trade or business was $100x, and Corp B's basis in the assets used in its trade or business was $112.5x.

(ii) *Analysis*. (A) As provided in paragraph (c)(5)(ii)(E) of this section, if a taxpayer applies the look-through rules of paragraph (c)(5)(ii) of this section, the taxpayer must begin with the lowest-tier entity to which it is eligible to apply the look-through rules. Corp A directly owns 100 percent of the stock of Corp C; thus, Corp A satisfies the 80 percent minimum ownership threshold with respect to Corp C. Corp A also owns 10 percent of the interests in PS1. There is no minimum ownership threshold for partnerships; thus, Corp A may apply the look-through rules to PS1. However, Corp A does not directly or indirectly own at least 80 percent of the stock of Corp D; thus, Corp A cannot look through its indirect interest in Corp D. In turn, Corp B directly owns 90 percent of the interests in PS1, and Corp B indirectly owns at least 80 percent of the stock of Corp D. Thus, Corp B must apply the look-through rules to PS1 and Corp D.

(B) From Corp A's perspective, PS1 is not engaged in a trade or business for purposes of section 163(j); instead, PS1 is merely holding its Corp D stock as an investment. Under paragraph (c)(5)(ii)(A)(*2*) of this section, if a partnership is not engaged in a trade or business, then its C corporation partner must treat its entire basis in the partnership interest as allocable to a non-excepted trade or business. Thus, for purposes of Corp A's application of the look-through rules, Corp C's entire basis in its PS1 interest ($25x) is allocable to a non-excepted trade or business. Corp C's basis in its other assets also is allocable to a non-excepted trade or business (the only trade or business in which Corp C is engaged). Thus, under paragraph (c) of this section, Corp A's $500x basis in its Corp C stock is allocable entirely to a non-excepted trade or business. Corp A's $100x basis in its other business assets is allocable to an excepted trade or business. Thus, 5⁄6 (or $125x) of Corp A's $150x of interest expense is properly allocable to a non-excepted trade or business and is business interest expense subject to the section 163(j) limitation, and the remaining $25x of Corp A's $150x of interest expense is allocable to an excepted trade or business and is not subject to the section 163(j) limitation.

(C) From Corp B's perspective, PS1 must look through its stock in Corp D to determine the extent to which PS1's basis in the stock is allocable to an excepted or non-excepted trade or business. Half of Corp D's basis in its assets is allocable to an excepted trade or business, and the other half is allocable to a non-excepted trade or business. Thus, from Corp B's perspective, $500x of PS1's basis in its Corp D stock (PS1's only asset) is allocable to an excepted trade or business, and the other half is allocable to a non-excepted trade or business. Corp B's basis in its PS1 interests is $225x. Applying the look-through rules to Corp B's PS1 interests, $112.5x of Corp B's basis in its PS1 interests is allocable to an excepted trade or business, and $112.5x of Corp B's basis in its PS1 interests is allocable to a non-excepted trade or business. Since Corp B's basis in the assets used in its non-excepted trade or business also was $112.5x, two-thirds of Corp B's interest expense ($100x) is properly allocable to a non-excepted trade or business and is business interest expense subject to the section 163(j) limitation, and one-third of Corp B's interest expense ($50x) is allocable to an excepted trade or business and is not subject to the section 163(j) limitation.

(4) *Example 4: Excepted and non-excepted trades or businesses in a consolidated group*—(i) *Facts*. P is the common parent of a consolidated group of which A and B are the only other members. A conducts an electing real property trade or business (Business X), and B conducts a non-excepted trade or business (Business Y). In Year 1, A pays or accrues (without regard to section 163(j)) $50x of interest expense and earns $70x of gross income in the conduct of Business X, and B pays or accrues (without regard to section 163(j)) $100x of interest expense and earns $150x of gross income in the conduct of Business Y. B owns Building V, which it uses in Business Y. For purposes of allocating the P group's Year 1 business interest expense between excepted and non-excepted trades or businesses under paragraph (c) of this section, the P group's basis in its assets (other than Building V) used in Businesses X and Y is $180x and $620x, respectively, and the P group's basis in Building V is $200x. At the end of Year 1, B sells Building V to a third party and realizes a gain of $60x in addition to the $150x of gross income B earned that year from the conduct of Business Y.

(ii) *Analysis*. (A) Under paragraphs (a)(4) and (c) of this section, the P group's basis in its assets used in its trades or businesses is allocated between the P group's excepted trade or business (Business X) and its non-excepted trade or business (Business Y) as though these trades or businesses were conducted by a single corporation. Under paragraph (c) of this section, the P group's basis in its assets used in Businesses X and Y is $180x and $820x, respectively. Accordingly, 18 percent ($180x/$1,000x) of the P group's total interest expense ($150x) is properly allocable to an excepted trade or business ($27x), and the remaining 82 percent of the P group's total interest expense is business interest expense properly allocable to a non-excepted trade or business ($123x).

(B) To determine the P group's section 163(j) limitation, paragraph (a) of this section requires that certain items of income and deduction be allocated to the excepted and non-excepted trades or businesses of the P group as though these trades or businesses were conducted by a single corporation. In Year 1, the P group's excepted trade or business (Business X) has gross income of $70x, and the P group's non-excepted trade or business (Business Y) has gross income of $150x. Because Building V was used exclusively in Business Y, the $60x of gain from the sale of Building V in Year 1 is attributed to Business Y under paragraph (b)(2) of this section. The P group's section 163(j) limitation is $63x (30 percent × $210x), which allows the P group to deduct $63x of its $123x of business interest expense allocated to the P group's non-excepted trades or businesses. The group's $27x of interest expense that is allocable to excepted trades or businesses may be deducted without limitation under section 163(j).

(iii) *Intercompany transaction*. The facts are the same as in *Example 4* in paragraph (e)(4)(i) of this section, except that A owns Building V and leases it to B in Year 1 for $20x for use in Business Y, and A sells Building V to a third party for a $60 gain at the end of Year 1. Under paragraphs (a)(4) and (c) of this section, all members of the P group are treated as a single corporation. As a result, the P group's basis in its assets used in its trades or businesses is allocated between the P group's excepted trade or business (Business X) and its non-excepted trade or business (Business Y) as though these trades or businesses were conducted by a single corporation. A lease between two divisions of a single corporation would produce no rental income or expense. Thus, the $20x of rent paid by B to A does not affect the P group's ATI. Moreover, under paragraph (c) of this section, Building V is an asset used in the P group's non-excepted trade or business (Business Y). Accordingly, although A owns Building V, the basis in Building V is added to the P group's basis in assets used in Business Y for purposes of allocating interest expense under paragraph (c) of this section. In the same vein, when A sells Building V to a third party at a gain of $60x, the gain is included in the P group's ATI because Building V was used in a non-excepted trade or business of the P group (Business Y) prior to its sale.

(5) *Example 5: Captive activities*—(i) *Facts*. S and T are members of a consolidated group of which P is the common parent. P conducts an electing real property trade or business (Business X), S conducts a non-excepted trade or business (Business Y), and T provides transportation services to Businesses X and Y but does not have any customers outside of the P group. For Year 1, T provides transportation services using a single bus with a basis of $120x.

(ii) *Analysis*. Under paragraph (a)(4) of this section, activities conducted by a consolidated group are treated as though those activities were conducted by a single corporation. Because the activities of T are limited to providing intercompany transportation services, T does not conduct a trade or business for purposes of section 163(j). Under paragraph (c)(3) of this section, business interest expense is allocated to excepted and non-excepted trades or businesses based on the relative basis of the assets used in those businesses. The basis in T's only asset, a bus, is therefore allocated between Business X and Business Y according to the use of T's bus by these businesses. Business X uses one-third of T's services, and Business Y uses two-thirds of T's services. Thus, $40x of the basis of T's bus is allocated to Business X, and $80x of the basis of T's bus is allocated to Business Y.

(6) *Example 6: Constructive ownership*—(i) *Facts*. P, S, T, and U are domestic C corporations that are not members of a consolidated group. P directly owns 80 percent of the stock of each of S and T as measured by total voting power and value; an unrelated third party, X, owns the remaining 20 percent. In turn, S and T directly own 15 percent and 80 percent, respectively, of the stock of U as measured by total voting power and value; P directly owns the remaining 5 percent. P conducts both excepted and non-excepted trades or businesses. S and T conduct only non-excepted trades or businesses, and U conducts both excepted and non-excepted trades or businesses.

(ii) *Analysis*. Under paragraph (c)(7)(i)(A) of this section, a shareholder must look through to the assets of a domestic non-consolidated C corporation for purposes of allocating the shareholder's basis in its stock in the corporation between excepted and non-excepted trades or businesses if the shareholder's direct and indirect interest in the corporation satisfies the ownership requirements of section 1504(a)(2). For purposes of paragraph (c)(7)(i)(A) of this section, a shareholder's stock ownership is determined by applying the constructive ownership rules of section 318(a). P directly owns 80 percent of each of S and T as measured by total voting power and value; thus, P must look through to the assets of S and T when allocating the basis in its stock of S and T. P directly owns 5 percent of the stock of U as measured by total voting power and value, and P constructively owns the other 95 percent; thus, P also must look through to U's assets when allocating the basis in its U stock. S directly owns 15 percent of the stock of U, and S constructively owns only 5 percent through P; thus, S cannot look through to U's assets when allocating the basis in its U stock. T directly owns 80 percent of the stock of U, and T constructively owns an additional 5 percent; thus, T must look through to U's assets when allocating the basis in its U stock.

(iii) *Dividend.* The facts are the same as in paragraph (e)(6)(i) of this section, except that U distributes a $160x dividend pro rata to its shareholders. Thus, P receives $8x (5 percent of $160x) of the U dividend, S receives $24x (15 percent of $160x), and T receives $128x (80 percent of $160x). Under paragraph (c)(7)(i)(B) of this section, if a shareholder's direct interest in a corporation satisfies the ownership requirements of section 1504(a)(2), the shareholder must look through to the activities of a domestic non-consolidated C corporation in determining whether dividend income is from an excepted or non-excepted trade or business. The constructive ownership rules do not apply in allocating dividends under paragraph (c)(7)(i)(B) of this section. P directly owns 5 percent of the stock of U as measured by vote and value, and S directly owns 15 percent of the stock of U as measured by vote and value; thus, neither P nor S is required to apply the look-through rules in allocating its dividend income from U, and all such income is allocable to non-excepted trades or businesses. T directly owns 80 percent of the stock of U as measured by vote and value; thus, T must allocate its U dividend in accordance with the activities of U's excepted and non-excepted trades or businesses.

(7) *Example 7: Dispositions with a principal purpose of shifting basis*—(i) *Facts.* U and V are members of a consolidated group of which P is the common parent. U conducts an electing farming business (Business F), and V conducts a farm equipment leasing business (Business L) that is a non-excepted trade or business. After the end of a farming season, the P group, with a principal purpose of shifting basis from Business L to Business F, has V sell to U all off-lease farming equipment that previously was leased out as part of Business L. Immediately before the start of the next season, U sells the farming equipment back to V for use in Business L.

(ii) *Analysis.* Under paragraph (c)(8) of this section, in the case of a disposition of assets undertaken with a principal purpose of artificially shifting the amount of basis allocable to excepted or non-excepted trades or businesses on a determination date, the additional basis or change in use will not be taken into account. Because V's sale of farming equipment to U for storage in Business F's facilities is undertaken with a principal purpose of shifting basis from Business L to Business F, the additional basis Business F receives from these transactions will not be taken into account for purposes of this section. Instead, the basis of the farming equipment will be allocated as though the farming equipment continued to be used in Business L.

(f) *Applicability dates*—(1) *In general.* This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–

13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year. Accordingly, for purposes of § 1.163(j)–10(c)(5), taxpayers make any change to the alternative depreciation system as of November 13, 2020, or if relying on the provisions of § 1.163(j)–10 in regulation project REG–106089–18 (83 FR 67490), as of December 28, 2018.

(2) *Paragraph (c)(5)(ii)(D)(2).* The rules contained in paragraph (c)(5)(ii)(D)(*2*) of this section apply for taxable years beginning on or after March 22, 2021. However, taxpayers may choose to apply the rules in paragraph (c)(5)(ii)(D)(*2*) of this section to 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 in the section 163(j) regulations as contained in T.D. 9905 (§§ 1.163(j)–0 through 1.163(j)–11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§ 1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.383–0, 1.383–1, 1.469–9, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§ 1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4 contained in T.D. 9905 as modified by T.D. 9943, to that taxable year and each subsequent taxable year.

[T.D. 9905, 85 FR 56760, Sept. 14, 2020, as amended at T.D. 9943, 86 FR 5539, Jan. 19, 2021]

§ 1.163(j)–11 Transition rules.

(a) *Overview.* This section provides transition rules regarding the section 163(j) limitation. Paragraph (b) of this section provides rules regarding the application of the section 163(j) limitation to a corporation that joins a consolidated group during a taxable year of the group beginning before January 1, 2018 and is subject to the section 163(j) limitation at the time of its change in status. Paragraph (c) of this section provides rules regarding the treatment of carryforwards of disallowed disqualified interest.

(b) *Application of section 163(j) limitation if a corporation joins a consolidated group during a taxable year of the group beginning before January 1, 2018*—(1) *In general.* If a corporation (S) joins a consolidated group during a taxable year of the group beginning before January 1, 2018, and if S is subject to the section 163(j) limitation at the time of its change in status, then section 163(j) will apply to S's short taxable year that ends on the day of S's change in status, but section 163(j) will not apply to S's short taxable year that begins the next day (when S is a member of the acquiring consolidated group). Any business interest expense paid or accrued (without regard to section 163(j)) by S in its short taxable year ending on the day of S's change in status for which a deduction is disallowed under section 163(j) will be carried forward to the acquiring group's first taxable year beginning after December 31, 2017. Those disallowed business interest expense carryforwards may be subject to limitation under other provisions of these regulations (see, for example, § 1.163(j)–5(c), (d), (e), and (f)).

(2) *Example.* Acquiring Group is a consolidated group with a fiscal year end of November 30; Target is a standalone calendar-year C corporation. On May 31, 2018, Acquiring Group acquires Target in a transaction that is not an ownership change for purposes of section 382. Acquiring Group is not subject to the section 163(j) limitation during its taxable year beginning December 1, 2017. As a result of the acquisition, Target has a short taxable year beginning January 1, 2018 and ending May 31, 2018. Target is subject to the section 163(j) limitation during this short taxable year. However, Target (as a member of Acquiring Group) is not subject to the section 163(j) limitation during Acquiring Group's taxable year ending November 30, 2018. Any disallowed business interest expense carryforwards from Target's taxable year ending May 31, 2018, will not be available for use in Acquiring Group's taxable year ending November 30, 2018. However, that disallowed business interest expense is carried forward to Acquiring Group's taxable year beginning December 1, 2018, and can be deducted by the group,

subject to the separate return limitation year (SRLY) limitation. See §1.163(j)–5(d).

(c) *Treatment of disallowed disqualified interest*—(1) *In general*. Disallowed disqualified interest is carried forward to the taxpayer's first taxable year beginning after December 31, 2017. Disallowed disqualified interest is subject to disallowance as a disallowed business interest expense carryforward under section 163(j) and §1.163(j)–2 to the extent the interest is properly allocable to a non-excepted trade or business under §1.163(j)–10. Disallowed disqualified interest that is properly allocable to an excepted trade or business is not subject to the section 163(j) limitation. See §1.163(j)–10(a)(6) for rules governing the allocation of disallowed disqualified interest between excepted and non-excepted trades or businesses.

(2) *Earnings and profits*. A taxpayer may not reduce its earnings and profits in a taxable year beginning after December 31, 2017, to reflect any disallowed disqualified interest carryforwards to the extent the payment or accrual of the disallowed disqualified interest reduced the earnings and profits of the taxpayer in a prior taxable year.

(3) *Disallowed disqualified interest of members of an affiliated group*—(i) *Scope*. This paragraph (c)(3)(i) applies to corporations that were treated as a single taxpayer under old section 163(j)(6)(C) and that had disallowed disqualified interest.

(ii) *Allocation of disallowed disqualified interest to members of the affiliated group*—(A) *In general*. Each member of the affiliated group is allocated its allocable share of the affiliated group's disallowed disqualified interest as provided in paragraph (c)(3)(ii)(B) of this section.

(B) *Definitions*. The following definitions apply for purposes of paragraph (c)(3)(ii) of this section.

(*1*) *Allocable share of the affiliated group's disallowed disqualified interest*. The term *allocable share of the affiliated group's disallowed disqualified interest* means, with respect to any member of an affiliated group for the member's last taxable year beginning before January 1, 2018, the product of the total amount of the disallowed disqualified interest of all members of the affiliated group under old section 163(j)(6)(C) and the member's disallowed disqualified interest ratio.

(*2*) *Disallowed disqualified interest ratio*. The term *disallowed disqualified interest ratio* means, with respect to any member of an affiliated group for the member's last taxable year beginning before January 1, 2018, the ratio of the exempt related person interest expense of the member for the last taxable year beginning before January 1, 2018, to the sum of the amounts of exempt related person interest expense for all members of the affiliated group.

(*3*) *Exempt related person interest expense*. The term *exempt related person interest expense* means interest expense that is, or is treated as, paid or accrued by a domestic C corporation, or by a foreign corporation with income, gain, or loss that is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States, to—

(*i*) Any person related to the taxpayer, within the meaning of sections 267(b) or 707(b)(1), applying the constructive ownership and attribution rules of section 267(c), if no U.S. tax is imposed with respect to the interest under subtitle A of the Code, determined without regard to net operating losses or net operating loss carryovers, and taking into account any applicable treaty obligation of the United States. For this purpose, interest that is subject to a reduced rate of tax under any treaty obligation of the United States applicable to the recipient is treated as, in part, subject to the statutory tax rate under sections 871 or 881 and, in part, not subject to tax, based on the proportion that the rate of tax under the treaty bears to the statutory tax rate. Thus, for purposes of section 163(j), if the statutory tax rate is 30 percent, and pursuant to a treaty U.S. tax is instead limited to a rate of 10 percent, two-thirds of the interest is considered interest not subject to U.S. tax under subtitle A of the Code;

(*ii*) A person that is not related to the taxpayer, within the meaning of section 267(b) or 707(b)(1), applying the constructive ownership and attribution rules of section 267(c), with respect to indebtedness on which there is a disqualified guarantee, within the meaning of paragraph (6)(D) of old section 163(j), of such indebtedness, and no gross basis U.S. tax is imposed with respect to the interest. For purposes of this paragraph (c)(3)(ii)(B)(*3*)(*ii*), a *gross basis U.S. tax* means any tax imposed by this subtitle A of the Code that is determined by reference to the gross amount of any item of income without any reduction for any deduction allowed by subtitle A of the Code. Interest that is subject to a gross basis U.S. tax that is eligible for a reduced rate of tax under any treaty obligation of the United States applicable to the recipient is treated as, in part, subject to the statutory tax rate under section 871 or 881 and, in part, not subject to a gross basis U.S. tax, based on the proportion that the rate of tax under the treaty bears to the statutory tax rate. Thus, for purposes of section 163(j), if the statutory tax rate is 30 percent, and pursuant to a treaty U.S. tax is instead limited to a rate of 10 percent, two-thirds of the interest is considered interest not subject to a gross basis U.S. tax under subtitle A of the Code; or

(*iii*) A REIT, directly or indirectly, to the extent that the domestic C corporation, or a foreign corporation with income, gain, or loss that is effectively connected, or treated as effectively connected, with the conduct of a trade or business in the United States, is a taxable REIT subsidiary, as defined in section 856(l), with respect to the REIT.

(iii) *Treatment of carryforwards.* The amount of disallowed disqualified interest allocated to a taxpayer pursuant to paragraph (c)(3)(ii) of this section is treated in the same manner as described in paragraph (c)(1) of this section.

(4) *Application of section 382*—(i) *Ownership change occurring before* November 13, 2020—(A) *Pre-change loss.* For purposes of section 382(d)(3), unless the rules of §1.382–2(a)(7) apply, disallowed disqualified interest is not a pre-change loss under §1.382–2(a) subject to a section 382 limitation with regard to an ownership change on a change date occurring before November 13, 2020. But see section 382(h)(6)(B) (regarding built-in deduction items).

(B) *Loss corporation.* For purposes of section 382(k)(1), unless the rules of §1.382–2(a)(7) apply, disallowed disqualified interest is not a carryforward of disallowed interest described in section 381(c)(20) with regard to an ownership change on a change date occurring before November 13, 2020. But see section 382(h)(6) (regarding built-in deductions).

(ii) *Ownership change occurring on or after* November 13, 2020—(A) *Pre-change loss.* For rules governing the treatment of disallowed disqualified interest as a pre-change loss for purposes of section 382 with regard to an ownership change on a change date occurring on or after November 13, 2020, see §§1.382–2(a)(2) and 1.382–6(c)(3).

(B) *Loss corporation.* For rules governing when disallowed disqualified interest causes a corporation to be a loss corporation with regard to an ownership change occurring on or after November 13, 2020, see §1.382–2(a)(1)(i)(A).

(5) *Treatment of excess limitation from taxable years beginning before January 1, 2018.* No amount of excess limitation under old section 163(j)(2)(B) may be carried forward to taxable years beginning after December 31, 2017.

(6) *Example: Members of an affiliated group*—(i) *Facts.* A, B, and C are calendar-year domestic C corporations that are members of an affiliated group (within the meaning of section 1504(a)) that was treated as a single taxpayer under old section 163(j)(6)(C) and the proposed regulations in this part under old section 163(j) (see formerly proposed §1.163(j)–5). For the taxable year ending December 31, 2017, the separately determined amounts of exempt related person interest expense of A, B, and C were $0, $600x, and $150x, respectively (for a total of $750x). The affiliated group has $200x of disallowed disqualified interest in that year.

(ii) *Analysis.* The affiliated group's disallowed disqualified interest expense for the 2017 taxable year ($200x) is allocated among A, B, and C based on the ratio of each member's exempt related person interest expense to the group's exempt related person interest expense. Because A has no exempt related person interest expense, no disallowed disqualified interest is allocated to A. Disallowed disqualified interest of $160x is allocated to B (($600x/$750x) × $200x), and disallowed disqualified interest of $40x is allocated to C (($150x/$750x) × $200x). Thus, B and C have $160x and $40x, respectively, of disallowed disqualified interest that is carried forward to the first taxable year beginning after December 31, 2017. No excess limitation that was allocated to A, B, or C under old section 163(j) will carry forward to a taxable year beginning after December 31, 2017.

(iii) *Carryforward of disallowed disqualified interest to 2018 taxable year*. The facts are the same as in the *Example* in paragraph (c)(7)(i) of this section, except that, for the taxable year ending December 31, 2018, A, B, and C are members of a consolidated group that has a section 163(j) limitation of $140x, current-year business interest expense (as defined in §1.163(j)–1(b)(9)) of $80x, and no excepted trade or business. Under paragraph (c)(1) of this section, disallowed disqualified interest is carried to the taxpayer's first taxable year beginning after December 31, 2017, and is subject to disallowance under section 163(j) and §1.163(j)–2. Under §1.163(j)–5(b)(3)(ii)(D)(*1*), a consolidated group that has section 163(j) limitation remaining for the current year after deducting all current-year business interest expense deducts each member's disallowed disqualified interest carryforwards from prior taxable years, starting with the earliest taxable year, on a pro rata basis (subject to certain limitations). In accordance with paragraph (c)(1) of this section, the rule in §1.163(j)–5(b)(3)(ii)(D)(*1*) applies to disallowed disqualified interest carried forward to the taxpayer's first taxable year beginning after December 31, 2017. Accordingly, after deducting $80x of current-year business interest expense in 2018, the group may deduct $60x of its $200x disallowed disqualified interest carryforwards. Under paragraph (c)(3) of this section, B has $160x of disallowed disqualified interest carryforwards, and C has $40x of disallowed disqualified interest carryforwards. Thus, $48x (($160x/$200x) × $60x) of B's disallowed disqualified interest carryforwards, and $12x (($40x/$200x) × $60x) of C's disallowed disqualified interest carryforwards, are deducted by the consolidated group in the 2018 taxable year.

(d) *Applicability date*. This section applies to taxable years beginning on or after November 13, 2020. However, taxpayers and their related parties, within the meaning of sections 267(b) and 707(b)(1), may choose to apply the rules of this section to a taxable year beginning after December 31, 2017, so long as the taxpayers and their related parties consistently apply the rules of the section 163(j) regulations, and, if applicable, §§1.263A–9, 1.263A–15, 1.381(c)(20)–1, 1.382–1, 1.382–2, 1.382–5, 1.382–6, 1.382–7, 1.383–0, 1.383–1, 1.469–9, 1.469–11, 1.704–1, 1.882–5, 1.1362–3, 1.1368–1, 1.1377–1, 1.1502–13, 1.1502–21, 1.1502–36, 1.1502–79, 1.1502–91 through 1.1502–99 (to the extent they effectuate the rules of §§1.382–2, 1.382–5, 1.382–6, and 1.383–1), and 1.1504–4, to that taxable year.

[T.D. 9905, 85 FR 56760, Sept. 14, 2020]

§ 1.164–1 Deduction for taxes.

(a) *In general*. Only the following taxes shall be allowed as a deduction under this section for the taxable year within which paid or accrued, according to the method of accounting used in computing taxable income:

(1) State and local, and foreign, real property taxes.

(2) State and local personal property taxes.

(3) State and local, and foreign, income, war profits, and excess profits taxes.

(4) State and local general sales taxes.

(5) State and local taxes on the sale of gasoline, diesel fuel, and other motor fuels.

In addition, there shall be allowed as a deduction under this section State and local and foreign taxes not described in subparagraphs (1) through (5) of this paragraph which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income). For example, dealers or investors in securities and dealers or investors in real estate may deduct State stock transfer and real estate transfer taxes, respectively, under section 164, to the extent they are expenses incurred in carrying on a trade or business or an activity for the production of income. In general, taxes are deductible only by the person upon whom they are imposed. However, see § 1.164–5 in the case of certain taxes paid by the consumer. Also, in the case of a qualified State individual income tax (as defined in section 6362 and the regulations thereunder) which is determined by reference to a percentage of the Federal income tax (pursuant to section 6362 (c)), an accrual method taxpayer shall use the cash receipts and disbursements method to compute the amount of his deduction therefor. Thus, the deduction under section 164 is in the amount actually paid with respect to the qualified tax, rather than the amount accrued with respect thereto, during the taxable year even though the taxpayer uses the accrual method of accounting for other purposes. In addition, see paragraph (f)(1) of § 301.6361–1 of this chapter (Regulations on Procedure and Administration) with respect to rules relating to allocation and reallocation of amounts collected on account of the Federal income tax and qualified taxes.

(b) *Taxable years beginning before January 1, 1964.* For taxable years beginning before January 1, 1964, except as otherwise provided in §§ 1.164–2 through 1.164–8, inclusive, taxes imposed by the United States, any State, territory, possession of the United States, or a political subdivision of any of the foregoing, or by any foreign country, are deductible from gross income for the taxable year in which paid or accrued, according to the method of accounting used in computing taxable income. For this purpose, postage is not a tax and automobile license or registration fees are ordinarily taxes.

(c) *Cross references.* For the definition of the term ''real property taxes'', see paragraph (d) of § 1.164–3. For the definition of the term ''foreign taxes'', see paragraph (d) of § 1.164–3. For the definition of the term ''general sales taxes'', see paragraph (f) of § 1.164–3. For the treatment of gasoline, diesel fuel, and other motor fuel taxes, see § 1.164–5. For apportionment of taxes on real property between seller and purchaser, see section 164(d) and § 1.164–6. For the general rule for taxable year of deduction, see section 461. For provisions disallowing any deduction for the tax paid at the source on interest from tax-free covenant bonds, see section 1451(f).

[T.D. 6780, 29 FR 18145, Dec. 22, 1964, as amended by T.D. 7577, 43 FR 59357, Dec. 20, 1978]

§ 1.164–2 Deduction denied in case of certain taxes.

This section and § 1.275 describe certain taxes for which no deduction is allowed. In the case of taxable years beginning before January 1, 1964, the denial is provided for by section 164(b) (prior to being amended by section 207 of the Revenue Act of 1964 (78 Stat. 40)). In the case of taxable years beginning after December 31, 1963, the denial is governed by sections 164 and 275. No deduction is allowed for the following taxes:

(a) *Federal income taxes.* Federal income taxes, including the taxes imposed by section 3101, relating to the tax on employees under the Federal Insurance Contributions Act (chapter 21 of the Code); sections 3201 and 3211, relating to the taxes on railroad employees and railroad employee representatives; section 3402, relating to the tax withheld at source on wages; and by corresponding provisions of prior internal revenue laws.

(b) *Federal war profits and excess profits taxes.* Federal war profits and excess profits taxes including those imposed by title II of the Revenue Act of 1917 (39 Stat. 1000), title III of the Revenue Act of 1918 (40 Stat. 1088), title III of the Revenue Act of 1921 (42 Stat. 271), section 216 of the National Industrial Recovery Act (48 Stat. 208), section 702 of the Revenue Act of 1934 (48 Stat. 770), Subchapter D, Chapter 1 of the Internal Revenue Code of 1939, and Subchapter E, Chapter 2 of the Internal Revenue Code of 1939.

(c) *Estate and gift taxes.* Estate, inheritance, legacy, succession, and gift taxes.

(d) *Foreign income taxes.* Except as provided in § 1.901–1(c)(2) and (3), foreign income taxes, as defined in § 1.901–2(a), paid or accrued (as the case may be, depending on the taxpayer's method of accounting for such taxes) in a taxable year, if the taxpayer chooses to take to any extent the benefits of section 901, relating to the credit for taxes of foreign countries and possessions of the United States, for taxes that are paid or accrued (according to the taxpayer's method of accounting for such taxes) in such taxable year.

(e) *Real property taxes.* Taxes on real property, to the extent that section 164(d) and § 1.164–6 require such taxes to be treated as imposed on another taxpayer.

(f) *Federal duties and excise taxes.* Federal import or tariff duties, business, license, privilege, excise, and stamp taxes (not described in paragraphs (a), (b), (c), or (h) of this section, or § 1.164–4) paid or accrued within the taxable year. The fact that any such tax is not deductible as a tax under section 164 does not prevent (1) its deduction under section 162 or section 212, provided it represents an ordinary and necessary expense paid or incurred during the taxable year by a corporation or an individual in the conduct of any trade or business or, in the case of an individual for the production or collection of income, for the management, conservation, or maintenance of property held for the production of income, or in connection with the determination, collection, or refund of any tax, or (2) its being taken into account during the taxable year by a corporation or an individual as a part of the cost of acquiring or producing property in the trade or business or, in the case of an individual, as a part of the cost of property held for the production of income with respect to which it relates.

(g) *Taxes for local benefits.* Except as provided in § 1.164–4, taxes assessed against local benefits of a kind tending to increase the value of the property assessed.

(h) *Excise tax on real estate investment trusts.* The excise tax imposed on certain real estate investment trusts by section 4981.

(i) *Applicability dates.* Paragraph (d) of this section applies to foreign taxes paid or accrued in taxable years beginning on or after December 28, 2021.

[T.D. 6780, 29 FR 18145, Dec. 22, 1964, as amended by T.D. 7767, 46 FR 11263, Feb. 6, 1981; T.D. 9959, 87 FR 317, Jan. 4, 2022]

§ 1.164–3 Definitions and special rules.

For purposes of section 164 and § 1.164–1 to § 1.164–8, inclusive—

(a) *State or local taxes.* A State or local tax includes only a tax imposed by a State, a possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

(b) *Real property taxes.* The term "real property taxes" means taxes imposed on interests in real property and levied for the general public welfare, but it does not include taxes assessed against local benefits. See § 1.164–4.

(c) *Personal property taxes.* The term "personal property tax" means an ad valorem tax which is imposed on an annual basis in respect of personal property. To qualify as a personal property tax, a tax must meet the following three tests:

(1) The tax must be ad valorem—that is, substantially in proportion to the value of the personal property. A tax which is based on criteria other than value does not qualify as ad valorem. For example, a motor vehicle tax based on weight, model year, and horsepower, or any of these characteristics is not an ad valorem tax. However, a tax which is partly based on value and partly based on other criteria may qualify in part. For example, in the case of a motor vehicle tax of 1 percent of value plus 40 cents per hundredweight, the part of the tax equal to 1 percent of value qualifies as an ad valorem tax and the balance does not qualify.

(2) The tax must be imposed on an annual basis, even if collected more frequently or less frequently.

(3) The tax must be imposed in respect of personal property. A tax may be considered to be imposed in respect of personal property even if in form it is imposed on the exercise of a privilege. Thus, for taxable years beginning after December 31, 1963, State and local taxes on the registration or licensing of highway motor vehicles are not deductible as personal property taxes unless and to the extent that the tests prescribed in this subparagraph are met. For example, an annual ad valorem tax qualifies as a personal property tax although it is denominated a

registration fee imposed for the privilege of registering motor vehicles or of using them on the highways.

(d) *Foreign taxes.* The term ''foreign tax'' includes only a tax imposed by the authority of a foreign country. A tax-imposed by a political subdivision of a foreign country is considered to be imposed by the authority of that foreign country.

(e) *Sales tax.* (1) The term ''sales tax'' means a tax imposed upon persons engaged in selling tangible personal property, or upon the consumers of such property, including persons selling gasoline or other motor vehicle fuels at wholesale or retail, which is a stated sum per unit of property sold or which is measured by the gross sales price or the gross receipts from the sale. The term also includes a tax imposed upon persons engaged in furnishing services which is measured by the gross receipts for furnishing such services.

(2) In general, the term ''consumer'' means the ultimate user or purchaser; it does not include a purchaser such as a retailer, who acquires the property for resale.

(f) *General sales tax.* A ''general sales tax'' is a sales tax which is imposed at one rate in respect of the sale at retail of a broad range of classes of items. No foreign sales tax is deductible under section 164(a) and paragraph (a)(4) of §1.164–1. To qualify as a general sales tax, a tax must meet the following two tests:

(1) The tax must be a tax in respect of sales at retail. This may include a tax imposed on persons engaged in selling property at retail or furnishing services at retail, for example, if the tax is measured by gross sales price or by gross receipts from sales or services. Rentals qualify as sales at retail if so treated under applicable State sales tax laws.

(2) The tax must be general—that is, it must be imposed at one rate in respect of the retail sales of a broad range of classes of items. A sales tax is considered to be general although imposed on sales of various classes of items at more than one rate provided that one rate applies to the retail sales of a broad range of classes of items. The term ''items'' includes both commodities and services.

(g) *Special rules relating to general sales taxes.* (1) A sales tax which is general is usually imposed at one rate in respect of the retail sales of all tangible personal property (with exceptions and additions). However, a sales tax which is selective—that is, a tax which applies at one rate with respect to retail sales of specified classes of items also qualifies as general if the specified classes represent a broad range of classes of items. A selective sales tax which does not apply at one rate to the retail sales of a broad range of classes of items is not general. For example, a tax which applies only to sales of alcoholic beverages, tobacco, admissions, luxury items, and a few other items is not general. Similarly, a tax imposed solely on services is not general. However, a selective sales tax may be deemed to be part of the general sales tax and hence may be deductible, even if imposed by a separate title, etc., of the State or local law, if imposed at the same rate as the general rate of tax (as defined in subparagraph (4) of this paragraph) which qualifies a tax in the taxing jurisdiction as a general sales tax. For example, if a State has a 5 percent general sales tax and a separate selective sales tax of 5 percent on transient accommodations, the tax on transient accommodations is deductible.

(2) A tax is imposed at one rate only if it is imposed at that rate on generally the same base for all items subject to tax. For example, a sales tax imposed at a 3 percent rate on 100 percent of the sales price of some classes of items and at a 3 percent rate on 50 percent of the sales price of other classes of items would not be imposed at one rate with respect to all such classes. However, a tax is considered to be imposed at one rate although it allows dollar exemptions, if the exemptions are designed to exclude all sales under a certain dollar amount. For example, a tax may be imposed at one rate although it applies to all sales of tangible personal property but applies only to sales amounting to more than 10 cents.

(3) The fact that a sales tax exempts food, clothing, medical supplies, and motor vehicles, or any of them, shall

not be taken into account in determining whether the tax applies to a broad range of classes of items. The fact that a sales tax applies to food, clothing, medical supplies, and motor vehicles, or any of them, at a rate which is lower than the general rate of tax (as defined in subparagraph (4) of this paragraph) is not taken into account in determining whether the tax is imposed at one rate on the retail sales of a broad range of classes of items. For purposes of this section, the term ''food'' means food for human consumption off the premises where sold, and the term ''medical supplies'' includes drugs, medicines, and medical devices.

(4) Except in the case of a lower rate of tax applicable in respect of food, clothing, medical supplies, and motor vehicles, or any of them, no deduction is allowed for a general sales tax in respect of any item if the tax is imposed on such item at a rate other than the general rate of tax. The general rate of tax is the one rate which qualifies a tax in a taxing jurisdiction as a general sales tax because the tax is imposed at such one rate on a broad range of classes of items. There can be only one general rate of tax in any one taxing jurisdiction. However, a general sales tax imposed at a lower rate or rates on food, clothing, motor vehicles, and medical supplies, or any of them, may nonetheless be deductible with respect to such items. For example, a sales tax which is imposed at 1 percent with respect to food, imposed at 3 percent with respect to a broad range of classes of tangible personal property, and imposed at 4 percent with respect to transient accommodations would qualify as a general sales tax. Taxes paid at the 1 percent and the 3 percent rates are deductible, but tax paid at the 4 percent rate is not deductible. The fact that a sales tax provides for the adjustment of the general rate of tax to reflect the sales tax rate in another taxing jurisdiction shall not be taken into account in determining whether the tax is imposed at one rate on the retail sales of a broad range of classes of items. Moreover, a general sales tax imposed at a lower rate with respect to an item in order to reflect the tax rate in another jurisdiction is also deductible at such lower rate. For example, State E imposes a general sales tax whose general rate is 3 percent. The State E sales tax law provides that in areas bordering on States with general sales taxes, selective sales taxes, or special excise taxes, the rate applied in the adjoining State will be used if such rate is under 3 percent. State F imposes a 2 percent sales tax. The 2 percent sales tax paid by residents of State E in areas bordering on State F is deductible.

(h) *Compensating use taxes.* A compensating use tax in respect of any item is treated as a general sales tax. The term ''compensating use tax'' means, in respect of any item, a tax which is imposed on the use, storage, or consumption of such item and which is complementary to a general sales tax which is deductible with respect to sales of similar items.

(i) *Special rules relating to compensating use taxes.* (1) In general, a use tax on an item is complementary to a general sales tax on similar items if the use tax is imposed on an item which was not subject to such general sales tax but which would have been subject to such general sales tax if the sale of the item had taken place within the jurisdiction imposing the use tax. For example, a tax imposed by State A on the use of a motor vehicle purchased in State B is complementary to the general sales tax of State A on similar items, if the latter tax applies to motor vehicles sold in State A.

(2) Since a compensating use tax is treated as a general sales tax, it is subject to the rule of subparagraph (C) of section 164(b)(2) and paragraph (g)(4) of this section that no deduction is allowed for a general sales tax imposed in respect of an item at a rate other than the general rate of tax (except in the case of lower rates on the sale of food, clothing, medical supplies, and motor vehicles). The fact that a compensating use tax in respect of any item provides for an adjustment in the rate of the compensating use tax or the amount of such tax to be paid on account of a sales tax on such item imposed by another taxing jurisdiction is not taken into account in determining whether the compensating use tax is imposed in respect of the item at a rate other than the general rate of tax. For

example, a compensating use tax imposed by State C on the use of an item purchased in State D is considered to be imposed at the general rate of tax even though the tax imposed by State C allows a credit for any sales tax paid on such item in State D, or the rate of such compensating use tax is adjusted to reflect the rate of sales tax imposed by State D.

(j) *Safe harbor for payments made by individuals in exchange for State or local tax credits*—(1) *In general.* An individual who itemizes deductions and who makes a payment to or for the use of an entity described in section 170(c) in consideration for a State or local tax credit may treat as a payment of State or local tax for purposes of section 164 the portion of such payment for which a charitable contribution deduction under section 170 is disallowed under §1.170A–1(h)(3). This treatment as payment of a State or local tax is allowed in the taxable year in which the payment is made to the extent that the resulting credit is applied, consistent with applicable State or local law, to offset the individual's State or local tax liability for such taxable year or the preceding taxable year.

(2) *Credits carried forward.* To the extent that a State or local tax credit described in paragraph (j)(1) of this section is not applied to offset the individual's applicable State or local tax liability for the taxable year of the payment or the preceding taxable year, any excess State or local tax credit permitted to be carried forward may be treated as a payment of State or local tax under section 164(a) in the taxable year or years for which the carryover credit is applied in accordance with State or local law.

(3) *Limitation on individual deductions.* Nothing in this paragraph (j) may be construed as permitting a taxpayer who applies this safe harbor to avoid the limitation of section 164(b)(6) for any amount paid as a tax or treated under this paragraph (j) as a payment of tax.

(4) *No safe harbor for transfers of property.* The safe harbor provided in this paragraph (j) applies only to a payment of cash or cash equivalent.

(5) *Coordination with other deductions.* An individual who deducts a payment under section 164 may not also deduct the same payment under any other Code section.

(6) *Examples.* In the following examples, the taxpayer is an individual who itemizes deductions for Federal income tax purposes.

(i) *Example 1.* In year 1, Taxpayer *A* makes a payment of $500 to an entity described in section 170(c). In return for the payment, *A* receives a dollar-for-dollar State income tax credit. Prior to application of the credit, *A*'s State income tax liability for year 1 was more than $500. *A* applies the $500 credit to *A*'s year 1 State income tax liability. Under paragraph (j)(1) of this section, *A* treats the $500 payment as a payment of State income tax in year 1. To determine *A*'s deduction amount, *A* must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation in section 164(b)(6). See paragraph (j)(3) of this section.

(ii) *Example 2.* In year 1, Taxpayer *B* makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, *B* receives a dollar-for-dollar State income tax credit, which under State law may be carried forward for three taxable years. Prior to application of the credit, *B*'s State income tax liability for year 1 was $5,000; *B* applies $5,000 of the $7,000 credit to *B*'s year 1 State income tax liability. Under paragraph (j)(1) of this section, *B* treats $5,000 of the $7,000 payment as a payment of State income tax in year 1. Prior to application of the remaining credit, *B*'s State income tax liability for year 2 exceeds $2,000. *B* applies the excess credit of $2,000 to *B*'s year 2 State income tax liability. For year 2, under paragraph (j)(2) of this section, *B* treats the $2,000 as a payment of State income tax under section 164. To determine *B*'s deduction amounts in years 1 and 2, *B* must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(iii) *Example 3.* In year 1, Taxpayer *C* makes a payment of $7,000 to an entity described in section 170(c). In return for the payment, *C* receives a local real property tax credit equal to 25 percent of the amount of this payment ($1,750).

Prior to application of the credit, *C*'s local real property tax liability in year 1 was more than $1,750. *C* applies the $1,750 credit to *C*'s year 1 local real property tax liability. Under paragraph (j)(1) of this section, for year 1, *C* treats $1,750 of the $7,000 payment as a payment of local real property tax for purposes of section 164. To determine *C*'s deduction amount, *C* must apply the provisions of section 164 applicable to payments of State and local taxes, including the limitation under section 164(b)(6). See paragraph (j)(3) of this section.

(7) *Applicability date*. This paragraph (j) applies to payments made to section 170(c) entities on or after June 11, 2019. However, a taxpayer may choose to apply this paragraph (j) to payments made to section 170(c) entities after August 27, 2018.

[T.D. 6780, 29 FR 18146, Dec. 22, 1964, as amended by T.D. 9907, 85 FR 48473, Aug. 11, 2020]

§ 1.164–4 Taxes for local benefits.

(a) So-called taxes for local benefits referred to in paragraph (g) of § 1.164–2, more properly assessments, paid for local benefits such as street, sidewalk, and other like improvements, imposed because of and measured by some benefit inuring directly to the property against which the assessment is levied are not deductible as taxes. A tax is considered assessed against local benefits when the property subject to the tax is limited to property benefited. Special assessments are not deductible, even though an incidental benefit may inure to the public welfare. The real property taxes deductible are those levied for the general public welfare by the proper taxing authorities at a like rate against all property in the territory over which such authorities have jurisdiction. Assessments under the statutes of California relating to irrigation, and of Iowa relating to drainage, and under certain statutes of Tennessee relating to levees, are limited to property benefited, and if the assessments are so limited, the amounts paid thereunder are not deductible as taxes. For treatment of assessments for local benefits as adjustments to the basis of property, see section 1016(a)(1) and the regulations thereunder.

(b)(1) Insofar as assessments against local benefits are made for the purpose of maintenance or repair or for the purpose of meeting interest charges with respect to such benefits, they are deductible. In such cases, the burden is on the taxpayer to show the allocation of the amounts assessed to the different purposes. If the allocation cannot be made, none of the amount so paid is deductible.

(2) Taxes levied by a special taxing district which was in existence on December 31, 1963, for the purpose of retiring indebtedness existing on such date, are deductible, to the extent levied for such purpose, if (i) the district covers the whole of at least one county, (ii) if at least 1,000 persons are subject to the taxes levied by the district, and (iii) if the district levies its assessments annually at a uniform rate on the same assessed value of real property, including improvements, as is used for purposes of the real property tax generally.

[T.D. 6780, 29 FR 18147, Dec. 22, 1964]

§ 1.164–5 Certain retail sales taxes and gasoline taxes.

For taxable years beginning before January 1, 1964, any amount representing a State or local sales tax paid by a consumer of services or tangible personal property is deductible by such consumer as a tax, provided it is separately stated and not paid in connection with his trade or business. For taxable years beginning after December 31, 1963, only the amount of any separately stated State and local general sales tax (as defined in paragraph (g) of § 1.164–3) and tax on the sale of gasoline, diesel fuel or other motor fuel paid by the consumer (other than in connection with his trade or business) is deductible by the consumer as tax. The fact that, under the law imposing it, the incidence of such State or local tax does not fall on the consumer is immaterial. The requirement that the amount of tax must be separately stated will be deemed complied with where it clearly appears that at the time of sale to the consumer, the tax was added to the sales price and collected or charged as a separate item. It is not necessary, for the purpose of this section, that the consumer be furnished with a sales slip, bill, invoice, or other statement on which the tax is separately stated. For example, where the law imposing the State or local tax for which the taxpayer seeks a deduction contains a prohibition against the seller absorbing the tax, or a provision requiring a posted notice stating that the tax will be added to the quoted price, or a requirement that the tax be separately shown in advertisements or separately stated on all bills and invoices, it is presumed that the amount of the State or local tax was separately stated at the time paid by the consumer; except that such presumption shall have no application to a tax on the sale of gasoline, diesel fuel or other motor fuel imposed upon a wholesaler unless such provisions of law apply with respect to both the sale at wholesale and the sale at retail.

[T.D. 6780, 29 FR 18147, Dec. 22, 1964]

§ 1.164–6 Apportionment of taxes on real property between seller and purchaser.

(a) *Scope.* Except as provided otherwise in section 164(f) and § 1.164–8, when real property is sold, section 164(d)(1) governs the deduction by the seller and the purchaser of current real property taxes. Section 164(d)(1) performs two functions: (1) It provides a method by which a portion of the taxes for the real property tax year in which the property is sold may be deducted by the seller and a portion by the purchaser; and (2) it limits the deduction of the seller and the purchaser to the portion of the taxes corresponding to the part of the real property tax year during which each was the owner of the property. These functions are accomplished by treating a portion of the taxes for the real property tax year in which the property is sold as imposed on the seller and a portion as imposed on the purchaser. To the extent that the taxes are treated as imposed on the seller and the purchaser, each shall be allowed a deduction, under section 164(a), in the taxable year such tax is paid or accrued, or treated as paid or accrued under section 164(d)(2) (A) or (D) and this section. No deduction is allowed for taxes on real property to the extent that they are imposed on another taxpayer, or are treated as imposed on another taxpayer under section 164(d). For the election to accrue real property taxes ratably see section 461(c) and the regulations thereunder.

(b) *Application of rule of apportionment.* (1)(i) For purposes of the deduction provided by section 164(a), if real property is sold during any real property tax year, the portion of the real property tax properly allocable to that part of the real property tax year which ends on the day before the date of the sale shall be treated as a tax imposed on the seller, and the portion of such tax properly allocable to that part of such real property tax year which begins on the date of the sale shall be treated as a tax imposed on the purchased. For definition of ''real property tax year'' see paragraph (c) of this section. This rule shall apply whether or not the seller and the purchaser apportion such tax. The rule of apportionment contained in section 164(d)(1) applies even though the same real property is sold more than once during the real property tax year. (See paragraph (d)(5) of this section for rule requiring inclusion in gross income of excess deductions.)

(ii) Where the real property tax becomes a personal liability or a lien before the beginning of the real property tax year to which it relates and the real property is sold subsequent to the time the tax becomes a personal liability or a lien but prior to the beginning of the related real property tax year—

(*a*) The seller may not deduct any amount for real property taxes for the related real property tax year, and

(*b*) To the extent that he holds the property for such real property tax year, the purchaser may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the seller, mortgagee, trustee or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iii) Similarly, where the real property tax becomes a personal liability or a lien after the end of the real property tax year to which it relates and the real property is sold prior to the time the tax becomes a personal liability or a lien but after the end of the related real property tax year—

(*a*) The purchaser may not deduct any amount for real property taxes for the related real property tax year, and

(*b*) To the extent that he holds the property for such real property tax year, the seller may deduct the amount of such taxes for the taxable year they are paid (or amounts representing such taxes are paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security) or accrued by him according to his method of accounting.

(iv) Where the real property is sold (or purchased) during the related real property tax year the real property taxes for such year are apportioned between the parties to such sale and may be deducted by such parties in accordance with the provisions of paragraph (d) of this section.

(2) Section 164(d) does not apply to delinquent real property taxes for any real property tax year prior to the real property tax year in which the property is sold.

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

Example 1. The real property tax year in County R is April 1 to March 31. A, the owner on April 1, 1954, of real property located in County R sells the real property to B on June 30, 1954. B owns the real property from June 30, 1954, through March 31, 1955. The real property tax for the real property tax year April 1, 1954–March 31, 1955 is $365. For purposes of section 164(a), $90 (90/365 × $365, April 1, 1954–June 29, 1954) of the real property tax is treated as imposed on A, the seller, and $275 (275/365 × $365, June 30, 1954–March 31, 1955) of such real property tax is treated as imposed on B, the purchaser.

Example 2. In County S the real property tax year is the calendar year. The real property tax becomes a lien on June 1 and is payable on July 1 of the current real property tax year, but there is no personal liability for such tax. On April 30, 1955, C, the owner of real property in County S on January 1, 1955, sells the real property to D. On July 1, 1955, D pays the 1955 real property tax. On August 31, 1955, D sells the same real property to E. C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164(d)(1), 119/365 (January 1–April 29, 1955) of the real property tax payable on July 1, 1955, for the 1955 real property tax year is treated as imposed on C, and, under the provisions of section 164(d)(2)(A), such portion is treated as having been paid by him on the date of sale. Under the provisions of section 164(d)(1), 123/365 (April 30–August 30, 1955) of the real property tax paid July 1, 1955, for the 1955 real property tax year is treated as imposed on D and may be deducted by him. Under the provisions of section 164(d)(1), 123/365 (August 31–December 31, 1955) of the real property tax due and paid on July 1, 1955, for the 1955 real property tax year is treated as imposed on E and, under the provisions of section 164(d)(2)(A) such portion is treated as having been paid by him on the date of sale.

Example 3. In State X the real property tax year is the calendar year. The real property tax becomes a lien on November 1 of the preceding calendar year. On November 15, 1955, F sells real property in State X to G. G owns the real property through December 31, 1956. Under section 164(d)(1), the real property tax (which became a lien on November 1, 1954) for the 1955 real property tax year is apportioned between F and G. No part of the real property tax for the 1956 real property tax year may be deducted by F. The entire real property tax for the 1956 real property tax year may be deducted by G when paid or accrued, depending upon the method of accounting used by him. See subparagraph (6) of paragraph (d) and section 461(c) and the regulations thereunder.

(c) *Real property tax year.* As used in section 164(d), the term ''real property tax year'' refers to the period which, under the law imposing the tax, is regarded as the period to which the tax imposed relates. Where the State and one or more local governmental units each imposes a tax on real property, the real property tax year for each tax must be determined for purposes of applying the rule of apportionment of section 164(d)(1) to each tax. The time when the tax rate is determined, the time when the assessment is made, the time when the tax becomes a lien, or the time when the tax becomes due or delinquent does not necessarily determine the real property tax year. The real property tax year may or may not correspond to the fiscal year of the governmental unit imposing the tax. In each case the State or local law determines what constitutes the real property tax year. Although the seller and the purchaser may or may not make an allocation of real property taxes, the meaning of ''real property tax year'' in section 164(d) and the application of section 164(d) do not depend upon what real property taxes were allocated nor the method of allocation used by the parties.

(d) *Special rules*—(1) *Seller using cash receipts and disbursements method of accounting.* Under the provisions of section 164(d), if the seller by reason of his method of accounting may not deduct any amount for taxes unless paid, and—

(i) The purchaser (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, or

(ii) The seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year and the tax is not payable until after the date of sale, then the portion of the tax treated under section 164(d)(1) as imposed upon the seller (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the purchaser, mortgagee, trustee, or other person having an interest in the property as security.

(2) *Purchasers using the cash receipts and disbursements method of accounting.* Under the provisions of section 164(d), if the purchaser by reason of his method of accounting may not deduct any amount for taxes unless paid and the seller (under the law imposing the real property tax) is liable for the real property tax for the real property tax year, the portion of the tax treated under section 164(d)(1) as imposed upon the purchaser (whether or not actually paid by him in the taxable year in which the sale occurs) shall be considered as having been paid by him in such taxable year. Such portion may be deducted by him for the taxable year in which the sale occurs, or, if at a later time, for the taxable year (which would be proper under the taxpayer's method of accounting) in which the tax is actually paid, or an amount representing such tax is paid to the seller, mortgagee, trustee, or other person having an interest in the property as security.

(3) *Persons considered liable for tax.* Where the tax is not a liability of any person, the person who holds the property at the time the tax becomes a lien on the property shall be considered liable for the tax. As to a particular sale, in determining:

(i) Whether the other party to the sale is liable for the tax or,

(ii) The person who holds the property at the time the tax becomes a lien on the property (where the tax is not a liability of any person),

prior or subsequent sales of the property during the real property tax year shall be disregarded.

(4) *Examples.* The provisions of subparagraphs (1), (2), and (3) of this paragraph may be illustrated as follows:

Example 1. In County X the real property tax year is the calendar year. The real property tax is a personal liability of the owner of the real property on June 30 of the current real property tax year, but is not payable until February 28 of the following real property tax year. A, the owner of real property in County X on January 1, 1955, uses the cash receipts and disbursements method of accounting. On May 30, 1955, A sells the real property to B, who also uses the cash receipts and disbursements method of accounting. B retains ownership of the real property for the balance of the 1955 calendar year. Under the provisions of section 164(d)(1), 149/365 (January 1–May 29, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on A, the seller, and under the provisions of section 164(d)(2)(A) such portion is treated as having been paid by him on the date of sale and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164(d)(1), 216/365 (May 30–December 31, 1955) of the real property tax payable on February 28, 1956, for the 1955 real property tax year is treated as imposed on B, the purchaser, and may be deducted by him for his taxable year in which the tax is actually paid, or an amount representing such tax is paid.

Example 2. In County Y, the real property tax year is the calendar year. The real property tax becomes a lien on January 1, 1955, and is payable on April 30, 1955. There is no personal liability for the real property tax imposed by County Y. On April 30, 1955, C, the owner of real property in County Y on January 1, 1955, pays the real property tax for the 1955 real property tax year. On May 1, 1955, C sells the real property to D. On September 1, 1955, D sells the real property to E.

C, D, and E use the cash receipts and disbursements method of accounting. Under the provisions of section 164(d)(1), 120/365 (January 1–April 30, 1955) of the real property tax is treated as imposed upon C and may be deducted by him for his taxable year in which the tax is actually paid. Under section 164(d)(1), 123/365 (May 1–August 31, 1955) of the real property tax is treated as imposed upon D and, under the provisions of section 164(d)(2)(A), is treated as having been paid by him on May 1, 1955, and may be deducted by D for his taxable year in which the sale from C to him occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid. Since, according to paragraph (d)(3) of this section, the prior sale by C to D is disregarded, under the provisions of section 164(d)(1), 122/365 (September 1–December 31, 1955) of the real property tax is treated as imposed on E and, under the provisions of section 164(d)(2)(A), is treated as having been paid by him on September 1, 1955, and may be deducted by E for his taxable year in which the sale from D to him occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which an amount representing such tax is paid.

Example 3. In County X the real property tax year is the calendar year and the real property taxes are assessed and become a lien on June 30 of the current real property tax year, but are not payable until September 1 of that year. There is no personal liability for the real property tax imposed by County X. A, the owner on January 1, 1955, of real property in County X, uses the cash receipts and disbursements method of accounting. On July 15, 1955, A sells the real property to B. Under the provisions of section 164(d)(1), 195/365 (January 1–July 14, 1955) of the real property tax payable on September 1, 1955, for the 1955 real property tax year is treated as imposed on A, and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year) or for his taxable year in which the tax is actually paid or an amount representing such tax is paid. Under the provisions of section 164(d)(1), 170/365 (July 15–December 31, 1955) of the real property tax is treated as imposed on B and may be deducted by him for his taxable year in which the sale occurs (whether or not such portion is actually paid by him in that year), or for his taxable year in which the tax is actually paid or an amount representing such tax is paid.

(5) *Treatment of excess deduction.* If, for a taxable year prior to the taxable year of sale of real property, a taxpayer has deducted an amount for real property tax in excess of the portion of such real property tax treated as imposed on him under the provisions of section 164(d), the excess of the amount deducted over the portion treated as imposed on him shall be included in his gross income for the taxable year of the sale, subject to the provisions of section 111, relating to the recovery of bad debts, prior taxes, and delinquency amounts. The provisions of this subparagraph may be illustrated as follows:

Example 1. In Borough Y the real property tax is due and payable on November 30 for the succeeding calendar year, which is also the real property tax year. On November 30, 1954, taxpayer A, who reports his income on a calendar year under the cash receipts and disbursements method of accounting, pays the real property tax on real property owned by him in Borough Y for the 1955 real property tax year. On June 30, 1955, A sells the real property. Under the provisions of section 164(d), only 180/365 (January 1–June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and the excess of the amount of real property tax for 1955 deducted by A, on his 1954 income tax return, over the 180/365 portion of such tax treated as imposed on him under section 164(d), must be included in gross income in A's 1955 income tax return, subject to the provisions of section 111.

Example 2. In County Z the real property tax year is the calendar year. The real property tax becomes a personal liability of the owner of real property on January 1 of the current real property tax year, and is payable on July 1 of the current real property tax year. On May 1, 1955, A, the owner of real property in County Z on January 1, 1955, sells the real property to B. On November 1, 1955, B sells the same real property to C. B uses the cash receipts and disbursements method of accounting and reports his income on the basis of a fiscal year ending July 31. B, on July 1, 1955, pays the entire real property tax for the real property tax year ending December 31, 1955. Under the provisions of section 164(d), only 184/365 (May 1–October 31, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on B, and the excess of the amount of real property tax for 1955 deducted by B on his income tax return for the fiscal year ending July 31, 1955, over the 184/365 portion of such tax treated as imposed on him under section 164(d), must be included in gross income in B's income tax return for his fiscal year ending July 31, 1956, subject to the provisions of section 111.

(6) *Persons using an accrual method of accounting.* Where real property is sold

and the seller or the purchaser computes his taxable income (for the taxable year during which the sale occurs) on an accrual method of accounting then, if the seller or the purchaser has not made the election provided in section 461(c) (relating to the accrual of real property taxes), the portion of any real property tax which is treated as imposed on him and which may not be deducted by him for any taxable year by reason of his method of accounting shall be treated as having accrued on the date of sale. The provisions of this subparagraph may be illustrated as follows:

Example. In County X the real property tax becomes a lien on property and is assessed on November 30 for the current calendar year, which is also the real property tax year. There is no personal liability for the real property tax imposed by County X. A owns, on January 1, 1955, real property in County X. A uses an accrual method of accounting and has not made any election under section 461(c) to accrue ratably real property taxes. A sells real property on June 30, 1955. By reason of A's method of accounting, he could not deduct any part of the real property tax for 1955 on the real property since he sold the real property prior to November 30, 1955, the accrual date. Under section 164(d)(1), 180/365 (January 1–June 29, 1955) of the real property tax for the 1955 real property tax year is treated as imposed on A, and under section 164(d)(2)(D) that portion is treated as having accrued on June 30, 1955, and may be deducted by A for his taxable year in which such date falls. B, the purchaser from A, who uses an accrual method of accounting, has likewise not made an election under section 461(c) to accrue real property taxes ratably. Under section 164(d)(1), 185/365 of the real property taxes may be accrued by B on November 30, 1955, and deducted for his taxable year in which such date falls.

(7) *Cross references.* For determination of amount realized on a sale of real property, see section 1001(b) and the regulations thereunder. For determination of basis of real property acquired by purchase, see section 1012 and the regulations thereunder.

(8) *Effective dates.* Section 164(d) applies to taxable years ending after December 31, 1953, but only in the case of sales made after December 31, 1953. However, section 164(d) does not apply to any real property tax to the extent that such tax was allowable as a deduction under the Internal Revenue Code of 1939 to the seller for any taxable year which ended before January 1, 1954.

§ 1.164–7 Taxes of shareholder paid by corporation.

Banks and other corporations paying taxes assessed against their shareholders on account of their ownership of the shares of stock issued by such corporations without reimbursement from such shareholders may deduct the amount of taxes so paid. In such cases no deduction shall be allowed to the shareholders for such taxes. The amount so paid should not be included in the gross income of the shareholder.

§ 1.164–8 Payments for municipal services in atomic energy communities.

(a) *General.* For taxable years beginning after December 31, 1957, amounts paid or accrued by any owner of real property within any community (as defined in section 21b of the Atomic Energy Community Act of 1955 (42 U.S.C. 2304)) to compensate the Atomic Energy Commission for municipal-type services (or any agent or contractor authorized by the Atomic Energy Commission to charge for such services) shall be treated as State real property taxes paid or accrued for purposes of section 164. Such amounts shall be deductible as taxes to the extent provided in section 164, §§ 1.164–1 through 1.164–7, and this section. See paragraph (b) of this section for definition of the term ''Atomic Energy Commission''; paragraph (c) of this section for the definition of the term ''municipal-type services''; and paragraph (d) of this section for the definition of the term ''owner''.

(b) *Atomic Energy Commission.* For purposes of paragraph (a) of this section, the term ''Atomic Energy Commission'' shall mean—

(1) The Atomic Energy Commission, and

(2) Any other agency of the United States Government to which the duties and responsibilities of providing municipal-type services are delegated under the authority of section 101 of the Atomic Energy Community Act of 1955 (42 U.S.C. 2313).

(c) *Municipal-type services.* For purposes of paragraph (a) of this section, the term ''municipal-type services'' includes services usually rendered by a municipality and usually paid for by taxes. Examples of municipal-type services are police protection, fire protection, public recreational facilities, public libraries, public schools, public health, public welfare, and the maintenance of roads and streets. The term shall include sewage and refuse disposal which are maintained out of revenues derived from a general charge for municipal-type services; however, the term shall not include sewage and refuse disposal if a separate charge for such services is made. Charges assessed against local benefits of a kind tending to increase the value of the property assessed are not charges for municipal-type services. See section 164(c)(1) and §1.164–4.

(d) *Owner.* For purposes of paragraph (a) of this section, the term ''owner'' includes a person who holds the real property under a leasehold of 40 or more years from the Atomic Energy Commission (or any agency of the United States Government to which the duties and responsibilities of leasing real property are delegated under section 101 of the Atomic Energy Community Act of 1955), and a person who has entered into a contract to purchase under section 61 of the Atomic Energy Community Act of 1955 (42 U.S.C. 2361). An assignee (either immediate or more remote) of a lessee referred to in the preceding sentence will also qualify as an owner for purposes of paragraph (a) of this section.

(e) *Nonapplication of section 164(d).* Section 164(d) and §1.164–6, relating to apportionment of taxes on real property between seller and purchaser, do not apply to a sale by the United States or any of its agencies of real property to which section 164(f) and this section apply. Thus, amounts paid or accrued which qualify under paragraph (a) of this section will continue to be deductible as taxes to the extent provided in this section, even in the taxable year in which the owner actually purchases the real property from the United States or any of its agencies. However, the provisions of section 164(d) and §1.164–6 shall apply to a sale of real property to which section 164(f) and this section apply, if the seller is other than the United States or any of its agencies.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6789, 29 FR 18147, Dec. 22, 1964]

§1.165–1 Losses.

(a) *Allowance of deduction.* Section 165(a) provides that, in computing taxable income under section 63, any loss actually sustained during the taxable year and not made good by insurance or some other form of compensation shall be allowed as a deduction subject to any provision of the internal revenue laws which prohibits or limits the amount of the deduction. This deduction for losses sustained shall be taken in accordance with section 165 and the regulations thereunder. For the disallowance of deductions for worthless securities issued by a political party, see §1.271–1.

(b) *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events, and, except as otherwise provided in section 165(h) and §1.165–11, relating to disaster losses, actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

(c) *Amount deductible.* (1) The amount of loss allowable as a deduction under section 165(a) shall not exceed the amount prescribed by §1.1011–1 as the adjusted basis for determining the loss from the sale or other disposition of the property involved. In the case of each such deduction claimed, therefore, the basis of the property must be properly adjusted as prescribed by §1.1011–1 for such items as expenditures, receipts, or losses, properly chargeable to capital account, and for such items as depreciation, obsolescence, amortization, and depletion, in order to determine the amount of loss allowable as a deduction. To determine the allowable loss in the case of property acquired before March 1, 1913, see also paragraph (b) of §1.1053–1.

(2) The amount of loss recognized upon the sale or exchange of property shall be determined for purposes of section 165(a) in accordance with §1.1002–1.

(3) A loss from the sale or exchange of a capital asset shall be allowed as a deduction under section 165(a) but only to the extent allowed in section 1211 (relating to limitation on capital losses) and section 1212 (relating to capital loss carrybacks and carryovers), and in the regulations under those sections.

(4) In determining the amount of loss actually sustained for purposes of section 165(a), proper adjustment shall be made for any salvage value and for any insurance or other compensation received.

(d) *Year of deduction.* (1) A loss shall be allowed as a deduction under section 165(a) only for the taxable year in which the loss is sustained. For this purpose, a loss shall be treated as sustained during the taxable year in which the loss occurs as evidenced by closed and completed transactions and as fixed by identifiable events occurring in such taxable year. For provisions relating to situations where a loss attributable to a disaster will be treated as sustained in the taxable year immediately preceding the taxable year in which the disaster actually occurred, see section 165(h) and §1.165–11.

(2)(i) If a casualty or other event occurs which may result in a loss and, in the year of such casualty or event, there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until it can be ascertained with reasonable certainty whether or not such reimbursement will be received. Whether a reasonable prospect of recovery exists with respect to a claim for reimbursement of a loss is a question of fact to be determined upon an examination of all facts and circumstances. Whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, by an adjudication of the claim, or by an abandonment of the claim. When a taxpayer claims that the taxable year in which a loss is sustained is fixed by his abandonment of the claim for reimbursement, he must be able to produce objective evidence of his having abandoned the claim, such as the execution of a release.

(ii) If in the year of the casualty or other event a portion of the loss is not covered by a claim for reimbursement with respect to which there is a reasonable prospect of recovery, then such portion of the loss is sustained during the taxable year in which the casualty or other event occurs. For example, if property having an adjusted basis of $10,000 is completely destroyed by fire in 1961, and if the taxpayer's only claim for reimbursement consists of an insurance claim for $8,000 which is settled in 1962, the taxpayer sustains a loss of $2,000 in 1961. However, if the taxpayer's automobile is completely destroyed in 1961 as a result of the negligence of another person and there exists a reasonable prospect of recovery on a claim for the full value of the automobile against such person, the taxpayer does not sustain any loss until the taxable year in which the claim is adjudicated or otherwise settled. If the automobile had an adjusted basis of $5,000 and the taxpayer secures a judgment of $4,000 in 1962, $1,000 is deductible for the taxable year 1962. If in 1963 it becomes reasonably certain that only $3,500 can ever be collected on such judgment, $500 is deductible for the taxable year 1963.

(iii) If the taxpayer deducted a loss in accordance with the provisions of this paragraph and in a subsequent taxable year receives reimbursement for such loss, he does not recompute the tax for the taxable year in which the deduction was taken but includes the amount of such reimbursement in his gross income for the taxable year in which received, subject to the provisions of section 111, relating to recovery of amounts previously deducted.

(3) Any loss arising from theft shall be treated as sustained during the taxable year in which the taxpayer discovers the loss (see §1.165–8, relating to theft losses). However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, no portion of the loss with respect to which reimbursement may be received is sustained, for purposes of section 165, until the taxable year in which it can

be ascertained with reasonable certainty whether or not such reimbursement will be received.

(4) The rules of this paragraph are applicable with respect to a casualty or other event which may result in a loss and which occurs after January 16, 1960. If the casualty or other event occurs on or before such date, a taxpayer may treat any loss resulting therefrom in accordance with the rules then applicable, or, if he so desires, in accordance with the provisions of this paragraph; but no provision of this paragraph shall be construed to permit a deduction of the same loss or any part thereof in more than one taxable year or to extend the period of limitations within which a claim for credit or refund may be filed under section 6511.

(e) *Limitation on losses of individuals.* In the case of an individual, the deduction for losses granted by section 165(a) shall, subject to the provisions of section 165(c) and paragraph (a) of this section, be limited to:

(1) Losses incurred in a trade or business;

(2) Losses incurred in any transaction entered into for profit, though not connected with a trade or business; and

(3) Losses of property not connected with a trade or business and not incurred in any transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other causalty, or from theft, and if the loss involved has not been allowed for estate tax purposes in the estate tax return. For additional provisions pertaining to the allowance of casualty and theft losses, see §§ 1.165–7 and 1.165–8, respectively.

For special rules relating to an election by a taxpayer to deduct disaster losses in the taxable year immediately preceding the taxable year in which the disaster occurred, see section 165(h) and § 1.165–11.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6735, 29 FR 6493, May 19, 1964; T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7301, 39 FR 963, Jan. 4, 1974; T.D. 7522, 42 FR 63411, Dec. 16, 1977]

§ 1.165–2 Obsolescence of nondepreciable property.

(a) *Allowance of deduction.* A loss incurred in a business or in a transaction entered into for profit and arising from the sudden termination of the usefulness in such business or transaction of any nondepreciable property, in a case where such business or transaction is discontinued or where such property is permanently discarded from use therein, shall be allowed as a deduction under section 165(a) for the taxable year in which the loss is actually sustained. For this purpose, the taxable year in which the loss is sustained is not necessarily the taxable year in which the overt act of abandonment, or the loss of title to the property, occurs.

(b) *Exceptions.* This section does not apply to losses sustained upon the sale or exchange of property, losses sustained upon the obsolescence or worthlessness of depreciable property, casualty losses, or losses reflected in inventories required to be taken under section 471. The limitations contained in sections 1211 and 1212 upon losses from the sale or exchange of capital assets do not apply to losses allowable under this section.

(c) *Cross references.* For the allowance under section 165(a) of losses arising from the permanent withdrawal of depreciable property from use in the trade or business or in the production of income, see § 1.167(a)–8, § 1.168(i)–1, or § 1.168(i)–8, as applicable. For provisions respecting the obsolescence of depreciable property for which depreciation is determined under section 167 (but not under section 168, section 1400I, section 1400L(c), section 168 prior to its amendment by the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2121 (1986)), or under an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k) through (n), 1400L(b), or 1400N(d))), see § 1.167(a)–9. For the allowance of casualty losses, see § 1.165–7.

(d) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (d)(2) and (d)(3) of this section, § 1.165–2 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of § 1.165–2(c).* A taxpayer may choose to apply paragraph (c) of this section to taxable

years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply §1.165–2T 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 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 9564, 76 FR 81084, Dec. 27, 2011; T.D. 9636, 78 FR 57706, Sept. 19, 2013; T.D. 9689, 79 FR 48667, Aug. 18, 2014]

§ 1.165–3 Demolition of buildings.

(a) *Intent to demolish formed at time of purchase.* (1) Except as provided in subparagraph (2) of this paragraph, the following rule shall apply when, in the course of a trade or business or in a transaction entered into for profit, real property is purchased with the intention of demolishing either immediately or subsequently the buildings situated thereon: No deduction shall be allowed under section 165(a) on account of the demolition of the old buildings even though any demolition originally planned is subsequently deferred or abandoned. The entire basis of the property so purchased shall, notwithstanding the provisions of §1.167(a)–5, be allocated to the land only. Such basis shall be increased by the net cost of demolition or decreased by the net proceeds from demolition.

(2)(i) If the property is purchased with the intention of demolishing the buildings and the buildings are used in a trade or business or held for the production of income before their demolition, a portion of the basis of the property may be allocated to such buildings and depreciated over the period during which they are so used or held. The fact that the taxpayer intends to demolish the buildings shall be taken into account in making the apportionment of basis between the land and buildings under §1.167(a)–5. In any event, the portion of the purchase price which may be allocated to the buildings shall not exceed the present value of the right to receive rentals from the buildings over the period of their intended use. The present value of such right shall be determined at the time that the buildings are first used in the trade or business or first held for the production of income. If the taxpayer does not rent the buildings, but uses them in his own trade or business or in the production of his income, the present value of such right shall be determined by reference to the rentals which could be realized during such period of intended use. The fact that the taxpayer intends to rent or use the buildings for a limited period before their demolition shall also be taken into account in computing the useful life in accordance with paragraph (b) of §1.167(a)–1.

(ii) Any portion of the purchase price which is allocated to the buildings in accordance with this subparagraph shall not be included in the basis of the land computed under subparagraph (1) of this paragraph, and any portion of the basis of the buildings which has not been recovered through depreciation or otherwise at the time of the demolition of the buildings is allowable as a deduction under section 165.

(iii) The application of this subparagraph may be illustrated by the following example:

Example. In January 1958, A purchased land and a building for $60,000 with the intention of demolishing the building. In the following April, A concludes that he will be unable to commence the construction of a proposed new building for a period of more than 3 years. Accordingly, on June 1, 1958, he leased the building for a period of 3 years at an annual rental of $1,200. A intends to demolish the building upon expiration of the lease. A may allocate a portion of the $60,000 basis of the property to the building to be depreciated over the 3-year period. That portion is equal to the present value of the right to receive $3,600 (3 times $1,200). Assuming that the present value of that right determined as of June 1, 1958, is $2,850, A may allocate that amount to the building and, if A files his return on the basis of a taxable year ending May 31, 1959, A may take a depreciation deduction with respect to such building of $950 for such taxable year. The basis of the land to A as determined under subparagraph (1) of this paragraph is reduced by $2,850. If on June 1, 1960, A ceases to rent the building and demolishes it, the balance of the undepreciated portion allocated to the buildings, $950, may be deducted from gross income under section 165.

(3) The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property originally purchased

even though such part was, at the time of purchase, allocated to the buildings to be demolished for purposes of determining allowable depreciation for the period before demolition.

(b) *Intent to demolish formed subsequent to the time of acquisition.* (1) Except as provided in subparagraph (2) of this paragraph, the loss incurred in a trade or business or in a transaction entered into for profit and arising from a demolition of old buildings shall be allowed as a deduction under section 165(a) if the demolition occurs as a result of a plan formed subsequent to the acquisition of the buildings demolished. The amount of the loss shall be the adjusted basis of the buildings demolished increased by the net cost of demolition or decreased by the net proceeds from demolition. See paragraph (c) of §1.165–1 relating to amount deductible under section 165. The basis of any building acquired in replacement of the old buildings shall not include any part of the basis of the property demolished.

(2) If a lessor or lessee of real property demolishes the buildings situated thereon pursuant to a lease or an agreement which resulted in a lease, under which either the lessor was required or the lessee was required or permitted to demolish such buildings, no deduction shall be allowed to the lessor under section 165(a) on account of the demolition of the old buildings. However, the adjusted basis of the demolished buildings, increased by the net cost of demolition or decreased by the net proceeds from demolition, shall be considered as a part of the cost of the lease to be amortized over the remaining term thereof.

(c) *Evidence of intention.* (1) Whether real property has been purchased with the intention of demolishing the buildings thereon or whether the demolition of the buildings occurs as a result of a plan formed subsequent to their acquisition is a question of fact, and the answer depends upon an examination of all the surrounding facts and circumstances. The answer to the question does not depend solely upon the statements of the taxpayer at the time he acquired the property or demolished the buildings, but such statements, if made, are relevant and will be considered. Certain other relevant facts and circumstances that exist in some cases and the inferences that might reasonably be drawn from them are described in subparagraphs (2) and (3) of this paragraph. The question as to the taxpayer's intention is not answered by any inference that is drawn from any one fact or circumstance but can be answered only by a consideration of all relevant facts and circumstances and the reasonable inferences to be drawn therefrom.

(2) An intention at the time of acquisition to demolish may be suggested by:

(i) A short delay between the date of acquisition and the date of demolition;

(ii) Evidence of prohibitive remodeling costs determined at the time of acquisition;

(iii) Existence of municipal regulations at the time of acquisition which would prohibit the continued use of the buildings for profit purposes;

(iv) Unsuitability of the buildings for the taxpayer's trade or business at the time of acquisition; or

(v) Inability at the time of acquisition to realize a reasonable income from the buildings.

(3) The fact that the demolition occurred pursuant to a plan formed subsequent to the acquisition of the property may be suggested by:

(i) Substantial improvement of the buildings immediately after their acquisition;

(ii) Prolonged use of the buildings for business purposes after their acquisition;

(iii) Suitability of the buildings for investment purposes at the time of acquisition;

(iv) Substantial change in economic or business conditions after the date of acquisition;

(v) Loss of useful value occurring after the date of acquisition;

(vi) Substantial damage to the buildings occurring after their acquisition;

(vii) Discovery of latent structural defects in the buildings after their acquisition;

(viii) Decline in the taxpayer's business after the date of acquisition;

(ix) Condemnation of the property by municipal authorities after the date of acquisition; or

(x) Inability after acquisition to obtain building material necessary for the improvement of the property.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 74474, 41 FR 55710, Dec. 22, 1976]

§ 1.165–4 Decline in value of stock.

(a) *Deduction disallowed.* No deduction shall be allowed under section 165(a) solely on account of a decline in the value of stock owned by the taxpayer when the decline is due to a fluctuation in the market price of the stock or to other similar cause. A mere shrinkage in the value of stock owned by the taxpayer, even though extensive, does not give rise to a deduction under section 165(a) if the stock has any recognizable value on the date claimed as the date of loss. No loss for a decline in the value of stock owned by the taxpayer shall be allowed as a deduction under section 165(a) except insofar as the loss is recognized under § 1.1002–1 upon the sale or exchange of the stock and except as otherwise provided in § 1.165–5 with respect to stock which becomes worthless during the taxable year.

(b) *Stock owned by banks.* (1) In the regulation of banks and certain other corporations, Federal and State authorities may require that stock owned by such organizations be charged off as worthless or written down to a nominal value. If, in any such case, this requirement is premised upon the worthlessness of the stock, the charging off or writing down will be considered prima facie evidence of worthlessness for purposes of section 165(a); but, if the charging off or writing down is due to a fluctuation in the market price of the stock or if no reasonable attempt to determine the worthlessness of the stock has been made, then no deduction shall be allowed under section 165(a) for the amount so charged off or written down.

(2) This paragraph shall not be construed, however, to permit a deduction under section 165(a) unless the stock owned by the bank or other corporation actually becomes worthless in the taxable year. Such a taxpayer owning stock which becomes worthless during the taxable year is not precluded from deducting the loss under section 165(a) merely because, in obedience to the specific orders or general policy of such supervisory authorities, the value of the stock is written down to a nominal amount instead of being charged off completely.

(c) *Application to inventories.* This section does not apply to a decline in the value of corporate stock reflected in inventories required to be taken by a dealer in securities under section 471. See § 1.471–5.

(d) *Definition.* As used in this section, the term ''stock'' means a share of stock in a corporation or a right to subscribe for, or to receive, a share of stock in a corporation.

§ 1.165–5 Worthless securities.

(a) *Definition of security.* As used in section 165(g) and this section, the term ''security'' means:

(1) A share of stock in a corporation;

(2) A right to subscribe for, or to receive, a share of stock in a corporation; or

(3) A bond, debenture, note, or certificate, or other evidence of indebtedness to pay a fixed or determinable sum of money, which has been issued with interest coupons or in registered form by a domestic or foreign corporation or by any government or political subdivision thereof.

(b) *Ordinary loss.* If any security which is not a capital asset becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss.

(c) *Capital loss.* If any security which is a capital asset becomes wholly worthless at any time during the taxable year, the loss resulting therefrom may be deducted under section 165(a) but only as though it were a loss from a sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g)(1). The amount so allowed as a deduction shall be subject to the limitations upon capital losses described in paragraph (c)(3) of § 1.165–1.

(d) *Loss on worthless securities of an affiliated corporation*—(1) *Deductible as an ordinary loss.* If a taxpayer which is a domestic corporation owns any security of a domestic or foreign corporation which is affiliated with the taxpayer within the meaning of subparagraph (2) of this paragraph and such security becomes wholly worthless during the taxable year, the loss resulting therefrom may be deducted under section 165(a) as an ordinary loss in accordance with paragraph (b) of this section. The fact that the security is in fact a capital asset of the taxpayer is immaterial for this purpose, since section 165(g)(3) provides that such security shall be treated as though it were not a capital asset for the purposes of section 165(g)(1). A debt which becomes wholly worthless during the taxable year shall be as an ordinary loss in accordance with the provisions of this subparagraph, to the extent that such debt is a security within the meaning of paragraph (a)(3) of this section.

(2) *Affiliated corporation defined.* For purposes of this paragraph, a corporation shall be treated as affiliated with the taxpayer owning the security if—

(i)(*a*) In the case of a taxable year beginning on or after January 1, 1970, the taxpayer owns directly—

(*1*) Stock possessing at least 80 percent of the voting power of all classes of such corporation's stock, and

(*2*) At least 80 percent of each class of such corporation's nonvoting stock excluding for purposes of this subdivision (i)(*a*) nonvoting stock which is limited and preferred as to dividends (see section 1504(a)), or

(*b*) In the case of a taxable year beginning before January 1, 1970, the taxpayer owns directly at least 95 percent of each class of the stock of such corporation;

(ii) None of the stock of such corporation was acquired by the taxpayer solely for the purpose of converting a capital loss sustained by reason of the worthlessness of any such stock into an ordinary loss under section 165(g)(3), and

(iii) More than 90 percent of the aggregate of the gross receipts of such corporation for all the taxable years during which it has been in existence has been from sources other than royalties, rents (except rents derived from rental of properties to employees of such corporation in the ordinary course of its operating business), dividends, interest (except interest received on the deferred purchase price of operating assets sold), annuities, and gains from sales or exchanges of stocks and securities. For this purpose, the term ''gross receipts'' means total receipts determined without any deduction for cost of goods sold, and gross receipts from sales or exchanges of stocks and securities shall be taken into account only to the extent of gains from such sales or exchanges.

(e) *Bonds issued by an insolvent corporation.* A bond of an insolvent corporation secured only by a mortgage from which nothing is realized for the bondholders on foreclosure shall be regarded as having become worthless not later than the year of the foreclosure sale, and no deduction in respect of the loss shall be allowed under section 165(a) in computing a bondholder's taxable income for a subsequent year. See also paragraph (d) of §1.165–1.

(f) *Decline in market value.* A taxpayer possessing a security to which this section relates shall not be allowed any deduction under section 165(a) on account of mere market fluctuation in the value of such security. See also §1.165–4.

(g) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any security reflected in inventories required to be taken by a dealer in securities under section 471. See §1.471–5.

(h) *Special rules for banks.* For special rules applicable under this section to worthless securities of a bank, including securities issued by an affiliated bank, see §1.582–1.

(i) *Abandonment of securities*—(1) *In general.* For purposes of section 165 and this section, a security that becomes wholly worthless includes a security described in paragraph (a) of this section that is abandoned and otherwise satisfies the requirements for a deductible loss under section 165. If the abandoned security is a capital asset and is not described in section 165(g)(3) and paragraph (d) of this section (concerning worthless securities of certain affiliated corporations), the resulting loss is treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset. See section 165(g)(1) and paragraph (c) of this section. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive no consideration in exchange for the security. For purposes of this section, all the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.

(2) *Effective/applicability date.* This paragraph (i) applies to any abandonment of stock or other securities after March 12, 2008.

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

Example 1. (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 100 percent of each class of the stock of Y Corporation; and, in addition, 19 percent of the common stock (the only class of stock) of Z Corporation, which it acquired in 1948. Y Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 81 percent of the common stock of Z Corporation, which it acquired in 1946. It is established that the stock of Z Corporation, which has from its inception derived all of its gross receipts from manufacturing operations, became worthless during 1971.

(ii) Since the stock of Z Corporation which is owned by X Corporation is a capital asset and since X Corporation does not directly own at least 80 percent of the stock of Z Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1971, of a capital asset. The loss so sustained by X Corporation shall be considered a long-term capital loss under the provisions of section 1222(4), since the stock was held by that corporation for more than 6 months.

(iii) Since Z Corporation is considered to be affiliated with Y Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by Y Corporation upon the worthlessness of the stock of Z Corporation shall be deducted in 1971 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss.

Example 2. (i) On January 1, 1971, X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 60 percent of each class of the stock of Y Corporation, a foreign corporation, which it acquired in 1950. Y Corporation has, from the date of its incorporation, derived all of its gross receipts from manufacturing operations. It is established that the stock of Y Corporation became worthless on June 30, 1971. On August 1, 1971, X Corporation acquires the balance of the stock of Y Corporation for the purpose of obtaining the benefit of section 165(g)(3) with respect to the loss it has sustained on the worthlessness of the stock of Y Corporation.

(ii) Since the stock of Y Corporation which is owned by X Corporation is a capital asset and since Y Corporation is not to be treated as affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, notwithstanding the fact that, at the close of 1971, X Corporation owns 100 percent of each class of stock of Y Corporation, any loss sustained by X Corporation upon the worthlessness of such stock shall be deducted under the provisions of section 165(g)(1) and paragraph (c) of this section as a loss from a sale or exchange on December 31, 1971, of a capital asset.

Example 3. (i) X Corporation, a domestic manufacturing corporation which makes its return on the basis of the calendar year, owns 80 percent of each class of the stock of Y Corporation, which from its inception has derived all of its gross receipts from manufacturing operations. As one of its capital assets, X Corporation owns $100,000 in registered bonds issued by Y Corporation payable at maturity on December 31, 1974. It is established that these bonds became worthless during 1971.

(ii) Since Y Corporation is considered to be affiliated with X Corporation under the provisions of paragraph (d)(2) of this section, any loss sustained by X Corporation upon the worthlessness of these bonds may be deducted in 1971 under section 165(g)(3) and paragraph (d)(1) of this section as an ordinary loss. The loss may not be deducted under section 166 as a bad debt. See section 166(e).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7224, 37 FR 25928, Dec. 6, 1972; T.D. 9386, 73 FR 13124, Mar. 12, 2008]

§ 1.165–6 Farming losses.

(a) *Allowance of losses.* (1) Except as otherwise provided in this section, any loss incurred in the operation of a farm as a trade or business shall be allowed as a deduction under section 165(a) or as a net operating loss deduction in accordance with the provisions of section 172. See § 1.172–1.

(2) If the taxpayer owns and operates a farm for profit in addition to being engaged in another trade or business,

but sustains a loss from the operation of the farming business, then the amount of loss sustained in the operation of the farm may be deducted from gross income, if any, from all other sources.

(3) Loss incurred in the operation of a farm for recreation or pleasure shall not be allowed as a deduction from gross income. See § 1.162–12.

(b) *Loss from shrinkage.* If, in the course of the business of farming, farm products are held for a favorable market, no deduction shall be allowed under section 165(a) in respect of such products merely because of shrinkage in weight, decline in value, or deterioration in storage.

(c) *Loss of prospective crop.* The total loss by frost, storm, flood, or fire of a prospective crop being grown in the business of farming shall not be allowed as a deduction under section 165(a).

(d) *Loss of livestock*—(1) *Raised stock.* A taxpayer engaged in the business of raising and selling livestock, such as cattle, sheep, or horses, may not deduct as a loss under section 165(a) the value of animals that perish from among those which were raised on the farm.

(2) *Purchased stock.* The loss sustained upon the death by disease, exposure, or injury of any livestock purchased and used in the trade or business of farming shall be allowed as a deduction under section 165(a). See, also, paragraph (e) of this section.

(e) *Loss due to compliance with orders of governmental authority.* The loss sustained upon the destruction by order of the United States, a State, or any other governmental authority, of any livestock, or other property, purchased and used in the trade or business of farming shall be allowed as a deduction under section 165(a).

(f) *Amount deductible*—(1) *Expenses of operation.* The cost of any feed, pasture, or care which is allowed under section 162 as an expense of operating a farm for profit shall not be included as a part of the cost of livestock for purposes of determining the amount of loss deductible under section 165(a) and this section. For the deduction of farming expenses, see § 1.162–12.

(2) *Losses reflected in inventories.* If inventories are taken into account in determining the income from the trade or business of farming, no deduction shall be allowed under this section for losses sustained during the taxable year upon livestock or other products, whether purchased for resale or produced on the farm, to the extent such losses are reflected in the inventory on hand at the close of the taxable year. Nothing in this section shall be construed to disallow the deduction of any loss reflected in the inventories of the taxpayer. For provisions relating to inventories of farmers, see section 471 and the regulations thereunder.

(3) *Other limitations.* For other provisions relating to the amount deductible under this section, see paragraph (c) of § 1.165–1, relating to the amount deductible under section 165(a); § 1.165–7, relating to casualty losses; and § 1.1231–1, relating to gains and losses from the sale or exchange of certain property used in the trade or business.

(g) *Other provisions applicable to farmers.* For other provisions relating to farmers, see § 1.61–4, relating to gross income of farmers; paragraph (b) of § 1.167(a)–6, relating to depreciation in the case of farmers; and § 1.175–1, relating to soil and water conservation expenditures.

§ 1.165–7 Casualty losses.

(a) *In general*—(1) *Allowance of deduction.* Except as otherwise provided in paragraphs (b)(4) and (c) of this section, any loss arising from fire, storm, shipwreck, or other casualty is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. However, see § 1.165–6, relating to farming losses, and § 1.165–11, relating to an election by a taxpayer to deduct disaster losses in the taxable year immediately preceding the taxable year in which the disaster occurred. The manner of determining the amount of a casualty loss allowable as a deduction in computing taxable income under section 63 is the same whether the loss has been incurred in a trade or business or in any transaction entered into for profit, or whether it has been a loss of property not connected with a trade or business and not incurred in any transaction entered into for profit. The amount of a casualty loss shall be determined in accordance with paragraph (b) of this section. For other rules relating to the treatment of deductible casualty losses, see § 1.1231–1, relating to the involuntary conversion of property.

(2) *Method of valuation.* (i) In determining the amount of loss deductible under this section, the fair market value of the property immediately before and immediately after the casualty shall generally be ascertained by competent appraisal. This appraisal must recognize the effects of any general market decline affecting undamaged as well as damaged property which may occur simultaneously with the casualty, in order that any deduction under this section shall be limited to the actual loss resulting from damage to the property.

(ii) The cost of repairs to the property damaged is acceptable as evidence of the loss of value if the taxpayer shows that (*a*) the repairs are necessary to restore the property to its condition immediately before the casualty, (*b*) the amount spent for such repairs is not excessive, (*c*) the repairs do not care for more than the damage suffered, and (*d*) the value of the property after the repairs does not as a result of the repairs exceed the value of the property immediately before the casualty.

(3) *Damage to automobiles.* An automobile owned by the taxpayer, whether used for business purposes or maintained for recreation or pleasure, may be the subject of a casualty loss, including those losses specifically referred to in subparagraph (1) of this paragraph. In addition, a casualty loss occurs when an automobile owned by the taxpayer is damaged and when:

(i) The damage results from the faulty driving of the taxpayer or other person operating the automobile but is not due to the willful act or willful negligence of the taxpayer or of one acting in his behalf or

(ii) The damage results from the faulty driving of the operator of the vehicle with which the automobile of the taxpayer collides.

(4) *Application to inventories.* This section does not apply to a casualty loss reflected in the inventories of the taxpayer. For provisions relating to inventories, see section 471 and the regulations thereunder.

(5) *Property converted from personal use.* In the case of property which originally was not used in the trade or business or for income-producing purposes and which is thereafter converted to either of such uses, the fair market value of the property on the date of conversion, if less than the adjusted basis of the property at such time, shall be used, after making proper adjustments in respect of basis, as the basis for determining the amount of loss under paragraph (b)(1) of this section. See paragraph (b) of § 1.165–9, and § 1.167(g)–1.

(6) *Theft losses.* A loss which arises from theft is not considered a casualty loss for purposes of this section. See § 1.165–8, relating to theft losses.

(b) *Amount deductible*—(1) *General rule.* In the case of any casualty loss whether or not incurred in a trade or business or in any transaction entered into for profit, the amount of loss to be taken into account for purposes of section 165(a) shall be the lesser of either—

(i) The amount which is equal to the fair market value of the property immediately before the casualty reduced by the fair market value of the property immediately after the casualty; or

(ii) The amount of the adjusted basis prescribed in § 1.1011–1 for determining the loss from the sale or other disposition of the property involved.

However, if property used in a trade or business or held for the production of income is totally destroyed by casualty, and if the fair market value of such property immediately before the casualty is less than the adjusted basis of such property, the amount of the adjusted basis of such property shall be treated as the amount of the loss for purposes of section 165(a).

(2) *Aggregation of property for computing loss.* (i) A loss incurred in a trade or business or in any transaction entered into for profit shall be determined under subparagraph (1) of this paragraph by reference to the single, identifiable property damaged or destroyed. Thus, for example, in determining the fair market value of the property before and after the casualty

in a case where damage by casualty has occurred to a building and ornamental or fruit trees used in a trade or business, the decrease in value shall be measured by taking the building and trees into account separately, and not together as an integral part of the realty, and separate losses shall be determined for such building and trees.

(ii) In determining a casualty loss involving real property and improvements thereon not used in a trade or business or in any transaction entered into for profit, the improvements (such as buildings and ornamental trees and shrubbery) to the property damaged or destroyed shall be considered an integral part of the property, for purposes of subparagraph (1) of this paragraph, and no separate basis need be apportioned to such improvements.

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

Example 1. In 1956 B purchases for $3,600 an automobile which he uses for nonbusiness purposes. In 1959 the automobile is damaged in an accidental collision with another automobile. The fair market value of B's automobile is $2,000 immediately before the collision and $1,500 immediately after the collision. B receives insurance proceeds of $300 to cover the loss. The amount of the deduction allowable under section 165(a) for the taxable year 1959 is $200, computed as follows:

Value of automobile immediately before casualty	$2,000
Less: Value of automobile immediately after casualty	1,500
Value of property actually destroyed	500
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($500) or adjusted basis of property ($3,600)	500
Less: Insurance received	300
Deduction allowable	200

Example 2. In 1958 A purchases land containing an office building for the lump sum of $90,000. The purchase price is allocated between the land ($18,000) and the building ($72,000) for purposes of determining basis. After the purchase A planted trees and ornamental shrubs on the grounds surrounding the building. In 1961 the land, building, trees, and shrubs are damaged by hurricane. At the time of the casualty the adjusted basis of the land is $18,000 and the adjusted basis of the building is $66,000. At that time the trees and shrubs have an adjusted basis of $1,200. The fair market value of the land and building immediately before the casualty is $18,000 and $70,000, respectively, and immediately after the casualty is $18,000 and $52,000, respectively. The fair market value of the trees and shrubs immediately before the casualty is $2,000 and immediately after the casualty is $400. In 1961 insurance of $5,000 is received to cover the loss to the building. A has no other gains or losses in 1961 subject to section 1231 and §1.1231–1. The amount of the deduction allowable under section 165(a) with respect to the building for the taxable year 1961 is $13,000, computed as follows:

Value of property immediately before casualty	$70,000
Less: Value of property immediately after casualty	52,000
Value of property actually destroyed	18,000
Less: Insurance received	5,000
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($18,000) or adjusted basis of property ($66,000)	18,000
Less: Insurance received	5,000
Deduction allowable	13,000

The amount of the deduction allowable under section 165(a) with respect to the trees and shrubs for the taxable year 1961 is $1,200, computed as follows:

Value of property immediately before casualty	$2,000
Less: Value of property immediately after casualty	$400
Value of property actually destroyed	1,600
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($1,600) or adjusted basis of property ($1,200)	1,200

Example 3. Assume the same facts as in example (2) except that A purchases land containing a house instead of an office building. The house is used as his private residence. Since the property is used for personal purposes, no allocation of the purchase price is necessary for the land and house. Likewise, no individual determination of the fair market values of the land, house, trees, and shrubs is necessary. The amount of the deduction allowable under section 165(a) with respect to the land, house, trees, and shrubs for the taxable year 1961 is $14,600, computed as follows:

Value of property immediately before casualty	$90,000
Less: Value of property immediately after casualty	70,400
Value of property actually destroyed	19,600
Loss to be taken into account for purposes of section 165(a): Lesser amount of property actually destroyed ($19,600) or adjusted basis of property ($91,200)	19,600
Less: Insurance received	5,000
Deduction allowable	14,600

(4) *Limitation on certain losses sustained by individuals after December 31, 1963.* (i) Pursuant to section 165(c)(3), the deduction allowable under section 165(a) in respect of a loss sustained—

(*a*) After December 31, 1963, in a taxable year ending after such date,

(*b*) In respect of property not used in a trade or business or for income producing purposes, and

(*c*) From a single casualty

shall be limited to that portion of the loss which is in excess of $100. The nondeductibility of the first $100 of loss applies to a loss sustained after December 31, 1963, without regard to when the casualty occurred. Thus, if property not used in a trade or business or for income producing purposes is damaged or destroyed by a casualty which occurred prior to January 1, 1964, and loss resulting therefrom is sustained after December 31, 1963, the $100 limitation applies.

(ii) The $100 limitation applies separately in respect of each casualty and applies to the entire loss sustained from each casualty. Thus, if as a result of a particular casualty occurring in 1964, a taxpayer sustains in 1964 a loss of $40 and in 1965 a loss of $250, no deduction is allowable for the loss sustained in 1964 and the loss sustained in 1965 must be reduced by $60 ($100−$40). The determination of whether damage to, or destruction of, property resulted from a single casualty or from two or more separate casualties will be made upon the basis of the particular facts of each case. However, events which are closely related in origin generally give rise to a single casualty. For example, if a storm damages a taxpayer's residence and his automobile parked in his driveway, any loss sustained results from a single casualty. Similarly, if a hurricane causes high waves, all wind and flood damage to a taxpayer's property caused by the hurricane and the waves results from a single casualty.

(iii) Except as otherwise provided in this subdivision, the $100 limitation applies separately to each individual taxpayer who sustains a loss even though the property damaged or destroyed is owned by two or more individuals. Thus, if a house occupied by two sisters and jointly owned by them is damaged or destroyed, the $100 limitation applies separately to each sister in respect of any loss sustained by her. However, for purposes of applying the $100 limitation, a husband and wife who file a joint return for the first taxable year in which the loss is allowable as a deduction are treated as one individual taxpayer. Accordingly, if property jointly owned by a husband and wife, or property separately owned by the husband or by the wife, is damaged or destroyed by a single casualty in 1964, and a loss is sustained in that year by either or both the husband or wife, only one $100 limitation applies if a joint return is filed for 1964. If, however, the husband and wife file separate returns for 1964, the $100 limitation applies separately in respect of any loss sustained by the husband and in respect of any loss sustained by the wife. Where losses from a single casualty are sustained in two or more separate tax years, the husband and wife shall, for purposes of applying the $100 limitation to such losses, be treated as one individual for all such years if they file a joint return for the first year in which a loss is sustained from the casualty; they shall be treated as separate individuals for all such years if they file separate returns for the first such year. If a joint return is filed in the first loss year but separate returns are filed in a subsequent year, any unused portion of the $100 limitation shall be allocated equally between the husband and wife in the latter year.

(iv) If a loss is sustained in respect of property used partially for business and partially for nonbusiness purposes, the $100 limitation applies only to that portion of the loss properly attributable to the nonbusiness use. For example, if a taxpayer sustains a $1,000 loss in respect of an automobile which he uses 60 percent for business and 40 percent for nonbusiness, the loss is allocated 60 percent to business use and 40 percent to nonbusiness use. The $100 limitation applies to the portion of the loss allocable to the nonbusiness loss.

(c) *Loss sustained by an estate.* A casualty loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is sustained during the settlement of an estate shall be allowed as a deduction under sections 165(a) and 641(b) in computing the taxable income of the estate if the loss has not been allowed under section 2054 in computing the taxable estate of the decedent and if the statement has been filed in accordance with § 1.642(g)–1. See section 165(c)(3).

(d) *Loss treated as though attributable to a trade or business.* For the rule treating a casualty loss not connected with a trade or business as though it were a deduction attributable to a trade or business for purposes of computing a net operating loss, see paragraph (a)(3)(iii) of § 1.172–3.

(e) *Effective date.* The rules of this section are applicable to any taxable year beginning after January 16, 1960. If, for any taxable year beginning on or before such date, a taxpayer computed the amount of any casualty loss in accordance with the rules then applicable, such taxpayer is not required to change the amount of the casualty loss allowable for any such prior taxable year. On the other hand, the taxpayer may, if he so desires, amend his income tax return for such year to compute the amount of a casualty loss in accordance with the provisions of this section, but no provision in this section shall be construed as extending the period of limitations within which a claim for credit or refund may be filed under section 6511.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3652, Mar. 24, 1964; T.D. 6786, 29 FR 18501, Dec. 29, 1964; T.D. 7522, 42 FR 63411, Dec. 16, 1977]

§ 1.165–8 Theft losses.

(a) *Allowance of deduction.* (1) Except as otherwise provided in paragraphs (b) and (c) of this section, any loss arising from theft is allowable as a deduction under section 165(a) for the taxable year in which the loss is sustained. See section 165(c)(3).

(2) A loss arising from theft shall be treated under section 165(a) as sustained during the taxable year in which the taxpayer discovers the loss. See section 165(e). Thus, a theft loss is not deductible under section 165(a) for the taxable year in which the theft actually occurs unless that is also the year in which the taxpayer discovers the loss. However, if in the year of discovery there exists a claim for reimbursement with respect to which there is a reasonable prospect of recovery, see paragraph (d) of § 1.165–1.

(3) The same theft loss shall not be taken into account both in computing a tax under chapter 1, relating to the income tax, or chapter 2, relating to additional income taxes, of the Internal Revenue Code of 1939 and in computing the income tax under the Internal Revenue Code of 1954. See section 7852(c), relating to items not to be twice deducted from income.

(b) *Loss sustained by an estate.* A theft loss of property not connected with a trade or business and not incurred in any transaction entered into for profit which is discovered during the settlement of an estate, even though the theft actually occurred during a taxable year of the decedent, shall be allowed as a deduction under sections 165(a) and 641(b) in computing the taxable income of the estate if the loss has not been allowed under section 2054 in computing the taxable estate of the decedent and if the statement has been filed in accordance with § 1.642(g)–1. See section 165(c)(3). For purposes of determining the year of deduction, see paragraph (a)(2) of this section.

(c) *Amount deductible.* The amount deductible under this section in respect of a theft loss shall be determined consistently with the manner prescribed in § 1.165–7 for determining the amount of casualty loss allowable as a deduction under section 165(a). In applying the provisions of paragraph (b) of § 1.165–7 for this purpose, the fair market value of the property immediately after the theft shall be considered to be zero. In the case of a loss sustained after December 31, 1963, in a taxable year ending after such date, in respect of property not used in a trade or business or for income producing purposes, the amount deductible shall be limited to that portion of the loss which is in excess of $100. For rules applicable in applying the $100 limitation, see paragraph (b)(4) of § 1.165–7. For other rules relating to the treatment of deductible theft losses, see § 1.1231–1, relating to the involuntary conversion of property.

(d) *Definition.* For purposes of this section the term ''theft'' shall be deemed to include, but shall not necessarily be limited to, larceny, embezzlement, and robbery.

(e) *Application to inventories.* This section does not apply to a theft loss reflected in the inventories of the taxpayer. For provisions relating to inventories, see section 471 and the regulations thereunder.

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

Example. In 1955 B, who makes her return on the basis of the calendar year, purchases for personal use a diamond brooch costing $4,000. On November 30, 1961, at which time it has a fair market value of $3,500, the brooch is stolen; but B does not discover the loss until January 1962. The brooch was fully insured against theft. A controversy develops with the insurance company over its liability in respect of the loss. However, in 1962, B has a reasonable prospect of recovery of the fair market value of the brooch from the insurance company. The controversy is settled in March 1963, at which time B receives $2,000 in insurance proceeds to cover the loss from theft. No deduction for the loss is allowable for 1961 or 1962; but the amount of the deduction allowable under section 165(a) for the taxable year 1963 is $1,500, computed as follows:

Value of property immediately before theft	$3,500
Less: Value of property immediately after the theft	0
Balance	3,500
Loss to be taken into account for purposes of section 165(a): ($3,500 but not to exceed adjusted basis of $4,000 at time of theft)	$3,500
Less: Insurance received in 1963	2,000
Deduction allowable for 1963	1,500

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6786, 29 FR 18502, Dec. 29, 1964]

§ 1.165–9 Sale of residential property.

(a) *Losses not allowed.* A loss sustained on the sale of residential property purchased or constructed by the taxpayer for use as his personal residence and so used by him up to the time of the sale is not deductible under section 165(a).

(b) *Property converted from personal use.* (1) If property purchased or constructed by the taxpayer for use as his personal residence is, prior to its sale, rented or otherwise appropriated to income-producing purposes and is used for such purposes up to the time of its sale, a loss sustained on the sale of the property shall be allowed as a deduction under section 165(a).

(2) The loss allowed under this paragraph upon the sale of the property shall be the excess of the adjusted basis prescribed in § 1.1011–1 for determining loss over the amount realized from the sale. For this purpose, the adjusted basis for determining loss shall be the lesser of either of the following amounts, adjusted as prescribed in § 1.1011–1 for the period subsequent to the conversion of the property to income-producing purposes:

(i) The fair market value of the property at the time of conversion, or

(ii) The adjusted basis for loss, at the time of conversion, determined under § 1.1011–1 but without reference to the fair market value.

(3) For rules relating to casualty losses of property converted from personal use, see paragraph (a)(5) of § 1.165–7. To determine the basis for depreciation in the case of such property, see § 1.167(g)–1. For limitations on the loss from the sale of a capital asset, see paragraph (c)(3) of § 1.165–1.

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

Example 1. Residential property is purchased by the taxpayer in 1943 for use as his personal residence at a cost of $25,000, of which $15,000 is allocable to the building. The taxpayer uses the property as his personal residence until January 1, 1952, at which time its fair market value is $22,000, of which $12,000 is allocable to the building. The taxpayer rents the property from January 1, 1952, until January 1, 1955, at which time it is sold for $16,000. On January 1, 1952, the building has an estimated useful life of 20 years. It is assumed that the building has no estimated salvage value and that there are no adjustments in respect of basis other than depreciation, which is computed on the straight-line method. The loss to be taken into account for purposes of section 165(a) for the taxable year 1955 is $4,200, computed as follows:

Basis of property at time of conversion for purposes of this section (that is, the lesser of $25,000 cost or $22,000 fair market value)	$22,000
Less: Depreciation allowable from January 1, 1952, to January 1, 1955 (3 years at 5 percent based on $12,000, the value of the building at time of conversion, as prescribed by § 1.167(g)–1)	1,800
Adjusted basis prescribed in § 1.1011–1 for determining loss on sale of the property	20,200

Less: Amount realized on sale	16,000
Loss to be taken into account for purposes of section 165(a)	4,200

In this example the value of the building at the time of conversion is used as the basis for computing depreciation. See example (2) of this paragraph wherein the adjusted basis of the building is required to be used for such purpose.

Example 2. Residential property is purchased by the taxpayer in 1940 for use as his personal residence at a cost of $23,000, of which $10,000 is allocable to the building. The taxpayer uses the property as his personal residence until January 1, 1953, at which time its fair market value is $20,000, of which $12,000 is allocable to the building. The taxpayer rents the property from January 1, 1953, until January 1, 1957, at which time it is sold for $17,000. On January 1, 1953, the building has an estimated useful life of 20 years. It is assumed that the building has no estimated salvage value and that there are no adjustments in respect of basis other than depreciation, which is computed on the straight-line method. The loss to be taken into account for purposes of section 165(a) for the taxable year 1957 is $1,000, computed as follows:

Basis of property at time of conversion for purposes of this section (that is, the lesser of $23,000 cost or $20,000 fair market value)	$20,000
Less: Depreciation allowable from January 1, 1953, to January 1, 1957 (4 years at 5 percent based on $10,000, the cost of the building, as prescribed by § 1.167(g)–1	2,000
Adjusted basis prescribed in § 1.1011–1 for determining loss on sale of the property	$18,000
Less: Amount realized on sale	17,000
Loss to be taken into account for purposes of section 165(a)	1,000

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3652, Mar. 24, 1964]

§ 1.165–10 Wagering losses.

Losses sustained during the taxable year on wagering transactions shall be allowed as a deduction but only to the extent of the gains during the taxable year from such transactions. In the case of a husband and wife making a joint return for the taxable year, the combined losses of the spouses from wagering transactions shall be allowed to the extent of the combined gains of the spouses from wagering transactions.

§ 1.165–11 Election to take disaster loss deduction for preceding year.

(a) *In general.* Section 165(i) allows a taxpayer who has sustained a loss attributable to a federally declared disaster in a taxable year to elect to deduct that disaster loss in the preceding year. This section provides rules and procedures for making and revoking an election to claim a disaster loss in the preceding year.

(b) *Definitions.* The following definitions apply for purposes of this section:

(1) A *federally declared disaster* means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (Stafford Act). A federally declared disaster includes both a major disaster declared under section 401 of the Stafford Act and an emergency declared under section 501 of the Stafford Act.

(2) A *federally declared disaster area* is the area determined to be eligible for assistance pursuant to the Presidential declaration in paragraph (b)(1) of this section.

(3) A *disaster loss* is a loss occurring in a federally declared disaster area that is attributable to a federally declared disaster and that is otherwise allowable as a deduction for the disaster year under section 165(a) and §§ 1.165–1 through 1.165–10.

(4) The *disaster year* is the taxable year in which a taxpayer sustains a loss attributable to a federally declared disaster.

(5) The *preceding year* is the taxable year immediately prior to the disaster year.

(c) *Scope and effect of election.* An election made pursuant to section 165(i) for a disaster loss attributable to a particular disaster applies to the entire loss sustained by the taxpayer from that disaster during the disaster year. If the taxpayer makes a section 165(i) election with respect to a particular disaster occurring during the disaster year, the disaster to which the election relates is deemed to have occurred, and the disaster loss to which the election applies is deemed to have been sustained, in the preceding year.

(d) *Requirement to file consistent returns.* A taxpayer may not make a section 165(i) election for a disaster loss if the taxpayer claims a deduction (as a loss, as cost of goods sold, or otherwise) for the same loss for the disaster year. If a taxpayer has claimed a deduction for a disaster loss for the disaster year and the taxpayer wants to make a section 165(i) election with respect to that loss, the taxpayer must file an amended Federal income tax return to remove the previously deducted loss on or before the date that the taxpayer makes the section 165(i) election for the loss. Similarly, if a taxpayer has claimed a deduction for a disaster loss for the preceding year based on a section 165(i) election and the taxpayer wants to revoke that election, the taxpayer must file an amended Federal income tax return to remove the loss for the preceding year on or before the date the taxpayer files the Federal income tax return or amended Federal income tax return for the disaster year that includes the loss.

(e) *Manner of making election.* An election under section 165(i) to deduct a disaster loss for the preceding year is made either on an original Federal income tax return for the preceding year or an amended Federal income tax return for the preceding year in the manner specified by guidance issued pursuant to this section.

(f) *Due date for making election.* The due date for making the section 165(i) election is six months after the due date for filing the taxpayer's Federal income tax return for the disaster year (determined without regard to any extension of time to file).

(g) *Revocation.* Subject to the requirements in paragraph (d) of this section, a section 165(i) election may be revoked on or before the date that is ninety (90) days after the due date for making the election.

(h) *Applicability dates*—(1) *In general.* Except as provided in paragraph (h)(2) of this section, this section applies to elections and revocations that are made on or after October 16, 2019.

(2) *Paragraph (b)(1) of this section.* The second sentence of paragraph (b)(1) of this section applies to elections and revocations that are made on or after June 11, 2021.

[T.D. 9878, 84 FR 55245, Oct. 16, 2019, as amended by T.D. 9950, 86 FR 31150, June 11, 2021]

§ 1.165–12 Denial of deduction for losses on registration-required obligations not in registered form.

(a) *In general.* Except as provided in paragraph (c) of this section, nothing in section 165(a) and the regulations thereunder, or in any other provision of law, shall be construed to provide a deduction for any loss sustained on any registration-required obligation held after December 31, 1982, unless the obligation is in registered form or 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 not be allowed a deduction for any loss sustained on such obligation unless paragraph (c) of this section applies. 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). For purposes of this section, the term *United States* means the United States and its possessions within the meaning of § 1.163–5(c)(2)(iv).

(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 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 165(j)(1).* Notwithstanding the fact that an obligation is a registration-required obligation that is not in registered form, the holder will not be subject to section 165(j)(1) if the holder meets the conditions of any one of the following subparagraphs (1), (2), (3), or (4) of this paragraph (c).

(1) *Persons permitted to hold in connection with the conduct of a trade or business.* (i) The holder is an underwriter, broker, dealer, bank, or other financial institution (defined in paragraph (c)(1)(iv)) that holds such obligation in connection with its trade or business conducted outside the United States; or the holder is a broker-dealer (registered under Federal or State law or exempted from registration by the provisions of such law because it is a bank) that holds such obligation for sale to customers in the ordinary course of its trade or business.

(ii) The holder must offer to sell, sell and deliver the obligation in bearer form only outside of the United States except that a holder that is a registered broker-dealer as described in paragraph (c)(1)(i) of this section may offer to sell and sell the obligation in bearer form inside the United States to a financial institution as defined in paragraph (c)(1)(iv) of this section for its own account or for the account of another financial institution or of an exempt organization as defined in section 501(c)(3).

(iii) The holder may deliver an obligation in bearer form that is offered or sold inside the United States only if the holder delivers it to a financial institution that is purchasing for its own account, or for the account of another financial institution or of an exempt organization, and the financial institution or organization that purchases the obligation for its own account or for whose account the obligation is purchased represents that it will comply with the requirements of section 165(j)(3) (A), (B), or (C). Absent actual knowledge that the representation is false, the holder may rely on a written statement provided by the financial institution or exempt organization, including a statement that is delivered in electronic form. The holder may deliver a registration-required obligation in bearer form that is offered and sold outside the United States to a person other than a financial institution only if the holder has evidence in its records that such person is not a U.S. citizen or resident and does not have actual knowledge that such evidence is false. Such evidence may include a written statement by that person, including a statement that is delivered electronically. For purposes of this paragraph (c), the term *deliver* includes a transfer of an obligation evidenced by a book entry including a book entry notation by a clearing organization evidencing transfer of the obligation from one member of the organization to another member. For purposes of this paragraph (c), the term *deliver* does not include a transfer of an obligation to the issuer or its agent for cancellation or extinguishment. The record-retention provisions in § 1.1441–1(e)(4)(iii) shall apply to any statement that a holder receives pursuant to this paragraph (c)(1)(iii).

(iv) For purposes of paragraph (c) of this section, the term ''financial institution'' means a person which itself is, or more than 50 percent of the total combined voting power of all classes of whose stock entitled to vote is owned by a person which is—

(A) Engaged in the conduct of a banking, financing, or similar business within the meaning of section 954(c)(3)(B) as in effect before the Tax

Reform Act of 1986, and the regulations thereunder;

(B) Engaged in business as a broker or dealer in securities;

(C) An insurance company;

(D) A person that provides pensions or other similar benefits to retired employees;

(E) Primarily engaged in the business of rendering investment advice;

(F) A regulated investment company or other mutual fund; or

(G) A finance corporation a substantial part of the business of which consists of making loans (including the acquisition of obligations under a lease which is entered into primarily as a financing transaction), acquiring accounts receivable, notes or installment obligations arising out of the sale of tangible personal property or the performing of services, or servicing debt obligations.

(2) *Persons permitted to hold obligations for their own investment account.* The holder is a financial institution holding the obligation for its own investment account that satisfies the conditions set forth in subdivisions (i), (ii), (iii), and (iv) of his paragraph (c) (2).

(i) The holder reports on its Federal income tax return for the taxable year any interest payments received (including original issue discount includable in gross income for such taxable year) with respect to such obligation and gain or loss on the sale or other disposition of such obligation;

(ii) The holder indicates on its Federal income tax return that income, gain or loss described in paragraph (c)(2)(i) is attributable to registration-required obligations held in bearer form for its own account;

(iii) The holder of a bearer obligation that resells the obligation inside the United States resells the obligation only to another financial institution for its own account or for the account of another financial institution or exempt organization; and

(iv) The holder delivers such obligation in bearer form to any other person in accordance with paragraph (c)(1) (ii) and (iii) of this section.

(3) *Persons permitted to hold through financial institutions.* The holder is any person that purchases and holds a registration-required obligation in bearer form through a financial institution with which the holder maintains a customer, custodial or nominee relationship and such institution agrees to satisfy, and does in fact satisfy, the conditions set forth in subdivisions (i), (ii), (iii), (iv) and (v) of this paragraph (c)(3).

(i) The financial institution makes a return of information to the Internal Revenue Service with respect to any interest payments received. The financial institution must report original issue discount includable in the holder's gross income for the taxable year on any obligation so held, but only if the obligation appears in an Internal Revenue Service publication of obligations issued at an original issue discount and only in an amount determined in accordance with information contained in that publication. An information return for any interest payment shall be made on a Form 1099 for the calendar year. It shall indicate the aggregate amount of the payment received, the name, address and taxpayer identification number of the holder, and such other information as is required by the form. No return of information is required under this subdivision if the financial institution reports payments under section 6041 or 6049.

(ii) The financial institution makes a return of information on Form 1099B with respect to any disposition by the holder of such obligation. The return shall show the name, address, and taxpayer identification number of the holder of the obligation, Committee on Uniform Security Information Procedures (CUSIP), gross proceeds, sale date, and such other information as may be required by the form. No return of information is required under this subdivision if such financial institution reports with respect to the disposition under section 6045.

(iii) In the case of a bearer obligation offered for resale or resold in the United States, the financial institution may resell the obligation only to another financial institution for its own account or for the account of an exempt organization.

(iv) The financial institution covenants with the holder that the financial institution will deliver the obligation in bearer form in accordance with the requirements set forth in paragraph (c)(1) (ii) and (iii).

(v) The financial institution delivers the obligation in bearer form in accordance with paragraph (c)(1) (ii) and (iv) as if the financial institution delivering the obligation were the holder referred to in such paragraph.

(4) *Conversion of obligations into registered form.* The holder is not a person described in paragraph (c) (1), (2), or (3) of this section, and within thirty days of the date when the seller or other transferor is reasonably able to make the bearer obligation available to the holder, the holder surrenders the obligation to a transfer agent or the issuer for conversion of the obligation into registered form. If such obligation is not registered within such 30 day period, the holder shall be subject to sections 165(j) and 1287(a).

(d) *Effective date.* These regulations apply generally to obligations issued after January 20, 1987. However, a taxpayer may choose to apply the rules of §1.165–12 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 45459, Dec. 19, 1986, as amended by T.D. 8734, 62 FR 53416, Oct. 14, 1997]

§ 1.166–1 Bad debts.

(a) *Allowance of deduction.* Section 166 provides that, in computing taxable income under section 63, a deduction shall be allowed in respect of bad debts owed to the taxpayer. For this purpose, bad debts shall, subject to the provisions of section 166 and the regulations thereunder, be taken into account either as—

(1) A deduction in respect of debts which become worthless in whole or in part; or as

(2) A deduction for a reasonable addition to a reserve for bad debts.

(b) *Manner of selecting method.* (1) A taxpayer filing a return of income for the first taxable year for which he is entitled to a bad debt deduction may select either of the two methods prescribed by paragraph (a) of this section for treating bad debts, but such selection is subject to the approval of the district director upon examination of the return. If the method so selected is approved, it shall be used in returns for all subsequent taxable years unless the Commissioner grants permission to use the other method. A statement of facts substantiating any deduction claimed under section 166 on account of bad debts shall accompany each return of income.

(2) Taxpayers who have properly selected one of the two methods for treating bad debts under provisions of prior law corresponding to section 166 shall continue to use that method for all subsequent taxable years unless the Commissioner grants permission to use the other method.

(3)(i) For taxable years beginning after December 31, 1959, application for permission to change the method of treating bad debts shall be made in accordance with section 446(e) and paragraph (e)(3) of §1.446–1.

(ii) For taxable years beginning before January 1, 1960, application for permission to change the method of treating bad debts shall be made at least 30 days before the close of the taxable year for which the change is effective.

(4) Nothwithstanding paragraphs (b) (1), (2), and (3) of this section, a dealer in property currently employing the accrual method of accounting and currently maintaining a reserve for bad debts under section 166(c) (which may have included guaranteed debt obligations described in section 166(f)(1)(A)) may establish a reserve for section 166(f)(1)(A) guaranteed debt obligations for a taxable year ending after October 21, 1965 under section 166(f) and §1.166–10 by filing on or before April 17, 1986 an amended return indicating that such a reserve has been established. The establishment of such a reserve will not be considered a change in method of accounting for purposes of section 446(e). However, an election by a taxpayer to establish a reserve for bad debts under section 166(c) shall be treated as a change in method of accounting. See also §1.166–4, relating to reserve for bad debts, and §1.166–10, relating to reserve for guaranteed debt obligations.

(c) *Bona fide debt required.* Only a bona fide debt qualifies for purposes of section 166. A bona fide debt is a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money. A debt arising out of the receivables of an accrual method taxpayer is deemed to be an enforceable obligation for purposes of the preceding sentence to the extent that the income such debt represents have been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year. For example, a debt arising out of gambling receivables that are unenforceable under state or local law, which an accrual method taxpayer includes in income under section 61, is an enforceable obligation for purposes of this pargarph. A gift or contribution to capital shall not be considered a debt for purposes of section 166. The fact that a bad debt its not due at the time of deduction shall not of itself prevent is allowance under section 166. For the disallowance of deductions for bad debts owed by a political party, see §1.271–1.

(d) *Amount deductible*—(1) *General rule.* Except in the case of a deduction for a reasonable addition to a reserve for bad debts, the basis for determining the amount of deduction under section 166 in respect of a bad debt shall be the same as the adjusted basis prescribed by §1.1011–1 for determining the loss from the sale or other disposition of property. To determine the allowable deduction in the case of obligations acquired before March 1, 1913, see also paragraph (b) of §1.1053–1.

(2) *Specific cases.* Subject to any provision of section 166 and the regulations thereunder which provides to the contrary, the following amounts are deductible as bad debts:

(i) *Notes or accounts receivable.* (*a*) If, in computing taxable income, a taxpayer values his notes or accounts receivable at their fair market value when received, the amount deductible as a bad debt under section 166 in respect of such receivables shall be limited to such fair market value even though it is less than their face value.

(*b*) A purchaser of accounts receivable which become worthless during the taxable year shall be entitled under section 166 to a deduction which is based upon the price he paid for such receivables but not upon their face value.

(ii) *Bankruptcy claim.* Only the difference between the amount received in distribution of the assets of a bankrupt and the amount of the claim may be deducted under section 166 as a bad debt.

(iii) *Claim against decedent's estate.* The excess of the amount of the claim over the amount received by a creditor of a decedent in distribution of the assets of the decedent's estate may be considered a worthless debt under section 166.

(e) *Prior inclusion in income required.* Worthless debts arising from unpaid wages, salaries, fees, rents, and similar items of taxable income shall not be allowed as a deduction under section 166 unless the income such items represent has been included in the return of income for the year for which the deduction as a bad debt is claimed or for a prior taxable year.

(f) *Recovery of bad debts.* Any amount attributable to the recovery during the taxable year of a bad debt, or of a part of a bad debt, which was allowed as a deduction from gross income in a prior taxable year shall be included in gross income for the taxable year of recovery, except to the extent that the recovery is excluded from gross income under the provisions of §1.111–1, relating to the recovery of certain items previously deducted or credited. This paragraph shall not apply, however, to a bad debt which was previously charged against a reserve by a taxpayer on the reserve method of treating bad debts.

(g) *Worthless securities.* (1) Section 166 and the regulations thereunder do not apply to a debt which is evidenced by a bond, debenture, note, or certificate, or other evidence of indebtedness, issued by a corporation or by a government or political subdivision thereof, with interest coupons or in registered form. See section 166(e). For provisions allowing the deduction of a loss resulting from the worthlessness of such a debt, see §1.165–5.

(2) The provisions of subparagraph (1) of this paragraph do not apply to any loss sustained by a bank and resulting from the worthlessness of a security

described in section 165(g)(2)(C). See paragraph (a) of § 1.582–1.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6996, 34 FR 835, Jan. 18, 1969; T.D. 7902, 48 FR 33260, July 21, 1983; T.D. 8071, 51 FR 2479, Jan. 17, 1986]

§ 1.166–2 Evidence of worthlessness.

(a) *General rule.* In determining whether a debt is worthless in whole or in part the district director will consider all pertinent evidence, including the value of the collateral, if any, securing the debt and the financial condition of the debtor.

(b) *Legal action not required.* Where the surrounding circumstances indicate that a debt is worthless and uncollectible and that legal action to enforce payment would in all probability not result in the satisfaction of execution on a judgment, a showing of these facts will be sufficient evidence of the worthlessness of the debt for purposes of the deduction under section 166.

(c) *Bankruptcy*—(1) *General rule.* Bankruptcy is generally an indication of the worthlessness of at least a part of an unsecured and unpreferred debt.

(2) *Year of deduction.* In bankruptcy cases a debt may become worthless before settlement in some instances; and in others, only when a settlement in bankruptcy has been reached. In either case, the mere fact that bankruptcy proceedings instituted against the debtor are terminated in a later year, thereby confirming the conclusion that the debt is worthless, shall not authorize the shifting of the deduction under section 166 to such later year.

(d) *Banks and other regulated corporations*—(1) *Worthlessness presumed in year of charge-off.* If a bank or other corporation which is subject to supervision by Federal authorities, or by State authorities maintaining substantially equivalent standards, charges off a debt in whole or in part, either—

(i) In obedience to the specific orders of such authorities, or

(ii) In accordance with established policies of such authorities, and, upon their first audit of the bank or other corporation subsequent to the charge-off, such authorities confirm in writing that the charge-off would have been subject to such specific orders if the audit had been made on the date of the charge-off,

then the debt shall, to the extent charged off during the taxable year, be conclusively presumed to have become worthless, or worthless only in part, as the case may be, during such taxable year. But no such debt shall be so conclusively presumed to be worthless, or worthless only in part, as the case may be, if the amount so charged off is not claimed as a deduction by the taxpayer at the time of filing the return for the taxable year in which the charge-off takes place.

(2) *Evidence of worthlessness in later taxable year.* If such a bank or other corporation does not claim a deduction for such a totally or partially worthless debt in its return for the taxable year in which the charge-off takes place, but claims the deduction for a later taxable year, then the charge-off in the prior taxable year shall be deemed to have been involuntary and the deduction under section 166 shall be allowed for the taxable year for which claimed, provided that the taxpayer produces sufficient evidence to show that—

(i) The debt became wholly worthless in the later taxable year, or became recoverable only in part subsequent to the taxable year of the involuntary charge-off, as the case may be; and,

(ii) To the extent that the deduction claimed in the later taxable year for a debt partially worthless was not involuntarily charged off in prior taxable years, it was charged off in the later taxable year.

(3) *Conformity election*—(i) *Eligibility for election.* In lieu of applying paragraphs (d)(1) and (2) of this section, a bank (as defined in paragraph (d)(4)(i) of this section) that is subject to supervision by Federal authorities, or by state authorities maintaining substantially equivalent standards, may elect under this paragraph (d)(3) to use a method of accounting that establishes a conclusive presumption of worthlessness for debts, provided that the bank meets the express determination requirement of paragraph (d)(3)(iii)(D) of this section for the taxable year of the election.

(ii) *Conclusive presumption*—(A) *In general.* If a bank satisfies the express determination requirement of paragraph (d)(3)(iii)(D) of this section and elects to use the method of accounting under this paragraph (d)(3)—

(*1*) Debts charged off, in whole or in part, for regulatory purposes during a taxable year are conclusively presumed to have become worthless, or worthless only in part, as the case may be, during that year, but only if the charge-off results from a specific order of the bank's supervisory authority or corresponds to the bank's classification of the debt, in whole or in part, as a loss asset, as described in paragraph (d)(3)(ii)(C) of this section; and

(*2*) A bad debt deduction for a debt that is subject to regulatory loss classification standards is allowed for a taxable year only to the extent that the debt is conclusively presumed to have become worthless under paragraph (d)(3)(ii)(A)(*1*) of this section during that year.

(B) *Charge-off should have been made in earlier year.* The conclusive presumption that a debt is worthless in the year that it is charged off for regulatory purposes applies even if the bank's supervisory authority determines in a subsequent year that the charge-off should have been made in an earlier year. A pattern of charge-offs in the wrong year, however, may result in revocation of the bank's election by the Commissioner pursuant to paragraph (d)(3)(iv)(D) of this section.

(C) *Loss asset defined.* A debt is classified as a loss asset by a bank if the bank assigns the debt to a class that corresponds to a loss asset classification under the standards set forth in the ‘‘Uniform Agreement on the Classification of Assets and Securities Held by Banks’’ (See Attachment to Comptroller of the Currency Banking Circular No. 127, Rev. 4–26–91, Comptroller of the Currency, Communications Department, Washington, DC 20219) or similar guidance issued by the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve, or the Farm Credit Administration; or for institutions under the supervision of the Office of Thrift Supervision, 12 CFR 563.160(b)(3).

(iii) *Election*—(A) *In general.* An election under this paragraph (d)(3) is to be made on bank-by-bank basis and constitutes either the adoption of or a change in method of accounting, depending on the particular bank's facts. A change in method of accounting that results from the making of an election under this paragraph (d)(3) has the effects described in paragraph (d)(3)(iii)(B) of this section.

(B) *Effect of change in method of accounting.* A change in method of accounting resulting from an election under this paragraph (d)(3) does not require or permit an adjustment under section 481(a). Under this cut-off approach—

(*1*) There is no change in the §1.1011–1 adjusted basis of the bank's existing debts (as determined under the bank's former method of accounting for bad debts) as a result of the change in method of accounting;

(*2*) With respect to debts that are subject to regulatory loss classification standards and are held by the bank at the beginning of the year of change (to the extent that they have not been charged off for regulatory purposes), and with respect to debts subject to regulatory loss classification standards that are originated or acquired subsequent to the beginning of the year of change, bad debt deductions in the year of change and thereafter are determined under the method of accounting for bad debts prescribed by this paragraph (d)(3);

(*3*) With respect to debts that are not subject to regulatory loss classification standards or that have been totally charged off prior to the year of change, bad debt deductions are determined under the general rules of section 166; and

(*4*) If there was any partial charge-off of a debt in a prechange year, any portion of which was not claimed as a deduction, the deduction reflecting that partial charge-off must be taken in the first year in which there is any further charge-off of the debt for regulatory purposes.

(C) *Procedures*—(*1*) *In general.* A new bank adopts the method of accounting under this paragraph (d)(3) for any taxable year ending on or after December 31, 1991 (and for all subsequent taxable years) when it adopts its overall method of accounting for bad debts, by attaching a statement to this effect to its income tax return for that year. Any other bank makes an election for any taxable year ending on or after December 31, 1991 (and for all subsequent taxable years) by filing a completed Form 3115 (Application for Change in Accounting Method) in accordance with the rules of paragraph (d)(3)(iii)(C)(*2*) or (*3*) of this section. The statement or Form 3115 must include the name, address, and taxpayer identification number of the electing bank and contain a declaration that the express determination requirement of paragraph (d)(3)(iii)(D) of this section is satisfied for the taxable year of the election. When a Form 3115 is used, the declaration must be made in the space provided on the form for ''Other changes in method of accounting.'' The words ''ELECTION UNDER §1.166–2(d)(3)'' must be typed or legibly printed at the top of the statement or page 1 of the Form 3115.

(*2*) *First election.* The first time a bank makes this election, the statement or Form 3115 must be attached to the bank's timely filed return (taking into account extensions of time to file) for the first taxable year covered by the election. The consent of the Commissioner to make a change in method of accounting under this paragraph (d)(3) is granted, pursuant to section 446(e), to any bank that makes the election in accordance with this paragraph (d)(3)(iii)(C), provided the bank has not made a prior election under this paragraph (d)(3).

(*3*) *Subsequent elections.* The advance consent of the Commissioner is required to make any election under this paragraph (d)(3) after a previous election has been revoked pursuant to paragraph (d)(3)(iv) of this section. This consent must be requested under the procedures, terms, and conditions prescribed under the authority of section 446(e) and §1.446–1(e) for requesting a change in method of accounting.

(D) *Express determination requirement.* In connection with its most recent examination involving the bank's loan review process, the bank's supervisory authority must have made an express determination (in accordance with any applicable administrative procedure prescribed hereunder) that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of that supervisory authority. For purposes of this paragraph (d)(3)(iii)(D), the supervisory authority of a bank is the *appropriate Federal banking agency* for the bank, as that term is defined in 12 U.S.C. 1813(q), or, in the case of an institution in the Farm Credit System, the Farm Credit Administration.

(E) *Transition period election.* For taxable years ending before completion of the first examination of the bank by its supervisory authority (as defined in paragraph (d)(3)(iii)(D) of this section) that is after October 1, 1992, and that involves the bank's loan review process, the statement or Form 3115 filed by the bank must include a declaration that the bank maintains and applies loan loss classification standards that are consistent with the regulatory standards of that supervisory authority. A bank that makes this declaration is deemed to satisfy the express determination requirement of paragraph (d)(3)(iii)(D) of this section for those years, even though an express determination has not yet been made.

(iv) *Revocation of Election*—(A) *In general.* Revocation of an election under this paragraph (d)(3) constitutes a change in method of accounting that has the effects described in paragraph (d)(3)(iv)(B) of this section. If an election under this paragraph (d)(3) has been revoked, a bank may make a subsequent election only under the provisions of paragraph (d)(3)(iii)(C)(*3*) of this section.

(B) *Effect of change in method of accounting.* A change in method of accounting resulting from revocation of an election under this paragraph (d)(3) does not require or permit an adjustment under section 481(a). Under this cut-off approach—

(*1*) There is no change in the §1.1011–1 adjusted basis of the bank's existing debts (as determined under this paragraph (d)(3) method or any other former method of accounting used by the bank with respect to its bad debts) as a result of the change in method of accounting; and

(*2*) Bad debt deductions in the year of change and thereafter with respect to all debts held by the bank, whether in existence at the beginning of the year of change or subsequently originated or acquired, are determined under the new method of accounting.

(C) *Automatic revocation*—(*1*) *In general*—A bank's election under this paragraph (d)(3) is revoked automatically if, in connection with any examination involving the bank's loan review process by the bank's supervisory authority as defined in paragraph (d)(3)(iii)(D) of this section, the bank does not obtain the express determination required by that paragraph.

(*2*) *Year of revocation.* If a bank makes the conformity election under the transition rules of paragraph (d)(3)(iii)(E) of this section and does not obtain the express determination in connection with the first examination involving the bank's loan review process that is after October 1, 1992, the election is revoked as of the beginning of the taxable year of the election or, if later, the earliest taxable year for which tax may be assessed. In other cases in which a bank does not obtain an express determination in connection with an examination of its loan review process, the election is revoked as of the beginning of the taxable year that includes the date as of which the supervisory authority conducts the examination even if the examination is completed in the following taxable year.

(*3*) *Consent granted.* Under the Commissioner's authority in section 446(e) and §1.446–1(e), the bank is directed to and is granted consent to change from this paragraph (3)(1) method as of the year of revocation (year of change) prescribed by paragraph (d)(3)(iv)(C)(*2*) of this section.

(*4*) *Requirements.* A bank changing its method of accounting under the automatic revocation rules of this paragraph (d)(3)(iv)(C) must attach a completed Form 3115 to its income tax return for the year of revocation prescribed by paragraph (d)(3)(iv)(C)(*2*) of this section. The words ''REVOCATION OF §1.166–2(d)(3) ELECTION'' must be typed or legibly printed at the top of page 1 of the Form 3115. If the year of revocation is a year for which the bank has already filed its income tax return, the bank must file an amended return for that year reflecting its change in method of accounting and must attach the completed Form 3115 to that amended return. The bank also must file amended returns reflecting the new method of accounting for all subsequent taxable years for which returns have been filed and tax may be assessed.

(D) *Revocation by Commissioner.* An election under this paragraph (d)(3) may be revoked by the Commissioner as of the beginning of any taxable year for which a bank fails to follow the method of accounting prescribed by this paragraph. In addition, the Commissioner may revoke an election as of the beginning of any taxable year for which the Commissioner determines that a bank has taken charge-offs and deductions that, under all facts and circumstances existing at the time, were substantially in excess of those warranted by the exercise of reasonable business judgment in applying the regulatory standards of the bank's supervisory authority as defined in paragraph (d)(3)(III)(D) of this section.

(E) *Voluntary revocation.* A bank may apply for revocation of its election made under this paragraph (d)(3) by timely filing a completed Form 3115 for the appropriate year and obtaining the consent of the Commissioner in accordance with section 446(e) and §1.446–1(e) (including any applicable administrative procedures prescribed thereunder). The words ''REVOCATION OF §1.166–2(d)(3) ELECTION'' must be typed or legibly printed at the top of page 1 of the Form 3115. If any bank has had its election automatically revoked pursuant to paragraph (d)(3)(iv)(C) of this section and has not changed its method of accounting in accordance with the requirements of that paragraph, the Commissioner will require that any voluntary change in method of accounting under this paragraph (d)(3)(iv)(E) be implemented retroactively pursuant to the same amended return terms and conditions as are prescribed by paragraph (d)(3)(iv)(C) of this section.

(4) *Definitions.* For purposes of this paragraph (d)—

(i) *Bank.* The term *bank* has the meaning assigned to it by section 581.

The term *bank* also includes any corporation that would be a bank within the meaning of section 581 except for the fact that it is a foreign corporation, but this paragraph (d) applies only with respect to loans the interest on which is effectively connected with the conduct of a banking business within the United States. In addition, the term *bank* includes a Farm Credit System institution that is subject to supervision by the Farm Credit Administration.

(ii) *Charge-off.* For banks regulated by the Office of Thrift Supervision, the term *charge-off* includes the establishment of specific allowances for loan losses in the amount of 100 percent of the portion of the debt classified as loss.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7254, 38 FR 2418, Jan. 26, 1973; T.D. 8396, 57 FR 6294, Feb. 24, 1992; T.D. 8441, 57 FR 45569, Oct. 2, 1992; T.D. 8492, 58 FR 53658, Oct. 18, 1993]

§ 1.166–3 Partial or total worthlessness.

(a) *Partial worthlessness*—(1) *Applicable to specific debts only.* A deduction under section 166(a)(2) on account of partially worthless debts shall be allowed with respect to specific debts only.

(2) *Charge-off required.* (i) If, from all the surrounding and attending circumstances, the district director is satisfied that a debt is partially worthless, the amount which has become worthless shall be allowed as a deduction under section 166(a)(2) but only to the extent charged off during the taxable year.

(ii) If a taxpayer claims a deduction for a part of a debt for the taxable year within which that part of the debt is charged off and the deduction is disallowed for that taxable year, then, in a case where the debt becomes partially worthless after the close of that taxable year, a deduction under section 166(a)(2) shall be allowed for a subsequent taxable year but not in excess of the amount charged off in the prior taxable year plus any amount charged off in the subsequent taxable year. In such instance, the charge-off in the prior taxable year shall, if consistently maintained as such, be sufficient to that extent to meet the charge-off requirement of section 166(a)(2) with respect to the subsequent taxable year.

(iii) Before a taxpayer may deduct a debt in part, he must be able to demonstrate to the satisfaction of the district director the amount thereof which is worthless and the part thereof which has been charged off.

(3) *Significantly modified debt*—(i) *Deemed charge-off.* If a significant modification of a debt instrument (within the meaning of §1.1001–3) during a taxable year results in the recognition of gain by a taxpayer under §1.1001–1(a), and if the requirements of paragraph (a)(3)(ii) of this section are met, there is a deemed charge-off of the debt during that taxable year in the amount specified in paragraph (a)(3)(iii) of this section.

(ii) *Requirements for deemed charge-off.* A debt is deemed to have been charged off only if—

(A) The taxpayer (or, in the case of a debt that constitutes transferred basis property within the meaning of section 7701(a)(43), a transferor taxpayer) has claimed a deduction for partial worthlessness of the debt in any prior taxable year; and

(B) Each prior charge-off and deduction for partial worthlessness satisfied the requirements of paragraphs (a) (1) and (2) of this section.

(iii) *Amount of deemed charge-off.* The amount of the deemed charge-off, if any, is the amount by which the tax basis of the debt exceeds the greater of the fair market value of the debt or the amount of the debt recorded on the taxpayer's books and records reduced as appropriate for a specific allowance for loan losses. The amount of the deemed charge-off, however, may not exceed the amount of recognized gain described in paragraph (a)(3)(i) of this section.

(iv) *Effective date.* This paragraph (a)(3) applies to significant modifications of debt instruments occurring on or after September 23, 1996.

(b) *Total worthlessness.* If a debt becomes wholly worthless during the taxable year, the amount thereof which has not been allowed as a deduction from gross income for any prior taxable year shall be allowed as a deduction for the current taxable year.

[T.D. 6500, 25 FR 11402, Nov. 29, 1960, as amended by T.D. 8763, 63 FR 4396, Jan. 29, 1998]

§ 1.166–4 Reserve for bad debts.

(a) *Allowance of deduction.* A taxpayer who has established the reserve method of treating bad debts and has maintained proper reserve accounts for bad debts or who, in accordance with paragraph (b) of § 1.166–1, adopts the reserve method of treating bad debts may deduct from gross income a reasonable addition to a reserve for bad debts in lieu of deducting specific bad debt items. This paragraph applies both to bad debts owed to the taxpayer and to bad debts arising out of section 166(f)(1)(A) guaranteed debt obligations. If a reserve is maintained for bad debts arising out of section 166(f)(1)(A) guaranteed debt obligations, then a separate reserve must also be maintained for all other debt obligations of the taxpayer in the same trade or business, if any. A taxpayer may not maintain a reserve for bad debts arising out of section 166(f)(1)(A) guaranteed debt obligations if with respect to direct debt obligations in the same trade or business the taxpayer takes deductions when the debts become worthless in whole or in part rather than maintaining a reserve for such obligations. See § 1.166–10 for rules concerning section 166(f)(1)(A) guaranteed debt obligations.

(b) *Reasonableness of addition to reserve*—(1) *Relevant factors.* What constitutes a reasonable addition to a reserve for bad debts shall be determined in the light of the facts existing at the close of the taxable year of the proposed addition. The reasonableness of the addition will vary as between classes of business and with conditions of business prosperity. It will depend primarily upon the total amount of debts outstanding as of the close of the taxable year, including those arising currently as well as those arising in prior taxable years, and the total amount of the existing reserve.

(2) *Correction of errors in prior estimates.* In the event that subsequent realizations upon outstanding debts prove to be more or less than estimated at the time of the creation of the existing reserve, the amount of the excess or inadequacy in the existing reserve shall be reflected in the determination of the reasonable addition necessary in the current taxable year.

(c) *Statement required.* A taxpayer using the reserve method shall file with his return a statement showing—

(1) The volume of his charge sales or other business transactions for the taxable year and the percentage of the reserve to such amount;

(2) The total amount of notes and accounts receivable at the beginning and close of the taxable year;

(3) The amount of the debts which have become wholly or partially worthless and have been charged against the reserve account; and

(4) The computation of the addition to the reserve for bad debts.

(d) *Special rules applicable to financial institutions.* For special rules for the addition to the bad debt reserves of certain banks, see §§ 1.585–1 through 1.585–3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6728, 29 FR 5855, May 5, 1964; T.D. 7444, 41 FR 53481, Dec. 7, 1976; T.D. 8071, 51 FR 2479, Jan. 17, 1986; T.D. 9849, 84 FR 9233, Mar. 14, 2019]

§ 1.166–5 Nonbusiness debts.

(a) *Allowance of deduction as capital loss.* (1) The loss resulting from any nonbusiness debt's becoming partially or wholly worthless within the taxable year shall not be allowed as a deduction under either section 166(a) or section 166(c) in determining the taxable income of a taxpayer other than a corporation. See section 166(d)(1)(A).

(2) If, in the case of a taxpayer other than a corporation, a nonbusiness debt becomes wholly worthless within the taxable year, the loss resulting therefrom shall be treated as a loss from the sale or exchange, during the taxable year, 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). Such a loss is subject to the limitations provided in section 1211, relating to the limitation on capital losses, and section 1212, relating to the capital loss carryover, and in the regulations under

those sections. A loss on a nonbusiness debt shall be treated as sustained only if and when the debt has become totally worthless, and no deduction shall be allowed for a nonbusiness debt which is recoverable in part during the taxable year.

(b) *Nonbusiness debt defined.* For purposes of section 166 and this section, a nonbusiness debt is any debt other than—

(1) A debt which is created, or acquired, in the course of a trade or business of the taxpayer, determined without regard to the relationship of the debt to a trade or business of the taxpayer at the time when the debt becomes worthless; or

(2) A debt the loss from the worthlessness of which is incurred in the taxpayer's trade or business.

The question whether a debt is a nonbusiness debt is a question of fact in each particular case. The determination of whether the loss on a debt's becoming worthless has been incurred in a trade or business of the taxpayer shall, for this purpose, be made in substantially the same manner for determining whether a loss has been incurred in a trade or business for purposes of section 165(c)(1). For purposes of subparagraph (2) of this paragraph, the character of the debt is to be determined by the relation which the loss resulting from the debt's becoming worthless bears to the trade or business of the taxpayer. If that relation is a proximate one in the conduct of the trade or business in which the taxpayer is engaged at the time the debt becomes worthless, the debt comes within the exception provided by that subparagraph. The use to which the borrowed funds are put by the debtor is of no consequence in making a determination under this paragraph. For purposes of section 166 and this section, a nonbusiness debt does not include a debt described in section 165(g)(2)(C). See §1.165–5, relating to losses on worthless securities.

(c) *Guaranty of obligations.* For provisions treating a loss sustained by a guarantor of obligations as a loss resulting from the worthlessness of a debt, see §§1.166–8 and 1.166–9.

(d) *Examples.* The application of this section may be illustrated by the following examples involving a case where A, an individual who is engaged in the grocery business and who makes his return on the basis of the calendar year, extends credit to B in 1955 on an open account:

Example 1. In 1956 A sells the business but retains the claim against B. The claim becomes worthless in A's hands in 1957. A's loss is not controlled by the nonbusiness debt provisions, since the original consideration has been advanced by A in his trade or business.

Example 2. In 1956 A sells the business to C but sells the claim against B to the taxpayer, D. The claim becomes worthless in D's hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claim is a proximate result.

Example 3. In 1956 A dies, leaving the business, including the accounts receivable, to his son, C, the taxpayer. The claim against B becomes worthless in C's hands in 1957. C's loss is not controlled by the nonbusiness debt provisions. While C does not advance any consideration for the claim, or create or acquire it in connection with his trade or business, the loss is sustained as a proximate incident to the conduct of the trade or business in which he is engaged at the time the debt becomes worthless.

Example 4. In 1956 A dies, leaving the business to his son, C, but leaving the claim against B to his son, D, the taxpayer. The claim against B becomes worthless in D's hands in 1957. During 1956 and 1957, D is not engaged in any trade or business. D's loss is controlled by the nonbusiness debt provisions even though the original consideration has been advanced by A in his trade or business, since the debt has not been created or acquired in connection with a trade or business of D and since in 1957 D is not engaged in a trade or business incident to the conduct of which a loss from the worthlessness of such claim is a proximate result.

Example 5. In 1956 A dies; and, while his executor, C, is carrying on the business, the claim against B becomes worthless in 1957. The loss sustained by A's estate is not controlled by the nonbusiness debt provisions. While C does not advance any consideration for the claim on behalf of the estate, or create or acquire it in connection with a trade or business in which the estate is engaged, the loss is sustained as a proximate incident to the conduct of the trade or business in which the estate is engaged at the time the debt becomes worthless.

Example 6. In 1956, A, in liquidating the business, attempts to collect the claim against B but finds that it has become worthless. A's loss is not controlled by the nonbusiness debt provisions, since the original consideration has been advanced by A in his trade or business and since a loss incurred in liquidating a trade or business is a proximate incident to the conduct thereof.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7657, 44 FR 68464, Nov. 29, 1979; T.D. 7728, 45 FR 72650, Nov. 3, 1980]

§ 1.166–6 Sale of mortgaged or pledged property.

(a) *Deficiency deductible as bad debt*—(1) *Principal amount.* If mortgaged or pledged property is lawfully sold (whether to the creditor or another purchaser) for less than the amount of the debt, and the portion of the indebtedness remaining unsatisfied after the sale is wholly or partially uncollectible, the mortgagee or pledgee may deduct such amount under section 166(a) (to the extent that it constitutes capital or represents an item the income from which has been returned by him) as a bad debt for the taxable year in which it becomes wholly worthless or is charged off as partially worthless. See § 1.166–3.

(2) *Accrued interest.* Accrued interest may be included as part of the deduction allowable under this paragraph, but only if it has previously been returned as income.

(b) *Realization of gain or loss*—(1) *Determination of amount.* If, in the case of a sale described in paragraph (a) of this section, the creditor buys in the mortgaged or pledged property, loss or gain is also realized, measured by the difference between the amount of those obligations of the debtor which are applied to the purchase or bid price of the property (to the extent that such obligations constitute capital or represent an item the income from which has been returned by the creditor) and the fair market value of the property.

(2) *Fair market value defined.* The fair market value of the property for this purpose shall, in the absence of clear and convincing proof to the contrary, be presumed to be the amount for which it is bid in by the taxpayer.

(c) *Basis of property purchased.* If the creditor subsequently sells the property so acquired, the basis for determining gain or loss upon the subsequent sale is the fair market value of the property at the date of its acquisition by the creditor.

(d) *Special rules applicable to certain banking organizations.* For special rules relating to the treatment of mortgaged or pledged property by certain mutual savings banks, domestic building and loan associations, and cooperative banks, see section 595 and the regulations thereunder.

(e) *Special rules applicable to certain reacquisitions of real property.* Notwithstanding this section, special rules apply for taxable years beginning after September 2, 1964 (and for certain taxable years beginning after December 31, 1957), to the gain or loss on certain reacquisitions of real property, to indebtedness remaining unsatisfied as a result of such reacquisitions, and to the basis of the reacquired real property. See §§ 1.1038–1 through 1.1038–3.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6814, 30 FR 4472, Apr. 7, 1965, T.D. 6916, 32 FR 5923, Apr. 13, 1967]

§ 1.166–7 Worthless bonds issued by an individual.

(a) *Allowance of deduction.* A bond or other similar obligation issued by an individual, if it becomes worthless in whole or in part, is subject to the bad debt provisions of section 166. The loss from the worthlessness of any such bond or obligation is deductible in accordance with section 166(a), unless such bond or obligation is a nonbusiness debt as defined in section 166(d)(2). If the bond or obligation is a nonbusiness debt, it is subject to section 166(d) and § 1.166–5.

(b) *Decline in market value.* A taxpayer possessing debts evidenced by bonds or other similar obligations issued by an individual shall not be allowed any deduction under section 166 on account of mere market fluctuation in the value of such obligations.

(c) *Worthless bonds issued by corporation.* For provisions allowing the deduction under section 165(a) of the loss sustained upon the worthlessness of any bond or similar obligation issued by a corporation or a government, see §1.165–5.

(d) *Application to inventories.* This section does not apply to any loss upon the worthlessness of any bond or similar obligation reflected in inventories required to be taken by a dealer in securities under section 471. See §1.471–5.

§ 1.166–8 Losses of guarantors, endorsers, and indemnitors incurred on agreements made before January 1, 1976.

(a) *Noncorporate obligations*—(1) *Deductible as bad debt.* A payment during the taxable year by a taxpayer other than a corporation in discharge of part or all of his obligation as a guarantor, endorser, or indemnitor of an obligation issued by a person other than a corporation shall, for purposes of section 166 and the regulations thereunder, be treated as a debt's becoming worthless within the taxable year, if—

(i) The proceeds of the obligation so issued have been used in the trade or business of the borrower, and

(ii) The borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment except for the existence of the guaranty, endorsement, or indemnity, whether or not such obligation has in fact become worthless within the taxable year in which payment is made.

(2) *Nonbusiness debt rule not applicable.* If a payment is treated as a loss in accordance with the provisions of subparagraph (1) of this paragraph, section 166(d), relating to the special rule for losses sustained on the worthlessness of a nonbusiness debt, shall not apply. Accordingly, in each instance the loss shall be deducted under section 166(a)(1) as a wholly worthless debt even though there has been a discharge of only a part of the taxpayer's obligation. Thus, if the taxpayer makes a payment during the taxable year in discharge of only part of his obligation as a guarantor, endorser, or indemnitor, he may treat such payment under section 166(a)(1) as a debt's becoming wholly worthless within the taxable year, provided that he can establish that such part of the borrower's obligation to the person to whom the taxpayer's payment is made is worthless at the time of payment and the conditions of subparagraph (1) of this paragraph have otherwise been satisfied.

(3) *Other applicable provisions.* Other provisions of the internal revenue laws relating to bad debts, such as section 111, relating to the recovery of bad debts, shall be deemed to apply to any payment which, under the provisions of this paragraph, is treated as a bad debt. If the requirements of section 166(f) are not met, any loss sustained by a guarantor, endorser, or indemnitor upon the worthlessness of the debtor's obligation shall be treated under the provisions of law applicable thereto. See, for example, paragraph (b) of this section.

(b) *Corporate obligations.* The loss sustained during the taxable year by a taxpayer other than a corporation in discharge of all of his obligation as a guarantor of an obligation issued by a corporation shall be treated, in accordance with section 166(d) and the regulations thereunder, as a loss sustained on the worthlessness of a nonbusiness debt if the debt created in the guarantor's favor as a result of the payment does not come within the exceptions prescribed by section 166(d)(2) (A) or (B). See paragraph (a)(2) of §1.166–5.

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

Example 1. During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. B defaults on his obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of B to the X Bank being wholly worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a)(1) as a result of his payment during that year.

Example 2. During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used in B's business. In 1956, B pays a part of his obligation to the X Bank but defaults on the remaining part. In 1957, A makes payment to the X Bank, in discharge of part of his obligation as a guarantor, of the remaining unpaid part of B's obligation to the bank, such part of B's obligation then being worthless. For his taxable year 1957, A is entitled to a deduction under section 166(a) (1) as a result of his payment of the remaining unpaid part of B's obligation.

Example 3. During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of B, an individual, to the X Bank, the proceeds of the obligation being used for B's personal use. B defaults on his obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of B to X Bank being wholly worthless. A may not apply the benefit of section 166(f) to his loss, since the proceeds of B's obligation have not been used in B's trade or business.

Example 4. During 1955, A, an individual who makes his return on the basis of the calendar year, guarantees payment of an obligation of Y Corporation to the X Bank, the proceeds of the obligation being used in Y Corporation's business. Y Corporation defaults on its obligation in 1956. A makes payment to the X Bank during 1957 in discharge of his entire obligation as a guarantor, the obligation of Y Corporation to the X Bank being wholly worthless. At no time during 1955 or 1957 is A engaged in a trade or business. For his taxable year 1957, A is entitled to deduct a capital loss in accordance with the provisions of section 166(d) and paragraph (a) (2) of §1.166–5. He may not apply the benefit of section 166(f) to his loss, since his payment is in discharge of an obligation issued by a corporation.

(d) *Effective date.* This section applies only to losses, regardless of the taxable year in which incurred, on agreements made before January 1, 1976.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 7657, 44 FR 68464, Nov. 29, 1979]

§ 1.166–9 Losses of guarantors, endorsers, and indemnitors incurred, on agreements made after December 31, 1975, in taxable years beginning after such date.

(a) *Payment treated as worthless business debt.* This paragraph applies to taxpayers who, after December 31, 1975, enter into an agreement in the course of their trade or business to act as (or in a manner essentially equivalent to) a guarantor, endorser, or indemnitor of (or other secondary obligor upon) a debt obligation. Subject to the provisions of paragraphs (c), (d), and (e) of this section, a payment of principal or interest made during a taxable year beginning after December 31, 1975, by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor is treated as a business debt becoming worthless in the taxable year in which the payment is made or in the taxable year described in paragraph (e)(2) of this section. Neither section 163 (relating to interest) nor section 165 (relating to losses) shall apply with respect to such a payment.

(b) *Payment treated as worthless nonbusiness debt.* This paragraph applies to taxpayers (other than corporations) who, after December 31, 1975, enter into a transaction for profit, but not in the course of their trade or business, to act as (or in a manner essentially equivalent to) a guarantor, endorser, or indemnitor of (or other secondary obligor upon) a debt obligation. Subject to the provisions of paragraphs (c), (d), and (e) of this section, a payment of principal or interest made during a taxable year beginning after December 31, 1975, by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor is treated as a worthless nonbusiness debt in the taxable year in which the payment is made or in the taxable year described in paragraph (e)(2) of this section. Neither section 163 nor section 165 shall apply with respect to such a payment.

(c) *Obligations issued by corporations.* No treatment as a worthless debt is allowed with respect to a payment made by the taxpayer in discharge of part or all of the taxpayer's obligation as a guarantor, endorser, or indemnitor of an obligation issued by a corporation if, on the basis of the facts and circumstances at the time the obligation was entered into, the payment constitutes a contribution to capital by a shareholder. The rule of this paragraph (c) applies to payments whenever made (see paragraph (f) of this section).

(d) *Certain payments treated as worthless debts.* A payment in discharge of part or all of taxpayer's agreement to act as guarantor, endorser, or indemnitor of an obligation is to be treated as a worthless debt only if—

(1) The agreement was entered into in the course of the taxpayer's trade or business or a transaction for profit;

(2) There was an enforceable legal duty upon the taxpayer to make the payment (except that legal action need

not have been brought against the taxpayer); and

(3) The agreement was entered into before the obligation became worthless (or partially worthless in the case of an agreement entered into in the course of the taxpayer's trade or business). See §§ 1.166–2 and 1.166–3 for rules on worthless and partially worthless debts. For purposes of this paragraph (d)(3), an agreement is considered as entered into before the obligation became worthless (or partially worthless) if there was a reasonable expectation on the part of the taxpayer at the time the agreement was entered into that the taxpayer would not be called upon to pay the debt (subject to such agreement) without full reimbursement from the issuer of the obligation.

(e) *Special rules*—(1) *Reasonable consideration required.* Treatment as a worthless debt of a payment made by a taxpayer in discharge of part or all of the taxpayer's agreement to act as a guarantor, endorser, or indemnitor of an obligation is allowed only if the taxpayer demonstrates that reasonable consideration was received for entering into the agreement. For purposes of this paragraph (e)(1), reasonable consideration is not limited to direct consideration in the form of cash or property. Thus, where a taxpayer can demonstrate that the agreement was given without direct consideration in the form of cash or property but in accordance with normal business practice or for a good faith business purpose, worthless debt treatment is allowed with respect to a payment in discharge of part or all of the agreement if the conditions of this section are met. However, consideration received from a taxpayer's spouse or any individual listed in section 152(a) must be direct consideration in the form of cash or property.

(2) *Right of subrogation.* With respect to a payment made by a taxpayer in discharge of part or all of the taxpayer's agreement to act as a guarantor, endorser, or indemnitor where the agreement provides for a right of subrogation or other similar right against the issuer, treatment as a worthless debt is not allowed until the taxable year in which the right of subrogation or other similar right becomes totally worthless (or partially worthless in the case of an agreement which arose in the course of the taxpayer's trade or business).

(3) *Other applicable provisions.* Unless inconsistent with this section, other Internal Revenue laws concerning worthless debts, such as section 111 relating to the recovery of bad debts, apply to any payment which, under the provisions of this section, is treated as giving rise to a worthless debt.

(4) *Taxpayer defined.* For purposes of this section, except as otherwise provided, the term ''taxpayer'' means any taxpayer and includes individuals, corporations, partnerships, trusts and estates.

(f) *Effective date.* This section applies to losses incurred on agreements made after December 31, 1975, in taxable years beginning after such date. However, paragraph (c) of this section also applies to payments, regardless of the taxable year in which made, under agreements made before January 1, 1976.

[T.D. 7657, 44 FR 68465, Nov. 29, 1979, as amended by T.D. 7920, 48 FR 50712, Nov. 3, 1983]

§ 1.166–10 Reserve for guaranteed debt obligations.

(a) *Definitions.* The following provisions apply for purposes of this section and section 166(f):

(1) *Dealer in property.* A dealer in property is a person who regularly sells property in the ordinary course of the person's trade or business.

(2) *Guaranteed debt obligation.* A guaranteed debt obligation is a legal duty of one person as a guarantor, endorser or indemnitor of a second person to pay a third person. It does not include duties based solely on moral or good public relations considerations that are not legally binding. A guaranteed debt obligation typically arises where a seller receives in payment for property or services the debt obligation of a purchaser and sells that obligation to a third party with recourse. However, a guaranteed debt obligation also may arise out of a sale in respect of which there is no direct debtor-creditor relationship between the debtor purchaser and the seller. For example, it arises where a purchaser borrows money from

a third party to make payment to the seller and the seller guarantees the payment of the purchaser's debt. Generally, debt obligations which are sold without recourse do not result in any obligation of the seller as a guarantor, endorser, or indemnitor. However, there are certain without-recourse transactions which may give rise to a seller's liability as a guarantor or indemnitor. For example, such a liability may arise where a holder of a debt obligation holds money or other property of a seller which the holder may apply, without seeking permission of the seller, against any uncollectible debt obligations transferred to the holder by the seller without recourse, or where the seller is under a legal obligation to reacquire the real or tangible personal property from the holder of the debt obligation who repossessed property in satisfaction of the debt obligations.

(3) *Real or tangible personal property*. Real or tangible personal property generally does not include other forms of property, such as securities. However, if the sale of other property is related to the sale of actual real or tangible personal property, the other property will be considered to be real or tangible personal property. In order for the sale of other property to be related, it must be—

(i) Incidental to the sale of the actual real or tangible personal property; and

(ii) Made under an agreement, entered into at the same time as the sale of actual real or tangible personal property, between the dealer in that property and the customer with respect to that property.

The other property may be charged for as a part of, or in addition to, the sales price of the actual real or tangible personal property. If the value of the other property is not greater than 20 percent of the total sales price, including the value of all related services other than financing services, the sale of the other property is related to the sale of actual real or tangible personal property.

(4) *Related services*. In the case of a sale of both property and services a determination must be made as to whether the services are related to the property. Related services include only those services which are—

(i) Incidental to the sale of the real or tangible personal property; and

(ii) To be performed under an agreement, entered into at the same time as the sale of the property, between the dealer in property and the customer with respect to the property.

Delivery, financing installation. maintenance, repair, or instructional services generally qualify as related services. The services may be charged for as a part of, or in addition to, the sales price of the property. Where the value of all services other than financing services is not greater than 20 percent of the total of the sales price of the property, including the value of all the services other than financing services, all of the services are considered to be incidental to the sale of the property. Where the value of the services is greater than 20 percent, the determination as to whether a service is a related service in a particular case is to be made on the basis of all relevant facts and circumstances.

(5) *Examples*. The following examples apply to paragraph (a)(4) of this section:

Example 1. A. a dealer in television sets sells a television set to B, his customer. If at the time of the sale A, for a separate charge which is added to the sales price of the set and which is not greater than 20 percent of the total sales price, provides a 3-year service contract on only that television set, the service contract is a related service agreement. However, if A does not sell the service contract to B contemporaneously with the sale of the television set, as would be the case if the service agreement were entered into after the sale of the set were completed, or if the service contract includes services for a television set in addition to the one then sold by A to B, the service contract is not an agreement for a related service.

Example 2. C, an automobile dealer, at the time of the sale by C of an automobile to D, agrees to made available to D driving instructions furnished by the M driving school, the cost of which is included in the sale price of the automobile and is not greater than 20 percent of the total sales price. C also agrees to pay M for the driving instructions furnished to D. Since C's agreement with D to make available driving instructions is incidental to the sale of the automobile, is made contemporaneously with the sale, and is charged for as part of the sales price of the automobile, it is an agreement for a related service. In contrast, however, because M's agreement with C is not an agreement between the dealer in property and the customer, M's agreement with C to provide driving instructions to C's customers is not an agreement for a related service.

(b) *Incorporation of section 166(c) rules*. A reserve for section 166(f)(1)(A) guaranteed debt obligations must be established and maintained under the rules applicable to the reserve for bad debts under section 166(c) (with the exception of the statement requirement under §1.166–4 (c)). For example, the rules in §1.166–4(b), relating to what constitutes a reasonable addition to a reserve for bad debts and to correction of errors in prior estimates, apply to a reserve for section 166(f)(1)(A) guaranteed debt obligations as well.

(c) *Special requirements*. Any reserve for section 166(f)(1)(A) guaranteed debt obligations must be established and maintained separately from any reserve for other debt obligations. In addition, a taxpayer who charges off direct debts when they become worthless in whole or in part rather than maintaining a reserve for such obligations may not maintain a reserve for section 166(f)(1)(A) guaranteed debt obligations in the same trade or business.

(d) *Requirement of statement*. A taxpayer who uses the reserve method of treating section 166(f)(1)(A) guaranteed debt obligations must attach to his return for each taxable year, returns for which are filed after April 17, 1986, and for each trade or business for which the reserve is maintained a statement showing—

(1) The total amount of these obligations at the beginning of the taxable year;

(2) The total amount of these obligations incurred during the taxable year;

(3) The amount of the initial balance of the suspense account, if any, established with respect to these obligations;

(4) The balance of the suspense account, if any, at the beginning of the taxable year,

(5) The adjustment, if any, to that account;

(6) The adjusted balance, if any, at the close of the taxable year;

(7) The reconciliation of the beginning and closing balances of the reserve for these obligations and the computation of the addition to the reserve; and

(8) The taxable year for which the reserve for these obligations was established.

(e) *Computation of opening balance*—(1) *In general*. The opening balance of a reserve for section 166(f)(1)(A) guaranteed debt obligations established for the first taxable year for which a taxpayer maintains such a reserve shall be determined as if the taxpayer had maintained such a reserve for the taxable years preceding that taxable year. The amount of the opening balance may be determined under the following formula:

$$OB = CG \times \frac{SNL}{SG}$$

where—

OB = the opening balance at the beginning of the first taxable year

CG = the amount of these obligations at the close of the last preceding taxable year

SG = the sum of the amounts of these obligations at the close of the five preceding taxable years

SNL the sum of the amounts of net losses arising from these obligations for the five preceding taxable years

(2) *Example*. The following example applies to paragraph (e)(1) of this section.

Example. For 1977, A, a dealer in automobiles who uses the calendar year as the taxable year, adopts in accordance with this section the reserve method of treating section 166(f)(1)(A) guaranteed debt obligations. A's first year in business as an automobile dealer is 1973. For 1972, 1973, 1974, 1975, and 1976, A's records disclose the following information with respect to these obligations:

Year	Obligations outstanding at close of year	Gross losses from these obligations	Recoveries from these obligations	Net losses from these obligations
1972	$0	$0	$0	$0
1973	780,000	9,700	1,000	8,700
1974	795,000	8,900	1,050	7,850

Year	Obligations outstanding at close of year	Gross losses from these obligations	Recoveries from these obligations	Net losses from these obligations
1975	850,000	8,850	850	8,000
1976	820,000	8,300	1,400	7,900
Total	3,245,000	36,750	4,300	32,450

The opening balance for 1977 of A's reserve for these obligations is $8,200, determined as follows:

$$\$8{,}200 = \$820{,}000 \times \frac{\$32{,}450}{\$3{,}245{,}000}$$

(3) *More appropriate balance.* A taxpayer may select a balance other than the one produced under paragraph (e)(1) of this section if it is more appropriate, based upon the taxpayer's actual experience, and in the event the taxpayer's return is examined, if the balance is approved by the district director.

(4) *No losses in the five preceding taxable years.* If a taxpayer is in the taxpayer's first taxable year of a particular trade or business, or if the taxpayer has no losses arising from section 166(f)(1)(A) guaranteed debt obligations in a particular trade or business for any other reason in the five preceding taxable years, then the taxpayer's opening balance is zero for that particular trade or business.

(5) *Where reserve method was used before October 22, 1965.* If for a taxable year ending before October 22, 1965, the taxpayer maintained a reserve for bad debts under section 166(c) which included guaranteed debt obligations described in section 166(f)(1)(A), and if the taxpayer is allowed a deduction referred to in paragraph (g)(2) of this section on account of those obligations, the amount of the opening balance of the reserve for section 166(f)(1)(A) guaranteed debt obligations for the taxpayer's first taxable year ending after October 21, 1965, shall be an amount equal to that portion of the section 166(c) reserve at the close of the last taxable year which is attributable to those debt obligations. The amount of the balance of the section 166(c) reserve for the taxable year shall be reduced by the amount of the opening balance of the reserve for those guaranteed debt obligations.

(f) *Suspense account*—(1) *Zero opening balance cases.* No suspense account shall be maintained if the opening balance of the reserve for section 166(f)(1)(A) guaranteed debt obligations under section 166(f)(3) is zero

(2) *Example.* The following example applies to section 166(f)(4)(B), relating to adjustments to the suspense account:

Example. In 1977, A, an individual who operates an appliance store and uses the calendar year as the taxable year, adopts the reserve method of treating section 166(f)(1)(A) guaranteed debt obligations. The initial balance of A's suspense account is $8,200. At the close of 1977, 1978, 1979, and 1980, the balance of A's reserve for these obligations is $8,400, $8,250, $8,150, and $8,175, respectively, after making the addition to the reserve for each year. The adjustments under section 166(f)(4)(B) to the suspense account at the close of each of the years involved are as follows:

(1) Taxable year	1977	1978	1979	1980
(2) Closing reserve account balance	$8,400	$8,250	$8,150	$8,175
(3) Opening suspense account balance	8,200	8,200	8,200	8,150
(4) Line (2) less line (3)	200	50	(50	25
(5) Adjustment to suspense account balance	0	0	(50	25
(6) Closing suspense account balance (line 3 plus line 5)	8,200	8,200	8,150	8,175

(g) *Effective date*—(1) *In general.* This section is generally effective for taxable years ending after October 21, 1965.

(2) *Transitional rule.* Section 2(b) of the Act of November 2, 1966 (Pub. L. 89–722, 80 Stat. 1151) allows additions to section 166(c) bad debt reserves in earlier taxable years on account of section 166(f)(1)(A) guaranteed debt obligations to be deducted for those earlier taxable

years. Paragraphs (c), (d), (e), and (f) of this section do not apply in determining whether a deduction is allowed under section 2(b) of the Act. See Rev. Rul. 68–313 (1968–1C.B. 75) for rules relating to that deduction.

[T.D. 8071, 51 FR 2479, Jan. 17, 1986; 51 FR 9787, Mar. 21, 1986]

§ 1.167(a)–1 Depreciation in general.

(a) *Reasonable allowance.* Section 167(a) provides that a reasonable allowance for the exhaustion, wear and tear, and obsolescence of property used in the trade or business or of property held by the taxpayer for the production of income shall be allowed as a depreciation deduction. The allowance is that amount which should be set aside for the taxable year in accordance with a reasonably consistent plan (not necessarily at a uniform rate), so that the aggregate of the amounts set aside, plus the salvage value, will, at the end of the estimated useful life of the depreciable property, equal the cost or other basis of the property as provided in section 167(g) and § 1.167(g)–1. An asset shall not be depreciated below a reasonable salvage value under any method of computing depreciation. However, see section 167(f) and § 1.167(f)–1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. See also paragraph (c) of this section for definition of salvage. The allowance shall not reflect amounts representing a mere reduction in market value. See section 179 and § 1.179–1 for a further description of the term ''reasonable allowance.''

(b) *Useful life.* For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. Some of the factors to be considered in determining this period are (1) wear and tear and decay or decline from natural causes, (2) the normal progress of the art, economic changes, inventions, and current developments within the industry and the taxpayer's trade or business, (3) the climatic and other local conditions peculiar to the taxpayer's trade or business, and (4) the taxpayer's policy as to repairs, renewals, and replacements. Salvage value is not a factor for the purpose of determining useful life. If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination. The estimated remaining useful life may be subject to modification by reason of conditions known to exist at the end of the taxable year and shall be redetermined when necessary regardless of the method of computing depreciation. However, estimated remaining useful life shall be redetermined only when the change in the useful life is significant and there is a clear and convincing basis for the redetermination. For rules covering agreements with respect to useful life, see section 167(d) and § 1.167(d)–1. If a taxpayer claims an investment credit with respect to an asset for a taxable year preceding the taxable year in which the asset is considered as placed in service under § 1.167(a)–10(b) or § 1.167(a)–11(e), the useful life of the asset under this paragraph shall be the same useful life assigned to the asset under § 1.46–3(e).

(c) *Salvage.* (1) Salvage value is the amount (determined at the time of acquisition) which is estimated will be realizable upon sale or other disposition of an asset when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service by the taxpayer. Salvage value shall not be changed at any time after the determination made at the time of acquisition merely because of changes in price levels. However, if there is a redetermination of useful life under the rules of paragraph (b) of this section, salvage value may be redetermined based upon facts known at the time of such redetermination of useful life. Salvage, when reduced by the cost of removal, is referred to as net salvage. The time at which an asset is retired from service may vary according to the policy of the taxpayer. If the taxpayer's policy is to dispose of assets which are still in good operating condition, the salvage value may represent a relatively large proportion of the original basis of the asset. However, if the taxpayer customarily uses an asset until its inherent useful life has been substantially exhausted, salvage value may represent no more than junk value. Salvage value must be taken into account in determining the depreciation deduction either by a reduction of the amount subject to depreciation or by a reduction in the rate of depreciation, but in no event shall an asset (or an account) be depreciated below a reasonable salvage value. See, however, paragraph (a) of § 1.167(b)–2 for the treatment of salvage under the declining balance method, and § 1.179–1 for the treatment of salvage in computing the additional first-year depreciation allowance. The taxpayer may use either salvage or net salvage in determining depreciation allowances but such practice must be consistently followed and the treatment of the costs of removal must be consistent with the practice adopted. For specific treatment of salvage value, see §§ 1.167(b)–1, 1.167(b)–2, and 1.167(b)–3. When an asset is retired or disposed of, appropriate adjustments shall be made in the asset and depreciation reserve accounts. For example, the amount of the salvage adjusted for the costs of removal may be credited to the depreciation reserve.

(2) For taxable years beginning after December 31, 1961, and ending after October 16, 1962, see section 167(f) and § 1.167(f)–1 for rules applicable to the reduction of salvage value taken into account for certain personal property acquired after October 16, 1962.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3653, Mar. 24, 1964; T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.167(a)–2 Tangible property.

The depreciation allowance in the case of tangible property applies only to that part of the property which is subject to wear and tear, to decay or decline from natural causes, to exhaustion, and to obsolescence. The allowance does not apply to inventories or stock in trade, or to land apart from the improvements or physical development added to it. The allowance does not apply to natural resources which are subject to the allowance for depletion provided in section 611. No deduction for depreciation shall be allowed on automobiles or other vehicles used solely for pleasure, on a building used by the taxpayer solely as his residence, or on furniture or furnishings therein, personal effects, or clothing; but properties and costumes used exclusively in a business, such as a theatrical business, may be depreciated.

§ 1.167(a)–3 Intangibles.

(a) *In general.* If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. Examples are patents and copyrights. An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life. No deduction for depreciation is allowable with respect to goodwill. For rules with respect to organizational expenditures, see section 248 and the regulations thereunder. For rules with respect to trademark and trade name expenditures, see section 177 and the regulations thereunder. See sections 197 and 167(f) and, to the extent applicable, §§ 1.197–2 and 1.167(a)–14 for amortization of goodwill and certain other intangibles acquired after August 10, 1993, or after July 25, 1991, if a valid retroactive election under § 1.197–1T has been made.

(b) *Safe harbor amortization for certain intangible assets*—(1) *Useful life.* Solely for purposes of determining the depreciation allowance referred to in paragraph (a) of this section, a taxpayer may treat an intangible asset as having a useful life equal to 15 years unless—

(i) An amortization period or useful life for the intangible asset is specifically prescribed or prohibited by the Internal Revenue Code, the regulations thereunder (other than by this paragraph (b)), or other published guidance in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter);

(ii) The intangible asset is described in §1.263(a)–4(c) (relating to intangibles acquired from another person) or §1.263(a)–4(d)(2) (relating to created financial interests);

(iii) The intangible asset has a useful life the length of which can be estimated with reasonable accuracy; or

(iv) The intangible asset is described in §1.263(a)–4(d)(8) (relating to certain benefits arising from the provision, production, or improvement of real property), in which case the taxpayer may treat the intangible asset as having a useful life equal to 25 years solely for purposes of determining the depreciation allowance referred to in paragraph (a) of this section.

(2) *Applicability to acquisitions of a trade or business, changes in the capital structure of a business entity, and certain other transactions.* The safe harbor useful life provided by paragraph (b)(1) of this section does not apply to an amount required to be capitalized by §1.263(a)–5 (relating to amounts paid to facilitate an acquisition of a trade or business, a change in the capital structure of a business entity, and certain other transactions).

(3) *Depreciation method.* A taxpayer that determines its depreciation allowance for an intangible asset using the 15-year useful life prescribed by paragraph (b)(1) of this section (or the 25-year useful life in the case of an intangible asset described in §1.263(a)–4(d)(8)) must determine the allowance by amortizing the basis of the intangible asset (as determined under section 167(c) and without regard to salvage value) ratably over the useful life beginning on the first day of the month in which the intangible asset is placed in service by the taxpayer. The intangible asset is not eligible for amortization in the month of disposition.

(4) *Effective date.* This paragraph (b) applies to intangible assets created on or after December 31, 2003.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8867, 65 FR 3825, Jan. 25, 2000; T.D. 9107, 69 FR 444, Jan. 5, 2004]

§ 1.167(a)–4 Leased property.

(a) *In general.* Capital expenditures made by either a lessee or lessor for the erection of a building or for other permanent improvements on leased property are recovered by the lessee or lessor under the provisions of the Internal Revenue Code (Code) applicable to the cost recovery of the building or improvements, if subject to depreciation or amortization, without regard to the period of the lease. For example, if the building or improvement is property to which section 168 applies, the lessee or lessor determines the depreciation deduction for the building or improvement under section 168. See section 168(i)(8)(A). If the improvement is property to which section 167 or section 197 applies, the lessee or lessor determines the depreciation or amortization deduction for the improvement under section 167 or section 197, as applicable.

(b) *Effective/applicability date*—(1) *In general.* Except as provided in paragraph (b)(2) or (b)(3) of this section, this section applies to taxable years beginning on or after January 1, 2014.

(2) *Application of this section to leasehold improvements placed in service after December 31, 1986, in taxable years beginning before January 1, 2014.* For leasehold improvements placed in service after December 31, 1986, in taxable years beginning before January 1, 2014, a taxpayer may—

(i) Apply the provisions of this section; or

(ii) Depreciate any leasehold improvement to which section 168 applies under the provisions of section 168 and depreciate or amortize any leasehold improvement to which section 168 does not apply under the provisions of the Code that are applicable to the cost recovery of that leasehold improvement, without regard to the period of the lease.

(3) *Application of this section to leasehold improvements placed in service before January 1, 1987.* Section 1.167(a)–4 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to leasehold improvements placed in service before January 1, 1987.

(4) *Change in method of accounting.* Except as provided in §1.446–1(e)(2)(ii)(*d*)(*3*)(*i*), a change to comply

with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. Except as provided in §1.446–1(e)(2)(ii)(*d*)(*3*)(*i*), a taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply.

[T.D. 9636, 78 FR 57706, Sept. 19, 2013]

§ 1.167(a)–5 Apportionment of basis.

In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. In the case of property which is subject to both the allowance for depreciation and amortization, depreciation is allowable only with respect to the portion of the depreciable property which is not subject to the allowance for amortization and may be taken concurrently with the allowance for amortization. After the close of the amortization period or after amortization deductions have been discontinued with respect to any such property, the unrecovered cost or other basis of the depreciable portion of such property will be subject to depreciation. For adjustments to basis, see section 1016 and other applicable provisions of law. For the adjustment to the basis of a structure in the case of a donation of a qualified conservation contribution under section 170(h), see §1.170A–14(h)(3)(iii).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8069, 51 FR 1498, Jan. 14, 1986]

§ 1.167(a)–5T Application of section 1060 to section 167 (temporary).

In the case of an acquisition of a combination of depreciable and nondepreciable property for a lump sum in an applicable asset acquisition to which section 1060 applies, the basis for depreciation of the depreciable property cannot exceed the amount of consideration allocated to that property under section 1060 and §1.1060–1T.

[T.D. 8215, 53 FR 27043, July 18, 1988]

§ 1.167(a)–6 Depreciation in special cases.

(a) *Depreciation of patents or copyrights.* The cost or other basis of a patent or copyright shall be depreciated over its remaining useful life. Its cost to the patentee includes the various Government fees, cost of drawings, models, attorneys' fees, and similar expenditures. For rules applicable to research and experimental expenditures, see sections 174 and 1016 and the regulations thereunder. If a patent or copyright becomes valueless in any year before its expiration the unrecovered cost or other basis may be deducted in that year. See §1.167(a)–14(c)(4) for depreciation of a separately acquired interest in a patent or copyright described in section 167(f)(2) acquired after January 25, 2000. See §1.197–2 for amortization of interests in patents and copyrights that constitute amortizable section 197 intangibles.

(b) *Depreciation in case of farmers.* A reasonable allowance for depreciation may be claimed on farm buildings (except a dwelling occupied by the owner), farm machinery, and other physical property but not including land. Livestock acquired for work, breeding, or dairy purposes may be depreciated unless included in an inventory used to determine profits in accordance with section 61 and the regulations thereunder. Such depreciation should be determined with reference to the cost or other basis, salvage value, and the estimated useful life of the livestock. See also section 162 and the regulations thereunder relating to trade or business expenses, section 165 and the regulations thereunder relating to losses of farmers, and section 175 and the regulations thereunder relating to soil or water conservation expenditures.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 8867, 65 FR 3825, Jan. 25, 2000]

§ 1.167(a)–7 Accounting for depreciable property.

(a) Depreciable property may be accounted for by treating each individual item as an account, or by combining two or more assets in a single account. Assets may be grouped in an account in a variety of ways. For example, assets similar in kind with approximately the same useful lives may be grouped together. Such an account is commonly known as a group account. Another appropriate grouping might consist of assets segregated according to use without regard to useful life, for example, machinery and equipment, furniture and fixtures, or transportation equipment. Such an account is commonly known as a classified account. A broader grouping, where assets are included in the same account regardless of their character or useful lives, is commonly referred to as a composite account. For example, all the assets used in a business may be included in a single account. Group, classified, or composite accounts may be further broken down on the basis of location, dates of acquisition, cost, character, use, etc.

(b) When group, classified, or composite accounts are used with average useful lives and a normal retirement occurs, the full cost or other basis of the asset retired, unadjusted for depreciation or salvage, shall be removed from the asset account and shall be charged to the depreciation reserve. Amounts representing salvage ordinarily are credited to the depreciation reserve. Where an asset is disposed of for reasons other than normal retirement, the full cost or other basis of the asset shall be removed from the asset account, and the depreciation reserve shall be charged with the depreciation applicable to the retired asset. For rules with respect to losses on normal retirements, see § 1.167 (a)–8.

(c) A taxpayer may establish as many accounts for depreciable property as he desires. Depreciation allowances shall be computed separately for each account. Such depreciation preferably should be recorded in a depreciation reserve account; however, in appropriate cases it may be recorded directly in the asset account. Where depreciation reserves are maintained, a separate reserve account shall be maintained for each asset account. The regular books of account or permanent auxiliary records shall show for each account the basis of the property, including adjustments necessary to conform to the requirements of section 1016 and other provisions of law relating to adjustments to basis, and the depreciation allowances for tax purposes. In the event that reserves for book purposes do not correspond with reserves maintained for tax purposes, permanent auxiliary records shall be maintained with the regular books of accounts reconciling the differences in depreciation for tax and book purposes because of different methods of depreciation, bases, rates, salvage, or other factors. Depreciation schedules filed with the income tax return shall show the accumulated reserves computed in accordance with the allowances for income tax purposes.

(d) In classified or composite accounts, the average useful life and rate shall be redetermined whenever additions, retirements, or replacements substantially alter the relative proportion of types of assets in the accounts. See example (2) in paragraph (b) of § 1.167(b)–1 for method of determining the depreciation rate for a classified or composite account.

(e) *Applicability.* Paragraphs (a), (b), and (d) of this section apply to property for which depreciation is determined under section 167 (but not under section 168, section 1400I, section 1400L(c), section 168 prior to its amendment by the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2121 (1986)), or under an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k) through (n), 1400L(b), or 1400N(d))). Paragraph (c) of this section does not apply to general asset accounts as provided by section 168(i)(4), § 1.168(i)–1, § 1.168(i)–1T and Prop. Reg. § 1.168(i)–1 (September 19, 2013).

(f) *Effective/applicability date*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (f)(2) and (f)(3) of this section, § 1.167(a)–7 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of § 1.167(a)–7(e).* A taxpayer may choose to apply paragraph (e) of this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564.* A taxpayer may choose to apply § 1.167(a)–7T 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 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 9564, 76 FR 81085, Dec. 27, 2011; T.D. 9636, 78 FR 57707, Sept. 19, 2013]

§ 1.167(a)–8 Retirements.

(a) *Gains and losses on retirements.* For the purposes of this section the term ''retirement'' means the permanent withdrawal of depreciable property from use in the trade or business or in the production of income. The withdrawal may be made in one of several ways. For example, the withdrawal may be made by selling or exchanging the asset, or by actual abandonment. In addition, the asset may be withdrawn from such productive use without disposition as, for example, by being placed in a supplies or scrap account. The tax consequences of a retirement depend upon the form of the transaction, the reason therefor, the timing of the retirement, the estimated useful life used in computing depreciation, and whether the asset is accounted for in a separate or multiple asset account. Upon the retirement of assets, the rules in this section apply in determining whether gain or loss will be recognized, the amount of such gain or loss, and the basis for determining gain or loss:

(1) Where an asset is retired by sale at arm's length, recognition of gain or loss will be subject to the provisions of sections 1002, 1231, and other applicable provisions of law.

(2) Where an asset is retired by exchange, the recognition of gain or loss will be subject to the provisions of sections 1002, 1031, 1231, and other applicable provisions of law.

(3) Where an asset is permanently retired from use in the trade or business or in the production of income but is not disposed of by the taxpayer or physically abandoned (as, for example, when the asset is transferred to a supplies or scrap account), gain will not be recognized. In such a case loss will be recognized measured by the excess of the adjusted basis of the asset at the time of retirement over the estimated salvage value or over the fair market value at the time of such retirement if greater, but only if—

(i) The retirement is an abnormal retirement, or

(ii) The retirement is a normal retirement from a single asset account (but see paragraph (d) of this section for special rule for item accounts), or

(iii) The retirement is a normal retirement from a multiple asset account in which the depreciation rate was based on the maximum expected life of the longest lived asset contained in the account.

(4) Where an asset is retired by actual physical abandonment (as, for example, in the case of a building condemned as unfit for further occupancy or other use), loss will be recognized measured by the amount of the adjusted basis of the asset abandoned at the time of such abandonment. In order to qualify for the recognition of loss from physical abandonment, the intent of the taxpayer must be irrevocably to discard the asset so that it will neither be used again by him nor retrieved by him for sale, exchange, or other disposition.

Experience with assets which have attained an exceptional or unusual age shall, with respect to similar assets, be disregarded in determining the maximum expected useful life of the longest lived asset in a multiple asset account. For example, if a manufacturer establishes a proper multiple asset account for 50 assets which are expected to have an average life of 30 years but which will remain useful to him for varying periods between 20 and 40 years, the maximum expected useful life will be 40 years, even though an occasional asset of this kind may last 60 years.

(b) *Definition of normal and abnormal retirements.* For the purpose of this section the determination of whether a retirement is normal or abnormal shall be made in the light of all the facts and circumstances. In general, a retirement shall be considered a normal retirement unless the taxpayer can show that the withdrawal of the asset was due to a cause not contemplated in setting the applicable depreciation rate. For example, a retirement is considered normal if made within the range of years taken into consideration in fixing the depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business. On the other hand, a retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(c) *Basis of assets retired.* The basis of an asset at the time of retirement for computing gain or loss shall be its adjusted basis for determining gain or loss upon a sale or other disposition as determined in accordance with the provisions of section 1011 and the following rules:

(1) In the case of a normal retirement of an asset from a multiple asset account where the depreciation rate is based on average expected useful life, the term ''adjusted basis'' means the salvage value estimated in determining the depreciation deduction in accordance with the provisions in paragraph (c) of §1.167(a)–1.

(2) In the case of a normal retirement of an asset from a multiple asset account on which the depreciation rate was based on the maximum expected life of the longest lived asset in the account, the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper if the asset had been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) using a rate based upon the maximum expected useful life of that asset, and

(3) In the case of an abnormal retirement from a multiple asset account the adjustment for depreciation allowed or allowable shall be made at the rate which would have been proper had the asset been depreciated in a single asset account (under the method of depreciation used for the multiple asset account) and using a rate based upon either the average expected useful life or the maximum expected useful life of the asset, depending upon the method of determining the rate of depreciation used in connection with the multiple asset account.

(d) *Special rule for item accounts.* (1) As indicated in paragraph (a)(3)(ii) and (iii) of this section, a loss is recognized upon the normal retirement of an asset from a single asset account but a loss on the normal retirement of an asset in a multiple asset account is not allowable where the depreciation rate is based upon the average useful life of the assets in the account. Where a taxpayer with more than one depreciable asset chooses to set up a separate account for each such asset and the depreciation rate is based on the average useful life of such assets (so that he uses the same life for each account), the question arises whether his depreciation deductions in substance are the equivalent of those which would result from the use of multiple asset accounts and, therefore, he should be subject to the rules governing losses on retirements of assets from multiple asset accounts. Where a taxpayer has only a few depreciable assets which he chooses to account for in single asset accounts, particularly where such assets cover a relatively narrow range of lives, it cannot be said in the usual case that the allowance of losses on retirements from such accounts clearly will distort income. This results from the fact that where a taxpayer has only a few depreciable assets it is usually not possible clearly to determine that the depreciation rate is based upon the average useful life of such assets. Accordingly, it cannot be said that the taxpayer is in effect clearly operating with a multiple asset account using an average life rate so that losses should not be allowed on normal retirements. Therefore, losses normally will be allowed upon retirement of assets from single asset accounts where the taxpayer has only a few depreciable assets. On the other hand, when a taxpayer who has only a few depreciable assets chooses to account for them in single asset accounts, using for each account a depreciation rate based on the average useful life of such assets, and the assets cover a wide range of lives, the likelihood that income will be distorted is greater than where the group of assets covers a relatively narrow range of lives. In those cases where the allowance of losses would distort income, the rules with respect to the allowance of losses on normal retirement shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(2) Where a taxpayer has a large number of depreciable assets and depreciation is based on the average useful life of such assets, then, whether such assets are similar or dissimilar and regardless of whether they are accounted for in individual asset accounts or multiple asset accounts the allowance of losses on the normal retirement of such assets would distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before the expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, if instead of accounting for a large number of similar or dissimilar depreciable assets in multiple asset accounts, the taxpayer chooses to account separately for such assets, using a rate based upon the average life of such assets, the rules with respect to the allowances of losses on normal retirements will be applied to such assets in the same manner as though the assets were accounted for in multiple asset accounts using a rate based upon average expected useful life.

(3) Where a taxpayer who does not have a large number of depreciable assets (and who therefore is not subject to subparagraph (2) of this paragraph) chooses to set up a separate account for each such asset, and has sought to compute an average life for such assets on which to base his depreciation deductions (so that he uses the same life for each account), the allowance of losses on normal retirements from such accounts may in some situations substantially distort income. Such distortion would result from the fact that the use of average useful life (and, accordingly, average rate) assumes that while some assets normally will be retired before expiration of the average life, others normally will be retired after expiration of the average life. Accordingly, where a taxpayer chooses to account separately for such assets instead of accounting for them in multiple asset accounts, and the result is to substantially distort his income, the rules with respect to the allowance of losses on normal retirements shall be applied to such assets in the same manner as though the assets had been accounted for in multiple asset accounts using a rate based upon average expected useful life.

(4) Whenever a taxpayer is treated under this paragraph as though his assets were accounted for in a multiple asset account using an average life rate, and, therefore, he is denied a loss on retirements, the unrecovered cost less salvage of each asset which was accounted for separately may be amortized in accordance with the regulation stated in paragraph (e)(1)(ii) of this section.

(e) *Accounting treatment of asset retirements.* (1) In the case of a normal retirement where under the foregoing rules no loss is recognized and where the asset is retired without disposition or abandonment, (i) if the asset was contained in a multiple asset account, the full cost of such asset, reduced by estimated salvage, shall be charged to the depreciation reserve, or (ii) if the asset was accounted for separately, the unrecovered cost or other basis, less salvage, of the asset may be amortized through annual deductions from gross income in amounts equal to the unrecovered cost or other basis of such asset, divided by the average expected useful life (not the remaining useful life) applicable to the asset at the time of retirement. For example, if an asset is retired after six years of use and at the time of retirement depreciation was being claimed on the basis of an average expected useful life of ten years, the unrecovered cost or other basis less salvage would be amortized through equal annual deductions over a period of ten years from the time of retirement.

(2) Where multiple asset accounts are used and acquisitions and retirements

are numerous, if a taxpayer, in order to avoid unnecessarily detailed accounting for individual retirements, consistently follows the practice of charging the reserve with the full cost or other basis of assets retired and of crediting it with all receipts from salvage, the practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income. Conversely, where the taxpayer customarily follows a practice of reporting all receipts from salvage as ordinary taxable income such practice may be continued so long as, in the opinion of the Commissioner, it clearly reflects income.

(f) *Cross reference*. For special rules in connection with the retirement of the last assets of a given year's acquisitions under the declining balance method, see example (2) in paragraph (b) of §1.167 (b)–2.

(g) *Applicability*. This section applies to property for which depreciation is determined under section 167 (but not under section 168, section 1400I, section 1400L(c), section 168 prior to its amendment by the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2121(1986)), or under an additional first year depreciation deduction provision of the Internal Revenue Code (for example, section 168(k) through (n), 1400L(b), or 1400N(d))).

(h) *Effective/applicability date*—(1) *In general*. This section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (h)(2) and (h)(3) of this section, §1.167(a)–8 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of §1.167(a)–8(g)*. A taxpayer may choose to apply paragraph (g) of this section to taxable years beginning on or after January 1, 2012.

(3) *Optional application of TD 9564*. A taxpayer may choose to apply §1.167(a)–8T 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 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960, as amended by T.D. 9564, 76 FR 81085, Dec. 27, 2011; T.D. 9636, 78 FR 57707, Sept. 19, 2013]

§ 1.167(a)–9 Obsolescence.

The depreciation allowance includes an allowance for normal obsolescence which should be taken into account to the extent that the expected useful life of property will be shortened by reason thereof. Obsolescence may render an asset economically useless to the taxpayer regardless of its physical condition. Obsolescence is attributable to many causes, including technological improvements and reasonably foreseeable economic changes. Among these causes are normal progress of the arts and sciences, supersession or inadequacy brought about by developments in the industry, products, methods, markets, sources of supply, and other like changes, and legislative or regulatory action. In any case in which the taxpayer shows that the estimated useful life previously used should be shortened by reason of obsolescence greater than had been assumed in computing such estimated useful life, a change to a new and shorter estimated useful life computed in accordance with such showing will be permitted. No such change will be permitted merely because in the unsupported opinion of the taxpayer the property may become obsolete. For rules governing the allowance of a loss when the usefulness of depreciable property is suddenly terminated, see §1.167(a)–8. If the estimated useful life and the depreciation rates have been the subject of a previous agreement, see section 167(d) and §1.167(d)–1.

§ 1.167(a)–10 When depreciation deduction is allowable.

(a) A taxpayer should deduct the proper depreciation allowance each year and may not increase his depreciation allowances in later years by reason of his failure to deduct any depreciation allowance or of his action in deducting an allowance plainly inadequate under the known facts in prior years. The inadequacy of the depreciation allowance for property in prior years shall be determined on the basis of the allowable method of depreciation used by the taxpayer for such property or under the straight line method if no allowance has ever been claimed for such property. The preceding sentence shall not be construed as precluding application of any method provided in section 167(b) if taxpayer's failure to claim any allowance for depreciation was due solely to erroneously treating as a deductible expense an item properly chargeable to capital account. For rules relating to adjustments to basis, see section 1016 and the regulations thereunder.

(b) The period for depreciation of an asset shall begin when the asset is placed in service and shall end when the asset is retired from service. A proportionate part of one year's depreciation is allowable for that part of the first and last year during which the asset was in service. However, in the case of a multiple asset account, the amount of depreciation may be determined by using what is commonly described as an ''averaging convention'', that is, by using an assumed timing of additions and retirements. For example, it might be assumed that all additions and retirements to the asset account occur uniformly throughout the taxable year, in which case depreciation is computed on the average of the beginning and ending balances of the asset account for the taxable year. See example (3) under paragraph (b) of § 1.167(b)–1. Among still other averaging conventions which may be used is the one under which it is assumed that all additions and retirements during the first half of a given year were made on the first day of that year and that all additions and retirements during the second half of the year were made on the first day of the following year. Thus, a full year's depreciation would be taken on additions in the first half of the year and no depreciation would be taken on additions in the second half. Moreover, under this convention, no depreciation would be taken on retirements in the first half of the year and a full year's depreciation would be taken on the retirements in the second half. An averaging convention, if used, must be consistently followed as to the account or accounts for which it is adopted, and must be applied to both additions and retirements. In any year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used.

§ 1.167(a)–11 Depreciation based on class lives and asset depreciation ranges for property placed in service after December 31, 1970.

(a) *In general*—(1) *Summary*. This section provides an asset depreciation range and class life system for determining the reasonable allowance for depreciation of designated classes of assets placed in service after December 31, 1970. The system is designed to minimize disputes between taxpayers and the Internal Revenue Service as to the useful life of property, and as to salvage value, repairs, and other matters. The system is optional with the taxpayer. The taxpayer has an annual election. Generally, an election for a taxable year must apply to all additions of eligible property during the taxable year of election, but does not apply to additions of eligible property in any other taxable year. The taxpayer's election, made with the return for the taxable year, may not be revoked or modified for any property included in the election. Generally, the taxpayer must establish vintage accounts for all eligible property included in the election, must determine the allowance for depreciation of such property in the taxable year of election, and in subsequent taxable years, on the basis of the asset depreciation period selected and must apply the first-year convention specified in the election to determine the allowance for depreciation of such property. This section also contains special provisions for the treatment of salvage value, retirements, and the costs of the repair, maintenance, rehabilitation or improvement of property. In general, a taxpayer may not apply any provision of this section unless he makes an election and thereby consents to, and agrees to apply, all the provisions of this section. A taxpayer who elects to apply this section does, however, have certain options as to the application of specified provisions of this section. A taxpayer may elect to apply this section for a taxable year only if for such taxable year he complies with the requirements of paragraph (f)(4) of this section.

(2) *Definitions*. For the meaning of certain terms used in this section, see paragraphs (b)(2) (''eligible property''),

(b)(3) (''vintage account'' and ''vintage''), (b)(4) (''asset depreciation range'', ''asset guideline class'', ''asset guideline period'', and ''asset depreciation period''), (b)(5)(iii)(*c*) (''used property''), (b)(6)(i) (''public utility property''), (c)(1)(iv) (''original use''), (c)(1)(v) (''unadjusted basis'' and ''adjusted basis''), (c)(2)(ii) (''modified half-year convention''), (c)(2)(iii) (''half-year convention''), (d)(1)(i) (''gross salvage value''), (d)(1)(ii) (''salvage value''), (d)(2)(iii) (''repair allowance'', ''repair allowance percentage'', and ''repair allowance property''), (d)(2)(vi) (''excluded addition''), (d)(2)(vii) (''property improvement''), (d)(3)(ii) (''ordinary retirement'' and ''extraordinary retirement''), (d)(3)(vi) (''special basis vintage account''), and (e)(1) (''first placed in service'') of this section.

(b) *Reasonable allowance using asset depreciation ranges*—(1) *In general.* The allowance for depreciation of eligible property (as defined in subparagraph (2) of this paragraph) to which the taxpayer elects to apply this section shall be determined as provided in paragraph (c) of this section and shall constitute the reasonable allowance for depreciation of such property under section 167(a).

(2) *Definition of eligible property.* For purposes of this section, the term ''eligible property'' means tangible property which is subject to the allowance for depreciation provided by section 167(a) but only if—

(i) An asset guideline class and asset guideline period are in effect for such property for the taxable year of election (see subparagraph (4) of this paragraph);

(ii) The property is first placed in service (as described in paragraph (e) (1) of this section) by the taxpayer after December 31, 1970 (but see subparagraph (7) of this paragraph for special rule where there is a mere change in the form of conducting a trade or business); and

(iii) The property is either—

(*a*) Section 1245 property as defined in section 1245(a) (3), or

(*b*) Section 1250 property as defined in section 1250(c).

See, however, subparagraph (6) of this paragraph for special rule for certain public utility property as defined in section 167(l)(3)(A). Property which meets the requirements of this subparagraph is eligible property even if depreciation with respect to such property, determined in accordance with this section, is allocated to or otherwise required to be reflected in the cost of a capitalized item. The term ''eligible property'' includes any property which meets the requirements of this subparagraph, whether such property is new property, ''used property'' (as described in subparagraph (5)(iii)(*c*) of this paragraph), a ''property improvement'' (as described in paragraph (d)(2)(vii) of this section), or an ''excluded addition'' (as described in paragraph (d)(2)(vi) of this section). For the treatment of expenditures for the repair, maintenance, rehabilitation or improvement of certain property, see paragraph (d) (2) of this section.

(3) *Requirement of vintage accounts*—(i) *In general.* For purposes of this section, a ''vintage account'' is a closed-end depreciation account containing eligible property to which the taxpayer elects to apply this section, first placed in service by the taxpayer during the taxable year of election. The ''vintage'' of an account refers to the taxable year during which the eligible property in the account is first placed in service by the taxpayer. Such an account will consist of an asset, or a group of assets, within a single asset guideline class established pursuant to subparagraph (4) of this paragraph and may contain only eligible property. Each item of eligible property to which the taxpayer elects to apply this section, first placed in service by the taxpayer during the taxable year of election (determined without regard to a convention described in paragraph (c)(2) of this section) shall be placed in a vintage account of the taxable year of election. For rule regarding ''special basis vintage accounts'' for certain property improvements, see paragraph (d)(2)(viii) and (3)(vi) of this section. Any number of vintage accounts of a taxable year may be established. More than one account of the same vintage may be established for different assets of the same asset guideline class. See paragraph (d)(3)(xi) of this section for special rule for

treatment of certain multiple asset and item accounts.

(ii) *Special rule.* Section 1245 property may not be placed in a vintage account with section 1250 property. Property the original use of which does not commence with the taxpayer may not be placed in a vintage account with property the original use of which commences with the taxpayer. Property described in section 167(f)(2) may not be placed in a vintage account with property not described in section 167(f)(2). Property described in section 179(d)(1) for which the taxpayer elects the allowance for the first taxable year in accordance with section 179(c) may not be placed in a vintage account with property not described in section 179(d)(1) or for which the taxpayer does not elect such allowance for the first taxable year. For special rule for property acquired in a transaction to which section 381(a) applies, see paragraph (e)(3)(i) of this section. For additional rules with respect to accounting for eligible property, see paragraph (e) of this section.

(4) *Asset depreciation ranges and periods*—(i) *Selection of asset depreciation period.* The taxpayers books and records must specify for each vintage account of the taxable year of election—

(*a*) In the case of vintage account for property in an asset guideline class for which no asset depreciation range is in effect for the taxable year, the asset depreciation period (which shall be equal to the asset guideline period for the assets in such account), or

(*b*) In the case of a vintage account for property in an asset guideline class for which an asset depreciation range is in effect for the taxable year, the asset depreciation period selected by the taxpayer from the asset depreciation range for the assets in such account.

Unless otherwise expressly provided in the establishment thereof, for purposes of this section, the term ''asset guideline class'' means a category of assets (including ''subsidiary assets'') for which a separate asset guideline period is in effect for the taxable year as provided in subdivision (ii) of this subparagraph. The ''asset depreciation range'' is a period of years which extends from 80 percent of the asset guideline period to 120 percent of such period, determined in each case by rounding any fractional part of a year to the nearer of the nearest whole or half year. Except as provided in paragraph (e)(3)(iv) of this section, in the case of an asset guideline class for which an asset depreciation range is in effect, any period within the asset depreciation range for the assets in a vintage account which is a whole number of years or a whole number of years plus a half year, may be selected. The term ''asset depreciation period'' means the period selected from the asset depreciation range, or if no asset depreciation range is in effect for the class, the asset guideline period. The ''asset guideline period'' is established in accordance with subdivision (ii) of this subparagraph and is the class life under section 167(m). See Revenue Procedure 72–10 for special rules for section 1250 property and property predominately used outside the United States. In general, an asset guideline period, but no asset depreciation range, is in effect for such property.

(ii) *Establishment of asset guideline classes and periods.* The asset guideline classes and the asset guideline periods, and the asset depreciation ranges determined from such periods, in effect for taxable years ending before the effective date of the first supplemental asset guideline classes, asset guideline periods, and asset depreciation ranges, established pursuant to this section are set forth in Revenue Procedure 72–10. Asset guideline classes and periods, and asset depreciation ranges, will from time to time be established, supplemented, and revised with express reference to this section, and will be published in the Internal Revenue Bulletin. The asset guideline classes, the asset guideline periods, and the asset depreciation ranges determined from such periods in effect as of the last day of a taxable year of election shall apply to all vintage accounts of such taxable year, except that neither the asset guideline period nor the lower limit of the asset depreciation range for any such account shall be longer than the asset guideline period or the lower limit of the asset depreciation range, as the case may be, for such account in effect as of the first day of the taxable year (or as of such later time in such year as an asset guideline class first established during such year becomes effective). Generally, the reasonable allowance for depreciation of property for any taxable year in a vintage account shall not be changed to reflect any supplement or revision of the asset guideline classes or periods, and asset depreciation ranges, for the taxable year in which the account is established, which occurs after the end of such taxable year. However, if expressly provided in such a supplement or revision, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented asset guideline classes or periods and asset depreciation ranges to such property for such taxable year and succeeding taxable years.

(iii) *Applicable guideline classes and periods in special situations.* (*a*) An electric or gas utility which would in accordance with Revenue Procedure 64–21 be entitled to use a composite guideline class basis for applying Revenue Procedure 62–21 may, solely with respect to property for which an asset depreciation range is in effect for the taxable year, elect to apply this section on the basis of a composite asset guideline class and asset guideline period determined by applying the provisions of Revenue Procedure 64–21 to such property. The asset depreciation range for such a composite asset guideline class shall be determined by reference to the composite asset guideline period at the beginning of the first taxable year to which the taxpayer elects to apply this section and shall not be changed until such time as major variations in the asset mix or the asset guideline classes or periods justify some other composite asset guideline period. Except as provided in paragraph (d)(2)(iii) of this section with respect to buildings and other structures, for the purposes of this section, all property in the composite asset guideline class shall be treated as included in a single asset guideline class. If the taxpayer elects to apply this subdivision, the election shall be made on the tax return filed for the first taxable year for which the taxpayer elects to apply this section. An election to apply this subdivision for any taxable year shall apply to all succeeding taxable years to which the taxpayer elects to apply this section, except to the extent the election to apply this subdivision is with the consent of the Commissioner terminated with respect to a succeeding taxable year and all taxable years thereafter.

(*b*) For purposes of this section, property shall be included in the asset guideline class for the activity in which the property is primarily used. See paragraph (e)(3)(iii) of this section for rule for leased property. Property shall be classified according to primary use even though the activity in which such property is primarily used is insubstantial in relation to all the taxpayer's activities. No change in the classification of property shall be made because of a change in primary use after the end of the taxable year in which property is first placed in service, including a change in use which results in section 1250 property becoming section 1245 property.

(*c*) An incorrect classification or characterization by the taxpayer of property for the purposes of this section (such as under (*b*) of this subdivision or under subparagraph (2) or (3)(ii) of this paragraph) shall not cause or permit a revocation of the election to apply this section for the taxable year in which such property was first placed in service. The classification or characterization of such property shall be corrected. All adjustments necessary to the correction shall be made, including adjustments of unadjusted basis, adjusted basis, salvage value, the reserve for depreciation of all vintage accounts affected, and the amount of depreciation allowable for all taxable years for which the period for assessment of tax prescribed in section 6501 has not expired. If because of incorrect classification or characterization property included in an election to apply this section was not placed in a vintage account and no asset depreciation period was selected for the property or the property was placed in a vintage account but an asset depreciation period was selected from an incorrect asset depreciation range, the taxpayer shall place the property in a vintage account and select an asset depreciation period for the account from the correct asset depreciation range.

(*d*) Generally, except as provided in subparagraph (5)(v)(*a*) of this paragraph, a taxpayer may not compute depreciation for eligible property first placed in service during the taxable year under a method of depreciation not described in section 167(b) (1), (2), or (3). (If the taxpayer computes depreciation with respect to such property under section 167(k), or amortizes such property, the property must be excluded from the election to apply this section.) (See subparagraph (5)(v)(*b*) of this paragraph.) However, if the taxpayer establishes to the satisfaction of the Commissioner that a method of depreciation not described in section 167(b) (1), (2), (3), or (k) was adopted for property in the asset guideline class on the basis of a good faith mistake as to the proper asset guideline class for the property, then, unless the requirements of subparagraph (5)(v)(*a*) of this paragraph are met, the taxpayer must terminate (as of the beginning of the taxable year) such method of depreciation with respect to all eligible property in the asset guideline class which was first placed in service during the taxable year. In such event, the taxpayer's election to apply this section shall include eligible property in the asset guideline class without regard to subparagraph (5)(v)(*a*) of this paragraph. The provisions of (*c*) of this subdivision shall apply to the correction in the classification of the property.

(*e*) If the provisions of section 167(j) apply to require a change in the method of depreciation with respect to an item of section 1250 property in a multiple asset vintage account, the asset shall be removed from the account and placed in a separate item vintage account. The unadjusted basis of the asset shall be removed from the unadjusted basis of the vintage account as of the first day of the taxable year in which the change in method of depreciation is required and the depreciation reserve established for the account shall be reduced by the depreciation allowable for the property computed in the manner prescribed in paragraph (c)(1)(v)(*b*) of this section for determination of the adjusted basis of property. See paragraph (d)(3)(vii)(*e*) of this section for treatment of salvage value when property is removed from a vintage account.

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

Example 1. Corporation X purchases a bulldozer for the use in its construction business. The bulldozer is first placed in service in 1972. Since the bulldozer is tangible property for which an asset guideline class and period have been established, the bulldozer is eligible property. The bulldozer is in asset guideline class 15.1 of Revenue Procedure 72–10, and the asset depreciation range is 4–6 years.

Example 2. In 1972, corporation Y first places in service a factory building. Since the factory building is tangible property for which an asset guideline class and period have been established, it is eligible property. The factory building is in asset guideline class 65.11 of Revenue Procedure 72–10. Since no asset depreciation range is in effect for the asset guideline class, the asset depreciation period is the asset guideline period of 45 years. (See subparagraph (5)(vi) of this paragraph for election to exclude certain section 1250 property during transition period.)

Example 3. In January of 1971, corporation Y, a calendar year taxpayer, pays or incurs $2,000 for the rehabilitation and improvement of machine A which was first placed in service in 1969. On January 1, 1971, corporation Y first placed in service machines B and C, each with an unadjusted basis of $10,000. Machines B and C are eligible property. Machine A would be eligible property but for the fact it was first placed in service prior to January 1, 1971 (that is, machine A is eligible property determined without regard to subparagraph (2)(ii) of this paragraph). Corporation Y elects to apply this section for the taxable year, and adopts the modified half-year convention described in paragraph (c)(2)(ii) of this section, but does not elect to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section. Machines A, B, and C are in asset guideline class 24.4 under Revenue Procedure 72–10 for which the asset depreciation range is 8 to 12 years. The $2,000 expended on machine A substantially increases its capacity and is a capital expenditure under sections 162 and 263. The $2,000 is a property improvement (as defined in paragraph (d)(2)(vii)(*b*) of this section) which is eligible property. However, corporation Y by mistake treats the property improvement of $2,000 as a deductible repair. Also by mistake, corporation Y includes machine B in asset guideline class 24.3 under Revenue Procedure 72–10 for which the asset depreciation range is 5 to 7 years. Corporation Y establishes vintage accounts for 1971, and computes depreciation for 1971 and 1972 as follows:

	Dec. 31, 1972, reserve for depreciation	Dec. 31, 1972, adjusted basis
Vintage account for machine B, with an asset depreciation period of 5 years and an unadjusted basis of $10,000 for which corporation Y adopts the straight line method	$4,000	$6,000
Vintage account for machine C, with an asset depreciation period of 8 years and an unadjusted basis of $10,000 for which corporation Y adopts the straight line method	2,500	7,500

After audit in 1973 of corporation Y's taxable years 1971 and 1972, it is determined that the $2,000 paid in 1971 for the rehabilitation and improvement of machine A is a capital expenditure and that machine B is in asset guideline class 24.4. The incorrect classification is corrected. Corporation Y places machine B and the property improvement in a vintage account of 1971 and on its tax return filed for 1973 selects an asset depreciation period of 8 years for that account. Giving effect to the correction in classification of the property in accordance with subdivision (iii)(*c*) of this subparagraph, at the end of 1972 the unadjusted basis, reserve for depreciation, and adjusted basis of the vintage account for machine B and the property improvement with respect to machine A are $12,000, $3,000, and $9,000, respectively. Corporation Y's deduction of the $2,000 property improvement in 1971 as a repair expense under section 162 is disallowed. For 1971 and 1972 depreciation deductions are disallowed in the amount of $500 each year (that is, $750 excess annual depreciation on machine B minus $250 annual depreciation on the property improvement).

Example 4. (a) In 1971, Corporation X, a calendar year taxpayer, first places in service machines A through M, all of which are eligible property. All the machines except machine A are in asset guideline class 24.3 under Revenue Procedure 72–10. Machine A is in asset guideline class 24.4 under Revenue Procedure 72–10. Machine B has an unadjusted basis equal to 80 percent of the total unadjusted basis of machines B through M. By good faith mistake as to proper classification, corporation X includes both machine A and machine B in asset guideline class 24.4. Corporation X consistently uses the machine hour method of depreciation on all property in asset guideline class 24.4, and for 1971 computes depreciation for machines A and B under that method. Corporation X elects to apply this section for 1971 on the assumption that the election includes machines C through M which are in asset guideline class 24.3. In 1973, upon audit of corporation X's taxable years 1971 and 1972, it is determined that machine B is included in asset guideline class 24.3 and that since for 1971 corporation X computed depreciation on machine B under the machine hour method, in accordance with subparagraph (5)(v)(*a*) of this paragraph, all property in asset guideline class 24.3 (machines B through M) is excluded from corporation X's election to apply this section for 1971. Although corporation X has consistently used the machine hour method for asset guideline class 24.4, corporation X has not in the past used the machine hour method for machines of the type and function of machines C through M which are in asset guideline class 24.3. Both machine A and machine B are used in connection with the manufacture of wood products. There is reasonable basis for corporation X having assumed that machine B is in asset guideline class 24.4 along with machine A to which it is similar. Corporation X establishes to the satisfaction of the Commissioner that it used the machine hour method for machine B on the basis of a good faith mistake as to the proper classification of the machine. Corporation X may, at its option (see subparagraph (5)(v) of this paragraph), terminate the machine hour method of depreciation for machine B as of the beginning of 1971, and in that event corporation X's election to apply this section for 1971 will apply to machines B through M without regard to subparagraph (5)(v)(*a*) of this paragraph. The adjustments provided in subdivision (iii)(*c*) of this subparagraph will be made as a result of the correction in classification of property. If corporation X does not terminate the machine hour method with respect to machine B, machines B through M must be excluded from the election to apply this section (see subparagraph (5)(v) of this paragraph).

(*b*) The facts are the same as in (*a*) of this example except that machine B has an unadjusted basis equal to only 65 percent of the total unadjusted basis of machines B through M.

In this case, corporation X must either terminate the machine hour method of depreciation with respect to asset B (since the provisions of subparagraph (5)(v) of this paragraph do not permit the exclusion of the property from the election to apply this section) or otherwise comply with the provisions of subparagraph (5)(v) of this paragraph. (See paragraph (c)(1)(iv) for limitation on methods which may be adopted for property included in the election to apply this section.)

(5) *Requirements of election*—(i) *In general.* Except as otherwise provided in paragraph (d)(2) of this section dealing

with expenditures for the repair, maintenance, rehabilitation or improvement of certain property, no provision of this section shall apply to any property other than eligible property to which the taxpayer elects in accordance with this section, to apply this section. For the time and manner of election, and certain conditions to an election, see paragraph (f) of this section. Except as otherwise provided in subparagraph (4)(iii) of this paragraph, subdivision (v) of this subparagraph and in subparagraph (6)(iii) of this paragraph, a taxpayer's election to apply this section may not be revoked or modified after the last day prescribed for filing the election. Thus, for example, after such day, a taxpayer may not cease to apply this section to property included in the election, establish different vintage accounts for the taxable year of election, select a different period from the asset depreciation range for any such account, or adopt a different first-year convention for any such account.

(ii) *Property required to be included in election.* Except as otherwise provided in subdivision (iii) of this subparagraph dealing with certain ''used property'', in subdivision (iv) of this subparagraph dealing with ''section 38 property'', in subdivision (v) of this subparagraph dealing with property subject to special depreciation or amortization, in subdivision (vi) of this subparagraph dealing with certain section 1250 property, in subdivision (vii) of this subparagraph dealing with certain subsidiary assets, and in paragraph (e)(3) (i) and (iv) of this section dealing with transactions to which section 381(a) applies, if the taxpayer elects to apply this section to any eligible property first placed in service by the taxpayer during the taxable year of election, the election shall apply to all such eligible property, whether placed in service in a trade or business or held for production of income.

(iii) *Special 10 percent used property rule.* (*a*) If (*1*) the unadjusted basis of eligible used section 1245 property (as defined in (*c*) of this subdivision) first placed in service by the taxpayer during the taxable year of election, for which no specific used property asset guideline class (as defined in (*c*) of this subdivision) is in effect for the taxable year, exceeds (*2*) 10 percent of the unadjusted basis of all eligible section 1245 property first placed in service during the taxable year of election, the taxpayer may exclude all (but not less than all) the property described in (*a*)(*1*) of this subdivision from the election to apply this section.

(*b*) If (*1*) the unadjusted basis of eligible used section 1250 property first placed in service by the taxpayer during the taxable year of election, for which no specific used property asset guideline class is in effect for the taxable year, exceeds (*2*) 10 percent of the unadjusted basis of all eligible section 1250 property first placed in service during the taxable year of election, the taxpayer may exclude all (but not less than all) the property described in (*b*)(*1*) of this subdivision from the election to apply this section.

(*c*) For the purposes of this section, the term ''used property'' means property the original use of which does not commence with the taxpayer. Solely for the purpose of determining whether the 10 percent rule of this subdivision is satisfied, (*1*) eligible used property first placed in service during the taxable year and excluded from the election to apply this section pursuant to subdivision (v)(*a*) of this subparagraph and (*2*) eligible property acquired during the taxable year in a transaction to which section 381(a) applies, shall all be treated as used property regardless of whether such property would be treated as new property under section 167(c) and the regulations thereunder. The term ''specific used property asset guideline class'' means a class established in accordance with subparagraph (4) of this paragraph solely for used property primarily used in connection with the activity to which the class relates.

(iv) *Property subject to investment tax credit.* The taxpayer may exclude from an election to apply this section all, or less than all, units of eligible property first placed in service during the taxable year which is—

(*a*) ''Section 38 property'' as defined in section 48(a) which meets the requirements of section 49 and which is not property described in section 50, or (*b*) Property to which section 47(a)(5)(B) applies which would be section 38 property but for section 49 and which is placed in service to replace section 38 property (other than property described in section 50) disposed of prior to August 15, 1971.

(v) *Property subject to special method of depreciation or authorization.* (*a*) In the case of eligible property first placed in service in a taxable year of election (and not otherwise properly excluded from an election to apply this section) the taxpayer may not compute depreciation for any of such property in the asset guideline class under a method not described in section 167(b) (1), (2), (3), or (k) unless he (*1*) computes depreciation under a method or methods not so described for eligible property first placed in service in the taxable year in the asset guideline class with an unadjusted basis at least equal to 75 percent of the unadjusted basis of all eligible property first placed in service in the taxable year in the asset guideline class and (*2*) agrees to continue to depreciate such property under such method or methods until the consent of the Commissioner is obtained to a change in method. The consent of the Commissioner must be obtained by filing Form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within the first 180 days of the taxable year for which the change is desired. If for the taxable year of election the taxpayer computes depreciation under any method not described in section 167(b) (1), (2), (3), or (k) for any eligible property (other than property otherwise properly excluded from an election to apply this section) first placed in service during the taxable year, an election to apply this section for the taxable year shall not include such property or any other eligible property in the same asset guideline class as such property. With respect to a taxable year beginning before January 1, 1973, if the taxpayer has adopted a method of depreciation which is not permitted under this subdivision, the taxpayer may under this section adopt a method of depreciation permitted under this subdivision or otherwise comply with the provisions of this subdivision.

(*b*) An election to apply this section shall not include eligible property for which, for the taxable year of election, the taxpayer computes depreciation under section 167(k), or computes amortization under section 169, 184, 185, 187, 188, or paragraph (b) of §1.162–11. If the taxpayer has elected to apply this section to eligible property described in section 167(k), 169, 184, 185, or 187 and the taxpayer thereafter computes depreciation or amortization for such property for any taxable year in accordance with section 167(k), 169, 184, 185, or 187, then the election to apply this section to such property shall terminate as of the beginning of the taxable year for which depreciation or amortization is computed under such section. Application of this section to the property for any period prior to the termination date will not be affected by the termination. The unadjusted basis of the property shall be removed as of the termination date from the unadjusted basis of the vintage account. The depreciation reserve established for the account shall be reduced by the depreciation allowable for the property, computed in the manner prescribed in paragraph (c)(1)(v)(*b*) of this section for determination of the adjusted basis of the property. See paragraph (d)(3)(vii)(*e*) of this section for treatment of salvage value when property is removed from a vintage account.

(vi) *Certain section 1250 property.* (*a*) The taxpayer may exclude from an election to apply this section all, or less than all, items of eligible section 1250 property first placed in service during the taxable year of election provided that—

(*1*) The item is first placed in service before the earlier of the effective date of the first supplemental asset guideline class including such property established in accordance with subparagraph (4)(ii) of this paragraph, or January 1, 1974, and

(*2*) The taxpayer establishes that a useful life shorter than the asset guideline period in effect on January 1, 1971, for such item of property is justified for such taxable year.

A useful life shorter than the asset guideline period in effect on January 1, 1971, will be considered justified only if such life is justified in accordance with the provisions of Revenue Procedure 62–21 (including all modifications, amendments or supplements thereto as of January 1, 1971), determined without application of the minimal adjustment rule in section 4, part II, of Revenue Procedure 65–13. If an item of section 1250 property is excluded from an election to apply this section pursuant to this subdivision, any elevator or escalator which is a part of such item shall also be excluded from the election.

(*b*) If the taxpayer excludes an item of section 1250 property from an election to apply this section in accordance with this subdivision, the useful life justified under Revenue Procedure 62–21 in accordance with this subdivision for the taxable year of exclusion will be treated as justified for such item of section 1250 property for the taxable year of the exclusion and all subsequent taxable years.

(vii) *Subsidiary assets*. The taxpayer may exclude from an election to apply this section all (but not less than all) subsidiary assets first placed in service during the taxable year of election in an asset guideline class, provided that—

(*a*) The unadjusted basis of eligible subsidiary assets first placed in service during the taxable year in the class is as much as 3 percent of the unadjusted basis of all eligible property first placed in service during the taxable year in the class, and

(*b*) Such subsidiary assets are first placed in service by the taxpayer before the earlier of (*1*) the effective date of the first supplemental asset guideline class including such subsidiary assets established in accordance with subparagraph (4)(ii) of this paragraph, or (*2*) January 1, 1974.

For purposes of this subdivision the term ''subsidiary assets'' includes jigs, dies, molds, returnable containers, glassware, silverware, textile mill cam assemblies, and other equipment included in group 1, class 5, of Revenue Procedure 62–21. which is usually and property accounted for separately from other property and under a method of depreciation not expressed in terms of years.

(6) *Special rule for certain public utility property*—(i) *Requirement of normalization in certain cases*. Under section 167(1), in the case of public utility property (as defined in section 167(1)(3)(A)), if the taxpayer—

(*a*) Is entitled to use a method of depreciation other than a ''subsection (1) method'' of depreciation (as defined in section 167(1)(3)(F)) only if it uses the ''normalization method of accounting'' (as defined in section 167(1)(3)(G)) with respect to such property, or

(*b*) Is entitled for the taxable year to use only a ''subsection (1) method'' of depreciation, such property shall be eligible property (as defined in subparagraph (2) of this paragraph) only if the taxpayer normalizes the tax deferral resulting from the election to apply this section.

(ii) *Normalization*. The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section only if it computes its tax expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using a period for depreciation no less than the lesser of—

(*a*) 100 percent of the asset guideline period in effect in accordance with subparagraph (4)(ii) of this paragraph for the first taxable year to which this section applies, or

(*b*) The period for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account, and makes adjustments to a reserve to reflect the deferral of taxes resulting from the election to apply this section. A determination whether the taxpayer is considered to normalize (within the meaning of the preceding sentence) the tax deferral resulting from the election to apply this section shall be made in a manner consistent with the principles for determining whether a taxpayer is using the ''normalization method of accounting'' (within the meaning of section 167(1)(3)(G)). [Removed] See §1.167(1)–1(h).

(iii) *Failure to normalize*. If a taxpayer, which has elected to apply this section to any eligible public utility property and is required under subdivision (i) of this subparagraph to normalize the tax deferral resulting from the election to apply this section to such property, fails to normalize such tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize such tax deferral. Application of this section to such property for any period prior to the termination date will not be affected by the termination. The unadjusted basis of the property shall be removed as of the termination date from the unadjusted basis of the vintage account. The depreciation reserve established for the account shall be reduced by the depreciation allowable for the property, computed in the manner prescribed in paragraph (c)(1)(v)(*b*) of this section for determination of the adjusted basis of the property. See paragraph (d)(3)(vii)(*e*) of this section for treatment of salvage value when property is removed from a vintage account.

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

Example 1. Corporation A is a gas pipeline company, subject to the jurisdiction of the Federal Power Commission, which is entitled under section 167(1) to use a method of depreciation other than a ''subsection (1) method'' of depreciation (as defined in section 167(1) (3) (F)) only if it uses the ''normalization method of accounting'' (as defined in section 167(1)(3)(G)). Corporation A elects to apply this section for 1972 with respect to all eligible property. In 1972, corporation A places in service eligible property with an unadjusted basis of $2 million. One hundred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.5 years. The taxpayer uses the double declining balance method of depreciation, selects an asset depreciation period of 17.5 years and applies the half-year convention (described in paragraph (c)(2)(iii) of this section). The depreciation allowable under this section with respect to such property in 1972 is $114,285. The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section and to use the ''normalization method of accounting'' (within the meaning of section 167(1)(3)(G)) if it computes its tax expense for purposes of determining its cost of service for rate making purposes and for reflecting operating results in its regulated books of account using a ''subsection (1) method'' of depreciation, such as the straight line method, determined by using a depreciation period of 22 years (that is, 100 percent of the asset guideline period). A depreciation allowance computed in this manner is $45,454. The difference in the amount determined under this section ($114,285) and the amount used in computing its tax expense for purposes of estimating its cost of service for rate making purposes and for reflecting operating results in its regulated books of account ($45,454) is $68,831. Assuming a tax rate of 48 percent, the deferral of taxes resulting from an election to apply this section and using a different method of depreciation for tax purposes from that used for establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account is 48 percent of $68,831, or $33,039, which amount should be added to a reserve to reflect the deferral of taxes resulting from the election to apply this section and from the use of a different method of depreciation in computing the allowance for depreciation under section 167 from that used in computing its depreciation expense for purposes of establishing its cost of service for rate making purposes and for reflecting operating results in its regulated books of account.

Example 2. Corporation B, a telephone company subject to the jurisdiction of the Federal Communications Commission used a ''flow-through method of accounting'' (as defined in section 167(1)(3)(H)) for its ''July 1969 accounting period'' (as defined in section 167(1)(3)(I)) with respect to all of its pre-1970 public utility property and did not make an election under section 167(1)(4)(A). Thus, corporation B is entitled under section 167(1) to use a method of depreciation other than a ''subsection (1) method'' with respect to certain property without using the ''normalization method of accounting.'' In 1972, corporation B makes an election to apply this section with respect to all eligible property. Corporation B is not required to normalize the tax deferral resulting from the election to apply this section in the case of property for which it is not required to use the ''normalization method of accounting'' under section 167(1).

Example 3. Assume the same facts as in example (2) except that corporation B made a timely election under section 167(1)(4)(A) that section 167(1)(2)(C) not apply with respect to property which increases the productive or operational capacity of the taxpayer. Corporation B must normalize the tax deferral resulting from the election to apply this section with respect to such property.

(7) *Mere change in form of conducting a trade or business.* Property which was first placed in service by the transferor before January 1, 1971, shall not be eligible property if such property is first placed in service by the transferee after December 31, 1970, by reason of a mere change in the form of conducting

a trade or business in which such property is used. A mere change in the form of conducting a trade or business in which such property is used will be considered to have occurred if—

(i) The transferor (or in a case where the transferor is a partnership, estate, trust, or corporation, the partners, beneficiaries, or shareholders) of such property retains a substantial interest in such trade or business, or

(ii) The basis of such property in the hands of the transferee is determined in whole or in part by reference to the basis of such property in the hands of the transferor.

For purposes of this subparagraph, a transferor (or in a case where the transferor is a partnership, estate, trust, or corporation, the partners, beneficiaries, or shareholders) shall be considered as having retained a substantial interest in the trade or business only if, after the change in form, his (or their) interest in such trade or business is substantial in relation to the total interest of all persons in such trade or business. This subparagraph shall apply to property first placed in service prior to January 1, 1971, held for the production of income (within the meaning of section 167(a)(2)) as well as to property used in a trade or business. The principles of this subdivision may be illustrated by the following examples:

Example 1. Corporation X and corporation Y are includible corporations in an affiliated group as defined in section 1504(a). In 1971 corporation X sells property to corporation Y for cash. The property would meet the requirements of subparagraph (2) of this paragraph for eligible property except that it was first placed in service by corporation X in 1970. After the transfer, the property is first placed in service by corporation Y in 1971. The property is not eligible property because of the mere change in the form of conducting a trade or business.

Example 2. In 1971, in a transaction to which section 351 applies, taxpayer B transfers to corporation W property which would meet the requirements of subparagraph (2) of this paragraph for eligible property except that the property was first placed in service by B in 1969. Corporation W first places the property in service in 1971. The property is not eligible property because of the mere change in the form of conducting a trade or business.

(c) *Manner of determining allowance*—(1) *In general*—(i) *Computation of allowance.* (*a*) The allowance for depreciation of property in a vintage account shall be determined in the manner specified in this paragraph by using the method of depreciation adopted by the taxpayer for the account and a rate based upon the asset depreciation period for the account. (For limitations on methods of depreciation permitted with respect to property, see section 167 (c) and (j) and subdivision (iv) of this subparagraph.) In applying the method of depreciation adopted by the taxpayer, the annual allowance for depreciation of a vintage account shall be determined without adjustment for the salvage value of the property in such account except that no account may be depreciated below the reasonable salvage value of the account. (For rules regarding estimation and treatment of salvage value, see paragraph (d)(1) and (3) (vii) and (viii) of this section.) Regardless of the method of depreciation adopted by the taxpayer, the depreciation allowable for a taxable year with respect to a vintage account may not exceed the amount by which (as of the beginning of the taxable year) the unadjusted basis of the account exceeds (*1*) the reserve for depreciation established for the account plus (*2*) the salvage value of the account. The unadjusted basis of a vintage account is defined in subdivision (v) of this subparagraph. The adjustments to the depreciation reserve are described in subdivision (ii) of this subparagraph.

(*b*) The annual allowance for depreciation of a vintage account using the straight line method of depreciation shall be determined by dividing the unadjusted basis of the vintage account (without reduction for salvage value) by the number of years in the asset depreciation period selected for the account. See subdivision (iii)(*b*) of this subparagraph for the manner of computing the depreciation allowance following a change from the declining balance method or the sum of the years-digits method to the straight line method.

(*c*) In the case of the sum of the years-digits method, the annual allowance for depreciation of a vintage account shall be computed by multiplying the unadjusted basis of the vintage account (without reduction for salvage value) by a fraction, the numerator of which changes each year to a number which corresponds to the years remaining in the asset depreciation period for the account (including the year for which the allowance is being computed) and the denominator of which is the sum of all the year's digits corresponding to the asset depreciation period for the account. See subdivision (iii)(*c*) of this subparagraph for the manner of computing the depreciation allowance following a change from the declining balance method to the sum of the years-digits method.

(*d*) The annual allowance for depreciation of a vintage account using a declining balance method is determined by applying a uniform rate to the excess of the unadjusted basis of the vintage account over the depreciation reserve established for that account. The rate under the declining balance method may not exceed twice the straight line rate based upon the asset depreciation period for the vintage account.

(*e*) The allowance for depreciation under this paragraph shall constitute the amount of depreciation allowable under section 167. See section 179 for additional first-year allowance for certain property.

(ii) *Establishment of depreciation reserve.* The taxpayer must establish a depreciation reserve for each vintage account. The amount of the reserve for a guideline class must be stated on each income tax return on which depreciation with respect to such class is determined under this section. The depreciation reserve for a vintage account consists of the accumulated depreciation allowable under this section with respect to the vintage account, increased by the adjustments for ordinary retirements prescribed by paragraph (d)(3)(iii) of this section, by the adjustments for reduction of the salvage value of a vintage account prescribed by paragraph (d)(3)(vii)(*d*) of this section, and by the adjustments for transfers to supplies or scrap prescribed by paragraph (d)(3)(viii)(*b*) of this section, and decreased by the adjustments for extraordinary retirements and certain special retirements as prescribed by paragraph (d)(3) (iv) and (v) of this section, by the adjustments for the amount of the reserve in excess of the unadjusted basis of a vintage account prescribed by paragraph (d)(3)(ix)(*a*) of this section, and by the adjustments for property removed from a vintage account prescribed by paragraphs (b)(4)(iii)(*e*), (5)(v)(*b*) and (6)(iii) of this section. The adjustments to the depreciation reserve for ordinary retirements during the taxable year shall be made as of the beginning of the taxable year. The adjustments to the depreciation reserve for extraordinary retirements shall be made as of the date the retirement is treated as having occurred in accordance with the first-year convention (described in subparagraph (2) of this paragraph) adopted by the taxpayer for the vintage account. The adjustment to the depreciation reserve for reduction of salvage value and for transfers to supplies or scrap shall, in the case of an ordinary retirement, be made as of the beginning of the taxable year, and in the case of an extraordinary retirement the adjustment for reduction of salvage value shall be made as of the date the retirement is treated as having occurred in accordance with the first-year convention (described in subparagraph (2) of this paragraph) adopted by the taxpayer for the vintage account. The adjustment to the depreciation reserve for property removed from a vintage account in accordance with paragraph (b)(4)(iii)(*e*), (5)(v)(*b*) and (6)(iii) of this section shall be made as of the beginning of the taxable year. The depreciation reserve of a vintage account may not be decreased below zero.

(iii) *Consent to change in method of depreciation.* (*a*) During the asset depreciation period for a vintage account, the taxpayer is permitted to change under this section from a declining balance method of depreciation to the sum of the years-digits method of depreciation and from a declining balance method of depreciation or the sum of the years-digits method of depreciation to the straight line method of depreciation with respect to such account. Except as provided in section 167(j)(2)(1), and paragraph (e)(3)(i) of this section, no other changes in the method of depreciation adopted for a vintage account will be permitted. The provisions of § 1.167(e)–1 shall not apply to any change in depreciation method permitted under this section. The change in method applies to all property in the vintage account and must be adhered to for the entire taxable year of the change.

(*b*) When a change is made to the straight line method of depreciation, the annual allowance for depreciation of the vintage account shall be determined by dividing the adjusted basis of the vintage account (without reduction for salvage value) by the number of years remaining (at the time as of which the change is made) in the asset depreciation period selected for the account. However, the depreciation allowable for any taxable year following a change to the straight line method may not exceed an amount determined by dividing the unadjusted basis of the vintage account (without reduction for salvage value) by the number of years in the asset depreciation period selected for the account.

(*c*) When a change is made from the declining balance method of depreciation to the sum of the years-digits method of depreciation, the annual allowance for depreciation of a vintage account shall be determined by multiplying the adjusted basis of the account (without reduction for salvage value) at the time as of which the change is made by a fraction, the numerator of which changes each year to a number which corresponds to the number of years remaining in the asset depreciation period selected for the account (including the year for which the allowance is being computed), and the denominator of which is the sum of all the year's digits corresponding to the number of years remaining in the asset depreciation period at the time as of which the change is made.

(*d*) The number of years remaining in the asset depreciation period selected for an account is equal to the asset depreciation period less the number of years of depreciation previously allowed. For this purpose, regardless of the first year convention adopted by the taxpayer, it will be assumed that depreciation was allowed for one-half of a year in the first year.

(*e*) The taxpayer shall furnish a statement setting forth the vintage accounts for which the change is made with the income tax return filed for the taxable year of the change.

(*f*) The principles of this subdivision may be illustrated by the following examples:

Example 1. A, a calendar year taxpayer, places new section 1245 property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis	Estimated salvage
X	Mar. 15, 1971	$400	$20
Y	June 13, 1971	500	50
Z	July 30, 1971	100	0

The property is eligible property and is properly included in a single vintage account. The asset depreciation range for such property is 5 to 7 years and the taxpayer selects an asset depreciation period of 5½ years and adopts the 200-percent declining balance method of depreciation. The taxpayer adopts the half-year convention described in subparagraph (2)(iii) of this paragraph. After 3 years, A changes from the 200-percent declining balance method to the straight line method of depreciation. Depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	0.18182	$181.82	$181.82	$818.18
1972	1,000	.36363	297.52	479.34	520.66
1973	1,000	.36363	189.33	668.67	331.33
1974	1,000	[1] .33333	110.44	779.11	220.89
1975	1,000	.33333	110.44	889.56	110.44
1976	1,000	.33333	[2] 40.44	930.00	70.00

[1] Rate applied to adjusted basis of the account (without reduction by salvage) at the time as of which the change is made to the straight line method.

[2] The allowable depreciation is limited by estimated salvage.

Example 2. The facts are the same as in example (1) except that A elects to use the modified half-year convention described in subparagraph (2)(ii) of this paragraph. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	[1] 0.36363	$327.27	$327.27	$672.73
1972	1,000	.36363	244.63	571.90	428.10
1973	1,000	.36363	155.67	727.57	272.43
1974	1,000	.33333	90.81	818.38	181.62
1975	1,000	.33333	90.81	909.19	90.81
1976	1,000	.33333	[2] 20.81	930.00	70.00

[1] Rate applied to $900, the amount of assets placed in service during the first half of the taxable year.
[2] The allowable depreciation is limited by estimated salvage.

Example 3. The facts are the same as in example (1) except that A adopted the sum of the years-digits method of depreciation and does not change to the straight line method of depreciation. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	[1] 2.75/18	$152.78	$152.78	$847.22
1972	1,000	5/18	277.78	430.56	569.44
1973	1,000	4/18	222.22	652.78	347.22
1974	1,000	3/18	166.67	819.45	180.55
1975	1,000	2/18	[2] 110.55	930.00	70.00
1976	1,000	1/18	0.00	930.00	70.00
1977	1,000	0.25/18	0.00	930.00	70.00

[1] Rate is equal to one-half of 5.5/18. The denominator is equal to 5.5 + 4.5 + 3.5 + 2.5 + 1.5 + 0.5.
[2] The allowable depreciation is limited by estimated salvage.

Example 4. The facts are the same as in example (3) except that A elects to use the modified half-year convention described in subparagraph (2) (ii) of this paragraph. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	[1] 5.5/18	$275.00	$275.00	$725.00
1972	1,000	5/18	277.78	552.78	447.22
1973	1,000	4/18	222.22	775.00	225.00
1974	1,000	3/18	[2] 155.00	930.00	70.00
1975	1,000	2/18	0.00	930.00	70.00
1976	1,000	1/18	0.00	930.00	70.00
1977	1,000	0.25/18	0.00	930.00	70.00

[1] Rate applied to $900, the amount of assets placed in service during the first half of the taxable year.
[2] The allowable depreciation is limited by estimated salvage.

Example 5. The facts are the same as in example (2) except that after 2 years A changes from the 200-percent declining balance method to the sum of the years-digits method of depreciation. The depreciation allowances would be as follows:

Year	Unadjusted basis	Rate	Depreciation	Reserve	Adjusted basis
1971	$1,000	0.36363	$327.27	$327.27	$672.73
1972	1,000	.36363	244.63	571.90	428.10
1973	1,000	4/10	171.24	743.14	256.86
1974	1,000	3/10	128.43	871.57	128.43
1975	1,000	2/10	[1] 58.43	930.00	70.00
1976	1,000	1/10	0.00	930.00	70.00

[1] The allowable depreciation is limited by estimated salvage.

(iv) *Limitation on methods.* (*a*) The same method of depreciation must be adopted for all property in a single vintage account. Generally, the method of depreciation which may be adopted is subject to the limitations contained in section 167 (c), (j) and (l).

(*b*) Except as otherwise provided in section 167(j) with respect to certain eligible section 1250 property—

(*1*) In the case of a vintage account for which the taxpayer has selected an asset depreciation period of 3 years or more and which only contains property the original use of which commences with the taxpayer, any method of depreciation described in section 167(b) (1), (2), or (3) may be adopted, but if the vintage account contains property the original use of which does not commence with the taxpayer, or if the asset depreciation period for the account is less than 3 years, a method of depreciation described in section 167(b) (2) or (3) may not be adopted for the account, and

(*2*) The declining balance method using a rate not in excess of 150 percent of the straight line rate based upon the asset depreciation period for the vintage account may be adopted for the account even if the original use of the property does not commence with the taxpayer provided the asset depreciation period for the account is at least 3 years.

(*c*) The term ''original use'' means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. (See § 1.167(c)–1).

(v) *Unadjusted and adjusted basis.* (*a*) For purposes of this section, the unadjusted basis of an asset (including an ''excluded addition'' and a ''property improvement'' as described, respectively, in paragraph (d)(2) (vi) and (vii) of this section) is its cost or other basis without any adjustment for depreciation or amortization (other than depreciation under section 179) but with other adjustments required under section 1016 or other applicable provisions of law. The unadjusted basis of a vintage account is the total of the unadjusted bases of all the assets in the account. The unadjusted basis of a ''special basis vintage account'' as described in paragraph (d)(3)(vi) of this section is the amount of the property improvement determined in paragraph (d)(2)(vii)(*a*) of this section.

(*b*) The adjusted basis of a vintage account is the amount by which the unadjusted basis of the account exceeds the reserve for depreciation for the account. The adjusted basis of an asset in a vintage account is the amount by which the unadjusted basis of the asset exceeds the amount of depreciation allowable for the asset under this section computed by using the method of depreciation and the rate applicable to the account. For purposes of this subdivision, the depreciation allowable for an asset shall include, to the extent identifiable, the amount of proceeds previously added to the depreciation reserve in accordance with paragraph (d)(3)(iii) of this section upon the retirement of any portion of such asset. (See paragraph (d)(3)(vi) of this section for election under certain circumstances to allocate adjusted basis of an amount of property improvement determined under paragraph (d)(2)(vii)(*a*) of this section.)

(2) *Conventions applied to additions and retirements*—(i) *In general.* The allowance for depreciation of a vintage account (whether an item account or a multiple asset account) shall be determined by applying one of the conventions described in subdivisions (ii) and (iii) of this subparagraph. (For the manner of applying a convention in the case of taxable years beginning before and ending after December 31, 1970, see subparagraph (3) of this paragraph.) The same convention must be adopted for all vintage accounts of a taxable year, but the same convention need not be adopted for the vintage accounts of another taxable year. An election to apply this section must specify the convention adopted. (See paragraph (f) of this section for information required in making the election.) The convention adopted by the taxpayer is a method of accounting for purposes of section 446, but the consent of the Commissioner will be deemed granted to make an annual adoption of either of the conventions described in subdivisions (ii) and (iii) of this subparagraph.

(ii) *Modified half-year convention.* The depreciation allowance for a vintage account for which the taxpayer adopts the ''modified half-year convention'' shall be determined by treating: (*a*) All property in such account which is placed in service during the first half of the taxable year as placed in service on the first day of the taxable year; and (*b*) all property in such account which is placed in service during the second half of the taxable year as placed in service on the first day of the succeeding taxable year. The depreciation allowance for a vintage account for a taxable year in which there is an extraordinary retirement (as defined in paragraph (d) (3) (ii) of this section) of property first placed in service during the first half of the taxable year is determined by treating all such retirements from such account during the first half of the taxable year as occurring on the first day of the taxable year and all such retirements from such account during the second half of the taxable year as occurring on the first day of the second half of the taxable year. The depreciation allowance for a vintage account for a taxable year in which there is an extraordinary retirement (as defined in paragraph (d)(3)(ii) of this section) of property first placed in service during the second half of the taxable year is determined by treating all such retirements from such account during the first half of the taxable year as occurring on the first day of the second half of the taxable year and all such retirements in the second half of the taxable year as occurring on the first day of the succeeding taxable year.

(iii) *Half-year convention.* The depreciation allowance for a vintage account for which the taxpayer adopts the ''half-year convention'' shall be determined by treating all property in the account as placed in service on the first day of the second half of the taxable year and by treating all extraordinary retirements (as defined in paragraph (d)(3)(ii) of this section) from the account as occurring on the first day of the second half of the taxable year.

(iv) *Rules of application.* (*a*) The first-year convention adopted for a vintage account must be consistently applied to all additions to and all extraordinary retirements from such account. See paragraph (d)(3) (ii) and (iii) of this section for definition and treatment of ordinary retirements.

(*b*) If the actual number of months in a taxable year is other than 12 full calendar months, depreciation is allowed only for such actual number of months and the term ''taxable year'', for purposes of this subparagraph, shall mean only such number of months. In such event, the first half of such taxable year shall be deemed to expire at the close of the last day of a calendar month which is the closest such last day to the middle of such taxable year and the second half of such taxable year shall be deemed to begin the day after the expiration of the first half of such taxable year. If a taxable year consists of a period which includes only 1 calendar month, the first half of the taxable year shall be deemed to expire on the first day which is nearest to the midpoint of the month, and the second half of the taxable year shall begin the day after the expiration of the first half of the month.

(*c*) For purposes of this subparagraph, for property placed in service after November 14, 1979, other than depreciable property described in paragraph (c)(2)(iv)(*e*) of this section, the taxable year of the person placing such property in service does not include any month before the month in which the person begins engaging in a trade or business or holding depreciable property for the production of income.

(*d*) For purposes of paragraph (c)(2) (iv)(*c*) of this section—

(*1*) For property placed in service after February 21, 1981, an employee is not considered engaged in a trade or business by virtue of employment.

(*2*) If a person engages in a small amount of trade or business activity after February 21, 1981, for the purpose of obtaining a disproportionately large depreciation deduction for assets for the taxable year in which they are placed in service, and placing those assets in service represents a substantial increase in the person's level of business activity, then for purposes of depreciating those assets the person will not be treated as beginning a trade or business until the increased amount of business activity begins. For property held for the production of income, the principle of the preceding sentence applies.

(*3*) A person may elect to apply the rules of §1.167(a)–11 (c)(2)(iv)(*d*) as set forth in T.D. 7763 (''(*d*) rules in T.D. 7763''). This election shall be made by reflecting it under paragraph (f)(4) of this section in the books and records. If necessary, amended returns shall be filed.

(*4*) If an averaging convention was adopted in reliance on or in anticipation of the (*d*) rules in T.D. 7763, that convention may be changed without regard to paragraph (f)(3) of this section. Similarly, if an election is made under paragraph (c)(2)(iv)(*d*)(*3*) of this section to apply to the (*d*) rules in T.D. 7763, the averaging convention adopted for the taxable years for which the election is made may be changed. The change shall be made by filing a timely amended return for the taxable year for which the convention was adopted. Notwithstanding the three preceding sentences, if an averaging convention was adopted in reliance on or in anticipation of the (*d*) rules in T.D. 7763, and if an election is made to apply those rules, the averaging convention adopted cannot be changed except as provided in paragraph (f) of this section.

(*e*) The rules in paragraph (c)(2)(iv)(*c*) of this section do not apply to depreciable property placed in service after November 14, 1979, and the rules in paragraph (c)(2)(iv)(*d*) of this section do not apply to depreciable property placed in service after February 21, 1981, with respect to which substantial expenditures were paid or incurred prior to November 15, 1979. For purposes of the preceding sentence, expenditures will not be considered substantial unless they exceed the lesser of 30 percent of the final cost of the property or $10 million. Expenditures that are not includible in the basis of the depreciable property will be considered expenditures with respect to property if they are directly related to a specific project involving such property. For purposes of determining whether expenditures were paid or incurred prior to November 15, 1979, expenditures made by a person (transferor) other than the person placing the property in service (transferee) will be taken into account only if the basis of the property in the hands of the transferee is determined in whole or in part by reference to the basis in the hands of the transferor. The principle of the preceding sentence also applies if there are multiple transfers.

(v) *Mass assets.* In the case of mass assets, if extraordinary retirements of such assets in a guideline class during the first half of the taxable year are allocated to a particular vintage year for which the taxpayer applied the modified half-year convention, then that portion of the mass assets so allocated which bears the same ratio to the total number of mass assets so allocated as the mass assets in the same vintage and assets guideline class placed in service during the first half of that vintage year bear to the total mass assets in the same vintage and asset guideline class shall be treated as retired on the first day of the taxable year. The remaining mass assets which are subject to extraordinary retirement during the first half of the taxable year and which are allocated to that vintage year and assets guideline class shall be treated as retired on the first days of the second half of the taxable year. If extraordinary retirements of mass assets in a guideline class occur in the second half of the taxable year and are allocated to a particular vintage year for which the taxpayer applied the modified half-year convention, then that portion of the mass assets so allocated which bears the same ratio to the total number of mass assets so allocated as the mass assets in the same vintage and asset guideline class first placed in service during the first half of that vintage year bear to the total mass assets in the same vintage and asset guideline class shall be treated as retired on the first day of the second half of the taxable year. The remaining mass assets which are subject to extraordinary retirements during the second half of the taxable year and which are allocated to that same vintage and asset guideline class shall be treated as retired on the first day of the succeeding taxable year. If the taxpayer has applied the half-year convention for the vintage year to which the extraordinary retirements are allocated, the mass assets shall be treated as retired on the first day of the second half of the taxable year.

(3) *Taxable years beginning before and ending after December 31, 1970.* In the case of a taxable year which begins before January 1, 1971, and ends after December 31, 1970, property first placed in service after December 31, 1970, but treated as first placed in service before January 1, 1971, by application of a convention described in subparagraph (2) of this paragraph shall be treated as provided in this subparagraph. The depreciation allowed (or allowable) for the taxable year shall consist of the depreciation allowed (or allowable) for the period before January 1, 1971, determined without regard to this section plus the amount allowable for the period after December 31, 1970, determined under this section. However, neither the modified half-year convention described in subparagraph (2)(ii) of this paragraph, nor the half-year convention described in subparagraph (2)(iii) of this paragraph may for any such taxable year be applied with respect to property placed in service after December 31, 1970, to allow depreciation for any period prior to January 1, 1971, unless such convention is consistent with the convention applied by the taxpayer with respect to property placed in service in such taxable year prior to January 1, 1971.

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

Example 1. Taxpayer A, a calendar year taxpayer, places new property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis
W	Apr. 1, 1971	$5,000
X	June 30, 1971	8,000
Y	July 15, 1971	12,000

Taxpayer A adopts the modified half-year convention described in subparagraph (2) (ii) of this paragraph. Assets W, X, and Y are placed in a multiple asset account for which the asset depreciation range is 8 to 12 years. A selects 8 years, the minimum asset depreciation period with respect to such assets, and adopts the declining balance method of depreciation using a rate twice the straight line rate (computed without reduction for salvage). The annual rate under this method using a period of 8 years is 25 percent. The depreciation allowance for assets W and X for 1971 is $3,250, a full year's depreciation under the modified half-year convention (that is, basis of $13,000 (unreduced by salvage) multiplied by 25 percent). The depreciation allowance for asset Y for 1971 is zero under the modified half-year convention.

Example 2. The facts are the same as in example (1), except that the taxpayer adopts the half-year convention described in subparagraph (2) (iii) of this paragraph. The depreciation allowance with respect to asset Y is $1,500 (that is the basis of $12,000 multiplied by 25 percent, then multiplied by ½). Assets W and X are also entitled to a depreciation allowance for only a half year. Thus, the depreciation allowance for assets W and X for 1971 is $1,625 (that is, ½ of the $3,250 allowance computed in example (1)).

Example 3. Asset Z is placed in service by a calendar year taxpayer on December 1, 1971. The taxpayer places asset Z in an item account and adopts the sum of the years-digits method and the half year convention described in subparagraph (2) (iii) of this paragraph. The asset depreciation range for such asset is 4 to 6 years and the taxpayer selects an asset depreciation period of 5 years. The depreciation allowance for asset Z in 1971 is $10,000 (that is, basis of $60,000 (unreduced by salvage) multiplied by $^5/_{15}$, the appropriate fraction using the sum of the years-digits method then multiplied by ½, since only one half year's depreciation is allowable under the convention).

Example 4. A is a calendar year taxpayer. All taxpayer A's assets are placed in service in the first half of 1971. If the taxpayer selects the modified half-year convention described in subparagraph (2) (ii) of this paragraph, a full year's depreciation is allowable for all assets.

Example 5. (i) The taxpayer during his taxable year which begins April 1, 1970, and ends March 31, 1971, places new property in service in a trade or business as follows:

Asset	Placed in service	Unadjusted basis
A	Apr. 30, 1970	$10,000
B	Dec. 15, 1970	10,000
C	Jan. 1, 1971	10,000

The taxpayer adopted a convention under §1.167(a)–10(b) with respect to assets placed in service prior to January 1, 1971, which treats assets placed in service during the first half of the year as placed in service on the first day of such year and assets placed in service in the second half of the year as placed in service on the first day of the following year. If the taxpayer selects the half-year convention described in subparagraph (2) (iii) of this paragraph, one year's depreciation is allowable on asset A determined without regard to this section. No depreciation is allowable for asset B. No depreciation is allowable for asset C for the period prior to January 1, 1971. One-fourth year's depreciation is allowable on asset C determined under this section.

(ii) The facts are the same as in (i) of this example except that the taxpayer adopts the modified half-year convention described in subparagraph (2) (ii) of this paragraph for 1971. No depreciation is allowable for assets B and C which were placed in service in the second half of the taxable year.

Example 6. The taxpayer during his taxable year which begins August 1, 1970, and ends July 31, 1971, places new property in service in a trade or business as follows:

Asset	Placed in service
A	Aug. 1, 1970.
B	Jan. 15, 1971.
C	June 30, 1971.

The taxpayer adopted a convention under §1.167(a)–10(b) with respect to assets placed in service prior to January 1, 1971, which treats all assets as placed in service at the mid-point of the taxable year. If the taxpayer selects the half-year convention described in subparagraph (2) (iii) of this paragraph, one-half year's depreciation is allowable for asset A determined without regard to this section. One-half year's depreciation is allowable for assets B and C determined under this section.

Example 7. X, a calendar year corporation, is incorporated on July 1, 1978, and begins engaging in a trade or business in September 1979. X purchases asset A and places it in service on November 20, 1979. Substantial expenditures were not paid or incurred by X with respect to asset A prior to November 15, 1979. For purposes of applying the conventions under this section to determine depreciation for asset A, the 1979 taxable year is treated as consisting of 4 months. The first half of the taxable year ends on October 31, 1979, and the second half begins on November 1, 1979. X adopts the half-year convention. Asset A is treated as placed in service on November 1, 1979.

Example 8. On January 20, 1982, A, B, and C enter an agreement to form partnership P for the purpose of purchasing and leasing a ship to a third party, Z. P uses the calendar year as its taxable year. On December 15, 1982, P acquires the ship and leases it to Z. For purposes of applying the conventions, P begins its leasing business in December 1982, and its taxable year begins on December 1, 1982. Assuming that P elects to apply this section and adopts the modified half-year convention, P depreciates the ship placed in service in 1982 for the 1-month period beginning December 1, 1982, and ending December 31, 1982.

Example 9. A and B form partnership P on December 15, 1981, to conduct a business of leasing small aircraft. P uses the calendar year as its taxable year. On January 15, 1982, P acquires and places in service a $25,000 aircraft. P begins engaging in business with only one aircraft for the purpose of obtaining a disproportionately large depreciation deduction for aircraft that P plans to acquire at the end of the year. On December 10, 1982, P acquires and places in service 4 aircraft, the total purchase price of which is $250,000. For purposes of applying the conventions to the aircraft acquired in December, P begins its leasing business in December 1982, and P's taxable year begins December 1, 1982, and ends December 31, 1982. Assuming that P elects to apply this section and adopts the modified half-year convention, P depreciates the aircraft placed in service in December 1982, for the 1-month period beginning December 1, 1982, and ending December 31, 1982. P depreciates the aircraft placed in service in January 1982, for the 12-month period beginning January 1, 1982, and ending December 31, 1982.

(d) *Special rules for salvage, repairs and retirements*—(1) *Salvage value*—(i) *Definition of gross salvage value*. ''Gross salvage'' value is the amount which is estimated will be realized upon a sale or other disposition of the property in the vintage account when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service, without reduction for the cost of removal, dismantling, demolition or similar operations. If a taxpayer customarily sells or otherwise disposes of property at a time when such property is still in good operating condition, the gross salvage value of such property is the amount expected to be realized upon such sale or disposition, and under certain circumstances, as where such property is customarily sold at a time when it is still relatively new, the gross salvage value may constitute a relatively large proportion of the unadjusted basis of such property.

(ii) *Definition of salvage value*. ''Salvage value'' means gross salvage value less the amount, if any, by which the gross salvage value is reduced by application of section 167(f). Generally, as provided in section 167(f), a taxpayer may reduce the amount of gross salvage value of a vintage account by an amount which does not exceed 10 percent of the unadjusted basis of the personal property (as defined in section 167(f)(2)) in the account. See paragraph (b)(3)(ii) of this section for requirement of separate vintage accounts for personal property described in section 167(f)(2).

(iii) *Estimation of salvage value.* The salvage value of each vintage account of the taxable year shall be estimated by the taxpayer at the time the election to apply this section is made, upon the basis of all the facts and circumstances existing at the close of the taxable year in which the account is established. The taxpayer shall specify the amount, if any, by which gross salvage value taken into account is reduced by application of section 167(f). See paragraph (f)(2) of this section for requirement that the election specify the estimated salvage value for each vintage account of the taxable year of election. The salvage value estimated by the taxpayer will not be redetermined merely as a result of fluctuations in price levels or as a result of other facts and circumstances occurring after the close of the taxable year of election. Salvage value for a vintage account need not be established or increased as a result of a property improvement as described in subparagraph (2) (vii) of this paragraph. The taxpayer shall maintain records reasonably sufficient to determine facts and circumstances taken into account in estimating salvage value.

(iv) *Salvage as limitation on depreciation.* In no case may a vintage account be depreciated below a reasonable salvage value after taking into account any reduction in gross salvage value permitted by section 167(f).

(v) *Limitation on adjustment of reasonable salvage value.* The salvage value established by the taxpayer for a vintage account will not be redetermined if it is reasonable. Since the determination of salvage value is a matter of estimation, minimal adjustments will not be made. The salvage value established by the taxpayer will be deemed to be reasonable unless there is sufficient basis in the facts and circumstances existing at the close of the taxable year in which the account is established for a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account by an amount greater than 10 percent of the unadjusted basis of the account at the close of the taxable year in which the account is established. If the salvage value established by the taxpayer for the account is not within the 10 percent range, or if the taxpayer follows the practice of understating his estimates of gross salvage value to take advantage of this subdivision, and if there is a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account, an adjustment will be made by increasing the salvage value established by the taxpayer for the account by an amount equal to the difference between the salvage value as determined and the salvage value established by the taxpayer for the account. For the purposes of this subdivision, a determination of salvage value shall include all determinations at all levels of audit and appellate proceedings, and as well as all final determinations within the meaning of section 1313(a) (1). This subdivision shall apply to each such determination. (See example (3) of subdivision (vi) of this subparagraph.)

(vi) *Examples.* The principles of this subparagraph may be illustrated by the following examples in which it is assumed that the taxpayer has not followed a practice of understating his estimates of gross salvage value:

Example 1. Taxpayer B elects to apply this section to assets Y and Z, which are placed in a multiple asset vintage account of 1971 for which the taxpayer selects an asset depreciation period of 8 years. The unadjusted basis of asset Y is $50,000 and the unadjusted basis of asset Z is $30,000. B estimates a gross salvage value of $55,000. The property qualifies under section 167(f) (2) and B reduces the amount of salvage taken into account by $8,000 (that is, 10 percent of $80,000 under section 167(f)). Thus, B establishes a salvage value of $47,000 for the account. Assume that there is not sufficient basis for determining a salvage value for the account greater than $52,000 (that is, $60,000 minus the $8,000 reduction under section 167(f)). Since the salvage value of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example 2. The facts are the same as in example (1) except that B estimates a gross salvage value of $50,000 and establishes a salvage value of $42,000 for the account (that is,

$50,000 minus the $8,000 reduction under section 167(f)). There is sufficient basis for determining an amount of salvage value greater than $50,000 (that is, $58,000 minus the $8,000 reduction under section 167(f)). The salvage value of $42,000 established by B for the account can be redetermined without regard to the limitation in subdivision (v) of this subparagraph, since it is not within the 10 percent range. Upon audit of B's tax return for a taxable year for which the redetermination would affect the amount of depreciation allowable for the account, salvage value is determined to be $52,000 after taking into account the reduction under section 167(f). Salvage value for the account will be adjusted to $52,000.

Example 3. The facts are the same as in example (1) except that upon audit of B's tax return for a taxable year the examining officer determines the salvage value to be $58,000 (that is, $66,000 minus the $8,000 reduction under section 167(f)), and proposes to adjust salvage value for the vintage account to $58,000 which will result in disallowing an amount of depreciation for the taxable year. B does not agree with the finding of the examining officer. After receipt of a "30-day letter", B waives a district conference and initiates proceedings before the Appellate Division. In consideration of the case by the Appellate Division it is concluded that there is not sufficient basis for determining an amount of salvage value for the account in excess of $55,000 (that is $63,000 minus the $8,000 reduction under section 167(f)). Since the salvage of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example 4. Taxpayer C elects to apply this section to factory building X which is placed in an item vintage account of 1971. The unadjusted basis of factory building X is $90,000. C estimates a gross salvage value for the account of $10,000. The property does not qualify under section 167(f)(2). C establishes a salvage value of $10,000 for the account. Assume that there is not sufficient basis for determining a salvage value for the account greater than $18,000. Since the salvage value of $10,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

(2) *Treatment of repairs*—(i) *In general.* (*a*) Sections 162, 212, and 263 provide general rules for the treatment of certain expenditures for the repair, maintenance, rehabilitation or improvement of property. In general, under those sections, expenditures which substantially prolong the life of an asset, or are made to increase its value or adapt it to a different use are capital expenditures. If an expenditure is treated as a capital expenditure under section 162, 212, or 263, it is subject to the allowance for depreciation. On the other hand, in general, expenditures which do not substantially prolong the life of an asset or materially increase its value or adapt it for a substantially different use may be deducted as an expense in the taxable year in which paid or incurred. Expenditures, or a series of expenditures, may have characteristics both of deductible expenses and capital expenditures. Other expenditures may have the characteristics of capital expenditures, as in the case of an "excluded addition" (as defined in subdivision (vi) of this subparagraph). This subparagraph provides a simplified procedure for determining whether expenditures with respect to certain property are to be treated as deductible expenses or capital expenditures.

(*b*) [Reserved]

(ii) *Election of repair allowance.* In the case of an asset guideline class which consists of "repair allowance property" as defined in subdivision (iii) of this subparagraph, subject to the provisions of subdivision (v) of this subparagraph, the taxpayer may elect to apply the asset guideline class repair allowance described in subdivision (iii) of this subparagraph for any taxable year ending after December 31, 1970, for which the taxpayer elects to apply this section.

(iii) *Repair allowance for an asset guideline class.* For a taxable year for which the taxpayer elects to apply this section, the "repair allowance" for an asset guideline class which consists of "repair allowance property" is an amount equal to—

(*a*) The average of (*1*) the unadjusted basis of all "repair allowance property" in the asset guideline class at the beginning of the taxable year, less in the case of such property in a vintage account the unadjusted basis of all such property retired in an ordinary retirement (as described in subparagraph (3)(ii) of this paragraph) in prior taxable years, and (*2*) the unadjusted basis of all "repair allowance property" in the asset guideline class at the end of the taxable year, less in the case of such property in a vintage account the unadjusted basis of all such property retired in an ordinary retirement (including ordinary retirements during the taxable year), multiplied by—

(*b*) The repair allowance percentage in effect for the asset guideline class for the taxable year.

In applying the assets guideline class repair allowance to buildings which are section 1250 property, for the purpose of this subparagraph each building shall be treated as in a separate asset guideline class. If two or more buildings are in the same asset guideline class determined without regard to the preceding sentence and are operated as an integrated unit (as evidenced by their actual operation, management, financing and accounting), they shall be treated as a single building for this purpose. The ''repair allowance percentages'' in effect for taxable years ending before the effective date of the first supplemental repair allowance percentages established pursuant to this section are set forth in Revenue Procedure 72–10. Repair allowance percentages will from time to time be established, supplemented and revised with express reference to this section. These repair allowance percentages will be published in the Internal Revenue Bulletin. The repair allowance percentages in effect on the last day of the taxable year shall apply for the taxable year, except that the repair allowance percentage for a particular taxable year shall not be less than the repair allowance percentage in effect on the first day of such taxable year (or as of such later time in such year as a repair allowance percentage first established during such year becomes effective). Generally, the repair allowance percentages for a taxable year shall not be changed to reflect any supplement or revision of the repair allowance percentages after the end of such taxable year. However, if expressly provided in such a supplement or revision of the repair allowance percentages, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented repair allowance percentages for such taxable year and succeeding taxable years. For the purposes of this section, ''repair allowance property'' means eligible property determined without regard to paragraph (b)(2)(ii) of this section (that is, without regard to whether such property was first placed in service by the taxpayer before or after December 31, 1970) in an asset guideline class for which a repair allowance percentage is in effect for the taxable year. The determination whether property is repair allowance property shall be made without regard to whether such property is excluded, under paragraph (b)(5) of this section, from an election to apply this section. Property in an asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance described in this subdivision, which results from expenditures in the taxable year of election for the repair, maintenance, rehabilitation, or improvement of property in an asset guideline class shall not be ''repair allowance property'' for such taxable year but shall be for each succeeding taxable year provided such property is a property improvement as described in subdivision (vii) (*a*) of this subparagraph and is in an asset guideline class for which a repair allowance percentage is in effect for such succeeding taxable year.

(iv) *Application of asset guideline class repair allowance.* In accordance with the principles of sections 162, 212, and 263, if the taxpayer pays or incurs any expenditures during the taxable year for the repair, maintenance, rehabilitation or improvement of eligible property (determined without regard to paragraph (b)(2)(ii) of this section), the taxpayer must either—

(*a*) If such property is repair allowance property and if the taxpayer elects to apply the repair allowance for the asset guideline class, treat an amount of all such expenditures in such taxable year with respect to all such property in the asset guideline class which does not exceed in total the repair allowance for that asset guideline class as deductible repairs, and treat the excess of all such expenditures with respect to all such property in the asset guideline class in the manner described for a property improvement in subdivision (viii) of this subparagraph, or

(*b*) If such property is not repair allowance property or if the taxpayer does not elect to apply the repair allowance for the asset guideline class, treat each of such expenditures in such taxable year with respect to all such property in the asset guideline class as either a capital expenditure or as a deductible repair in accordance with the principles of sections 162, 212, and 263 (without regard to (*a*) of this subdivision), and treat the expenditures which are required to be capitalized under sections 162, 212, and 263 (without regard to (*a*) of this subdivision) in the manner described for a property improvement in subdivision (viii) of this subparagraph.

For the purposes of (*a*) of this subdivision, expenditures for the repair, maintenance, rehabilitation or improvement of property do not include expenditures for an excluded addition or for which a deduction is allowed under section 167(k). (See subdivision (viii) of this subparagraph for treatment of an excluded addition.) The taxpayer shall elect each taxable year whether to apply the repair allowance and treat expenditures under (*a*) of this subdivision, or to treat expenditures under (*b*) of this subdivision. The treatment of expenditures under this subdivision for a taxable year for all asset guideline classes shall be specified in the books and records of the taxpayer for the taxable year. The taxpayer may treat expenditures under (*a*) of this subdivision with respect to property in one asset guideline class and treat expenditures under (*b*) of this subdivision with respect to property in some other asset guideline class. In addition, the taxpayer may treat expenditures with respect to property in an asset guideline class under (*a*) of this subdivision in one taxable year, and treat expenditures with respect to property in that asset guideline class under (*b*) of this subdivision in another taxable year.

(v) *Special rules for repair allowance.* (*a*) The asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall apply only to expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property (as described in subdivision (iii) of this subparagraph). The taxpayer may apply the asset guideline class repair allowance for the taxable year only if he maintains books and records reasonably sufficient to determine:

(*1*) The amount of expenditures paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of repair allowance property in the asset guideline class, and

(*2*) The expenditures (and the amount thereof) with respect to such property which are for excluded additions (such as whether the expenditure is for an additional identifiable unit of property, or substantially increases the productivity or capacity of an existing identifiable unit of property or adapts it for a substantially different use).

In general, such books and records shall be sufficient to identify the amount and nature of expenditures with respect to specific items of repair allowance property or groups of similar properties in the same asset guideline class. However, in the case of such expenditures with respect to property, part of which is in one asset guideline class and part in another, or part of which is repair allowance property and part of which is not, and in comparable circumstances involving property in the same asset guideline class, to the extent books and records are not maintained identifying such expenditures with specific items of property or groups of similar properties and it is not practicable to do so, the total amount of such expenditures which is not specifically identified may be allocated by any reasonable method consistently applied. In any case, the cost of repair, maintenance, rehabilitation or improvement of property performed by production personnel may be allocated by any reasonable method consistently applied and if performed incidental to production and not substantial in amount, no allocation to repair, maintenance, rehabilitation or improvement need be made. The types of expenditures for which specific identification would ordinarily be made include: Substantial expenditures such as for major parts or major structural materials for which a work order is or would customarily be written; expenditures for work performed by an outside contractor; or expenditures under a specific down time program. Types of expenditures for which specific identification would ordinarily be impractical include: General maintenance costs of machinery, equipment, and plant in the case of a taxpayer having assets in more than one class (or different types of assets in the same class) which are located together and generally maintained by the same work crew; small supplies which are used with respect to various classes or types of property; labor costs of personnel who work on property in different classes, or different types of property in the same class, if the work is performed on a routine, as needed, basis and the only identification of the property repaired is by the personnel. Factors which will be taken into account in determining the reasonableness of the taxpayer's allocation of expenditures include prior experience of the taxpayer; relative bases of the assets in the guideline class; types of assets involved; and relationship to specifically identified expenditures.

(*b*) If for the taxable year the taxpayer elects to deduct under section 263(e) expenditures with respect to repair allowance property consisting of railroad rolling stock (other than a locomotive) in a particular asset guideline class, the taxpayer may not, for such taxable year, use the asset guideline class repair allowance described in subdivision (iii) of this subparagraph for any property in such asset guideline class.

(*c*)(*1*) If the taxpayer repairs, rehabilitates or improves property for sale or resale to customers, the asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall not apply to expenditures for the repair, maintenance, rehabilitation or improvement of such property, or (*2*) if a taxpayer follows the practice of acquiring for his own use property (in need of repair, rehabilitation or improvement to be suitable for the use intended by the taxpayer) and of making expenditures to repair, rehabilitate or improve such property in order to take advantage of this subparagraph, the asset guideline class repair allowance described in subdivision (iii) of this subparagraph shall not apply to such expenditures. In either event, such property shall not be ''repair allowance property'' as described in subdivision (iii) of this subparagraph.

(vi) *Definition of excluded addition.* The term ''excluded addition'' means—

(*a*) An expenditure which substantially increases the productivity of an existing identifiable unit of property over its productivity when first acquired by the taxpayer;

(*b*) An expenditure which substantially increases the capacity of an existing identifiable unit of property over its capacity when first acquired by the taxpayer;

(*c*) An expenditure which modifies an existing identifiable unit of property for a substantially different use;

(*d*) An expenditure for an identifiable unit of property if (*1*) such expenditure is for an additional identifiable unit of property or (*2*) such expenditure (other than an expenditure described in (*e*) of this subdivision) is for replacement of an identifiable unit of property which was retired;

(*e*) An expenditure for replacement of a part in or a component or portion of an existing identifiable unit of property (whether or not such part, component or portion is also an identifiable unit of property) if such part, component or portion is for replacement of a part, component or portion which was retired in a retirement upon which gain or loss is recognized (or would be recognized but for a special nonrecognition provision of the Code or §1.1502–13).

(*f*) In the case of a building or other structure (in addition to (*b*), (*c*), (*d*), and (*e*) of this subdivision which also apply to such property), an expenditure for additional cubic or linear space; and

(*g*) In the case of those units of property of pipelines, electric utilities, telephone companies, and telegraph companies consisting of lines, cables and poles (in addition to (*a*) through (*e*) of this subdivision which also apply to such property), an expenditure for replacement of a material portion of the unit of property.

Except as provided in (*d*) and (*e*) of this subdivision, notwithstanding any other provision of this subdivision, the term ''excluded addition'' does not include any expenditure in connection with the repair, maintenance, rehabilitation or improvement of an identifiable unit of property which does not exceed $100.

For this purpose all related expenditures with respect to the unit of property shall be treated as a single expenditure. For the purposes of (*a*), and (*b*) of this subdivision, an increase in productivity or capacity is substantial only if the increase is more than 25 percent. An expenditure which merely extends the productive life of an identifiable unit of property is not an increase in productivity within the meaning of (*a*) of this subdivision. Under (*g*) of this subdivision a replacement is material only if the portion replaced exceeds 5 percent of the unit of property with respect to which the replacement is made. For the purposes of this subdivision, a unit of property generally consists of each operating unit (that is, each separate machine or piece of equipment) which performs a discrete function and which the taxpayer customarily acquires for original installation and retires as a unit. The taxpayer's accounting classification of units of property will generally be accepted for purposes of this subdivision provided the classifications are reasonably consistent with the preceding sentence and are consistently applied. In the case of a building the unit of property generally consists of the building as well as its structural components; except that each building service system (such as an elevator, an escalator, the electrical system, or the heating and cooling system) is an identifiable unit for the purpose of (*a*), (*b*), (*c*), and (*d*) of this subdivision. However, both in the case of machinery and equipment and in the case of a building, for the purpose of applying (*d*)(*1*) of this subdivision a unit of property may consist of a part in or a component or portion of a larger unit of property. In the case of property described in (*g*) of this subdivision (such as a pipeline), a unit of property generally consists of each segment which performs a discrete function either as to capacity, service, transmission or distribution between identifiable points. Thus, for example, under this subdivision in the case of a vintage account of five automobiles each automobile is an identifiable unit of property (which is not merely a part in or a component or portion of larger unit of property within the meaning of (*e*) of this subdivision). Accordingly, the replacement of one of the automobiles (which is retired) with another automobile is an excluded addition under (*d*)(*2*) of this subdivision. Also the purchase of a sixth automobile is an expenditure for an additional identifiable unit of property and is an excluded addition under (*d*)(*1*) of this subdivision. An automobile air conditioner is also an identifiable unit of property for the purposes of (*d)(1)* of this subdivision, but not for the purposes of (*d*)(*2*) of this subdivision. Accordingly, the addition of an air conditioner to an automobile is an excluded addition under (*d*)(*1*) of this subdivision, but the replacement of an existing air conditioner in an automobile is not an excluded addition under (*d*)(*2*) of this subdivision (since it is merely the replacement of a part in an existing identifiable unit of property). The replacement of the air conditioner may, however, be an excluded addition under (*e*) of this subdivision, if the air conditioner replaced was retired in a retirement upon which gain or loss was recognized. The principles of this subdivision may be further illustrated by the following examples in which it is assumed (unless otherwise stated) that (*e*) of this subdivision does not apply:

Example 1. For the taxable year, B pays or incurs only the following expenditures: (*1*) $5,000 for general maintenance of repair allowance property (as described in subdivision (iii) of this subparagraph) such as inspection, oiling, machine adjustments, cleaning, and painting; (*2*) $175 for replacement of bearings and gears in an existing lathe; (*3*) $125 for replacement of an electric starter (of the same capacity) and certain electrical wiring in an automatic drill press; (*4*) $300 for modification of a metal fabricating machine (including replacement of certain parts) which substantially increases its capacity; (*5*) $175 for repair of the same metal fabricating machine which does not substantially increase its capacity; (*6*) $800 for the replacement of an existing lathe with a new lathe; and (*7*) $65 for the repair of a drill press. Expenditures (*1*) through (*3*) are expenditures for the repair, maintenance, rehabilitation or improvement of property to which B can elect to apply the asset guideline class repair allowance described in subdivision (iii) of this subparagraph. Expenditure (*4*) is an excluded addition under (*b*) of this subdivision. Expenditure (*5*) is not an excluded addition. Expenditure (*6*) is an excluded addition under (*d*)(*2*) of this subdivision. Without regard to (*a*), (*b*), and (*c*) of this subdivision, expenditure (*7*) is not an excluded addition since the expenditure does not exceed $100.

Example 2. Corporation M operates a steel plant which produces rails, blooms, billets, special bar sections, reinforcing bars, and large diameter line pipe. During the taxable year, corporation M: (*1*) relines an openhearth furnace; (*2*) places in service 20 new ingot molds; (*3*) replaces one reversing roll in the blooming mill; (*4*) overhauls the rail and billet mill with no increase in capacity; (*5*) replaces a roll stand in the 20-inch bar mill; and (*6*) overhauls the 11-inch bar mill and reducing stands increasing billet speed from 1,800 feet per minute to 2,300 feet per minute. Assume that each expenditure exceeds $100. Expenditure (*1*) is not an excluded addition. Expenditure (*2*) is an excluded addition under (*d*)(*1*) of this subdivision. Expenditure (*3*) is not an excluded addition since the expenditure for the reversing roll merely replaces a part in an existing identifiable unit of property. Expenditure (*4*) is not an excluded addition. Expenditure (*5*) is an excluded addition under (*d*)(*2*) of this subdivision since the roll stand is not merely a part of an existing identifiable unit of property. Expenditure (*6*) is an excluded addition under (*a*) of this subdivision since it increases the billet speed by more than 25 percent.

Example 3. For the taxable year, corporation X pays or incurs the following expenditures: (*1*) $1,000 for two new temporary partition walls in the company's offices; (*2*) $1,400 for repainting the exterior of a terminal building; (*3*) $300 for repair of the roof of a warehouse; (*4*) $150 for replacement of two window frames and panes in the warehouse; and (*5*) $100 for plumbing repair. Expenditure (*1*) is an excluded addition under (*d*)(*1*) of this subdivision. None of the other expenditures are excluded additions.

Example 4. For the taxable year, corporation Y pays or incurs the following expenditures: (*1*) $10,000 for expansion of a loading dock from 600 square feet to 750 square feet; (*2*) $600 for replacement of two roof girders in a factory building; and (*3*) $9,500 for replacement of columns and girders supporting the floor of a second story loft storage area within the factory building in order to permit storage of supplies with a gross weight 50 percent greater than the previous capacity of the loft. Expenditure (*1*) is an excluded addition under (*f*) of this subdivision. Expenditure (*2*) is not an excluded addition. Expenditure (*3*) is an excluded addition under (*b*) of this subdivision.

Example 5. Corporation A has an office building with an unadjusted basis of $10 million. The building has 10 elevators, five of which are manually operated and five of which are automatic. During 1971, corporation A:

(*1*) Replaces the five manually operated elevators with highspeed automatic elevators at a cost of $400,000;

(*2*) Replaces the cable in one of the existing automatic elevators at a cost of $1,700. The replacements of the elevators are excluded additions under (*d*)(*2*) of this subdivision. The replacement of the cable is not an excluded addition.

Example 6. Taxpayer W, a cement manufacturer, engages in the following modification and maintenance activities during the taxable year: (*1*) Replaces eccentric-bearing, spindle, and wearing surface in a gyratory crusher; (*2*) places in service a new apron feeder and hammer mill; (*3*) replaces four buckets on a chain bucket elevator; (*4*) relines refractory surface in the burning zone of a rotary kiln; (*5*) installs additional new dust collectors; and (*6*) Replaces two 16-inch × 90-foot belts on his conveyer system. Assume that there is no increase in productivity or capacity and that each expenditure exceeds $100. Expenditure (*1*) is not an excluded addition. Expenditure (*2*) an excluded addition under (*d*)(*1*) of this subdivision. Expenditures (*3*) and (*4*) are not excluded additions. Expenditures (*5*) is an excluded addition under (*d*)(*1*) of this subdivision. Expenditure (*6*) is not an excluded addition.

Example 7. Corporation X, a gas pipeline company, has, in addition to others, the following units of property: (*1*) A gathering pipeline for a field consisting of 25 gas wells; (*2*) the main transmission line between compressor stations (that is, in the case of a 500-mile main transmission line with a compressor station every 100 miles, each one hundred miles section between compressor stations is a separate unit of property); (*3*) a lateral transmission line from the main transmission line to a city border station; (*4*) a medium pressure distribution line to the northern portion of the city; and (*5*) a low pressure distribution line serving a group of approximately 200 residential customers off the medium pressure distribution line. In 1971, corporation X pays or incurs the following expenditures in connection with the repair, maintenance, rehabilitation or improvement of repair allowance property: (*1*) replaces a meter on a gas well; (*2*) in connection with the repair and rehabilitation of a unit of property consisting of a 2-mile gathering pipeline, replaces a 3,000-foot section of the gathering line; (*3*) in connection with the repair of leaks in a unit of property consisting of a 100-mile gas transmission line (that is, the 100 miles between compressor stations), replaces a 2,000-foot section of pipeline at one point; and (*4*) at another point replaces a 7-mile section of the same 100-mile gas transmission line. Assume that none of these expenditures substantially increases capacity and that each expenditure exceeds $100. Expenditure (*1*) is an excluded addition under (*d*) of this subdivision. Expenditure (*2*) is an excluded addition under (*g*) of this subdivision since the portion replaced is more than 5 percent of the unit of property. Expenditure (*3*) is not an excluded addition. Expenditure (*4*) is an excluded addition under (*g*) of this subdivision.

Example 8. Taxpayer Y, an electric utility company, has in addition to others, the following units of property: (*1*) A high voltage transmission circuit from the switching station (at the generating station) to the transmission station; (*2*) a series of 100 poles (fully dressed) supporting the circuit in (*1*); (*3*) a high voltage circuit from the transmission station to the distribution substation; (*4*) a high voltage distribution circuit (either radial or looped) from the distribution substation; (*5*) a transformer on a distribution pole; (*6*) a circuit breaker on a distribution pole; and (*7*) all 220 (and lower) volt circuit (including customer service connections) off the distribution circuit in (*4*). In 1971, taxpayer Y pays or incurs the following expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property: (*1*) Replaces 25 adjacent poles in a unit of property consisting of the 300 poles supporting a radial distribution circuit from a distribution substation; (*2*) replaces a transformer on one of the poles in (*1*); (*3*) replaces a cross-arm on one of the poles in (*1*); (*4*) replaces a 200-foot section of a 2-mile radial distribution circuit serving 100 residential customers; and (*5*) replaces a 2,000-foot section on a 10-mile high voltage circuit from a transmission station to a distribution substation which was destroyed by a casualty which taxpayer Y treated as an extraordinary retirement under paragraph (d)(3)(ii) of this section. Expenditure (*1*) is an excluded addition under (*g*) of this subdivision. Expenditure (*2*) is an excluded addition under (*d*)(*2*) of this subdivision. Expenditures (*3*) and (*4*) are not excluded additions. Expenditure (*5*) is an excluded addition under (*e*) of this subdivision.

Example 9. Corporation Z, a telephone company, has in addition to others, the following units of property: (*1*) A buried feeder cable 3 miles in length off a local switching station; (*2*) a buried subfeeder cable 1 mile in length off the feeder cable in (*1*); (*3*) all the distribution cable (and customer service drops) off the subfeeder cable in (*2*); (*4*) the 300 poles (fully dressed) supporting the distribution cable in (*3*); (*5*) a 10-mile local trunk cable which interconnects two local tandem switching stations; (*6*) a toll connecting trunk cable from a local tandem switching station to a long distance tandem switching station; (*7*) a toll trunk cable 50 miles in length from the access point at one city to the access point at another city. In 1971, corporation Z pays or incurs the following expenditures in connection with the repair, maintenance, rehabilitation or improvement of repair allowance property: (*1*) replaces 100 feet of distribution cable in a unit of property consisting of 8 miles of local distribution cable (plus customer service drops); (*2*) replaces an amplifier in the distribution system; and (*3*) replaces 10 miles of a unit of property consisting of a toll trunk cable 50 miles in length. Expenditure (*1*) is not an excluded addition. Expenditure (*2*) is an excluded addition under (*d*)(*2*) of this subdivision. Expenditure (*3*) is an excluded addition under (*g*) of this subdivision.

(vii) *Definition of property improvement.* The term ''property improvement'' means—

(*a*) If the taxpayer treats expenditures for the asset guideline class under subdivision (iv) (*a*) of this subparagraph, the amount of all expenditures paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of repair allowance property in the asset guideline class, which exceeds the asset guideline class repair allowance for the taxable year; and

(*b*) If the taxpayer treats expenditures for the asset guideline class under subdivision (iv) (*b*) of this subparagraph, the amount of each expenditure paid or incurred during the taxable year for the repair, maintenance, rehabilitation or improvement of property which is treated under sections 162, 212, and 263 as a capital expenditure.

The term ''property improvement'' does not include any expenditure for an excluded addition.

(viii) *Treatment of property improvements and excluded additions.* If for the taxable year there is a property improvement as described in subdivision (vii) of this subparagraph or an excluded addition as described in subdivision (vi) of this subparagraph, the following rules shall apply—

(*a*) The total amount of any property improvement for the asset guideline class determined under subdivision (vii)(*a*) of this subparagraph shall be capitalized in a single ''special basis vintage account'' of the taxable year in accordance with the taxpayer's election to apply this section for the taxable year (applied without regard to paragraph (b)(5)(v)(*a*) of this section). See subparagraph (3)(vi) of this paragraph for definition and treatment of a ''special basis vintage account''.

(*b*) Each property improvement determined under subdivision (vii)(*b*) of this subparagraph, if it is eligible property, shall be capitalized in a vintage account of the taxable year in accordance with the taxpayer's election to apply this section for the taxable year (applied without regard to paragraph (b)(5)(v)(*a*) of this section).

(*c*) Each excluded addition, if it is eligible property, shall be capitalized in a vintage account of the taxable year in accordance with the taxpayer's election to apply this section for the taxable year.

For rule as to date on which a property improvement or an excluded addition is first placed in service, see paragraph (e)(1) (iii) and (iv) of this section.

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

Example 1. For the taxable year 1972, B elects to apply this section. B has repair allowance property (as described in subdivision (iii) of this subparagraph) in asset guideline class 20.2 under Revenue Procedure 72–10 with an average unadjusted basis determined as provided in subdivision (iii) (*a*) of this subparagraph of $100,000 and repair allowance property in asset guideline class 24.4 with an average unadjusted basis of $300,000. The repair allowance percentage for asset guideline class 20.2 is 4.5 percent and for asset guideline class 24.4 is 6.5 percent. The two asset guideline class repair allowances for 1972 are $4,500 and $19,500, respectively, determined as follows:

Asset Guideline Class 20.2	
$100,000 average unadjusted basis multiplied by 4.5 percent	$4,500
Asset Guideline Class 24.4	
$300,000 average unadjusted basis multiplied by 6.5 percent	$19,500

Example 2. The facts are the same as in example (1). During the taxable year 1972, B pays or incurs the following expenditures for the repair, maintenance, rehabilitation or improvement of repair allowance property in asset guideline class 20.2

General maintenance (including primarily labor costs)	$3,000
Replacement of parts in several machines (including labor costs of $1,650)	4,000
	7,000

In addition, in connection with the rehabilitation and improvement of two other machines B pays or incurs $6,000 (including labor costs of $2,000) which is treated as an excluded addition because the capacity of the machines was substantially increased. For 1972, B elects to apply this section and to apply the asset guideline class repair allowance to asset guideline class 20.2. Since the asset guideline class repair allowance is $4,500, B can deduct $4,500 in accordance with subdivision (iv) (*a*) of this subparagraph. B must capitalize $2,500 in a special basis vintage account in accordance with subdivisions (vii) (*a*) and (viii) (*a*) of this subparagraph. Since the excluded addition is a capital item and is eligible property, B must also capitalize $6,000 in a vintage account in accordance with subdivision (viii) (*c*) of this subparagraph. B selects from the asset depreciation range an asset depreciation period of 17 years for the special basis vintage account. B includes the excluded addition in a vintage account of 1972 for which he also selects an asset depreciation period of 17 years.

(3) *Treatment of retirements*—(i) *In general.* The rules of this subparagraph specify the treatment of all retirements from vintage accounts. The rules of § 1.167(a)–8 shall not apply to any retirement from a vintage account. An asset in a vintage account is retired when such asset is permanently withdrawn from use in a trade or business or in the production of income by the taxpayer. A retirement may occur as a result of a sale or exchange, by other act of the taxpayer amounting to a permanent disposition of an asset, or by physical abandonment of an asset. A retirement may also occur by transfer of an asset to supplies or scrap.

(ii) *Definitions of ordinary and extraordinary retirements.* The term ''ordinary retirement'' means any retirement of section 1245 property from a vintage account which is not treated as an ''extraordinary retirement'' under this subparagraph. The retirement of an asset from a vintage account in a taxable year is an ''extraordinary retirement'' if—

(*a*) The asset is section 1250 property;

(*b*) The asset is section 1245 property which is retired as the direct result of fire, storm, shipwreck, or other casualty and the taxpayer, at his option consistently applied (taking into account type, frequency, and the size of such casualties) treats such retirements as extraordinary; or

(*c*)*(1)* The asset is section 1245 property which is retired (other than by transfer to supplies or scrap) in a taxable year as the direct result of a cessation, termination, curtailment, or disposition of a business, manufacturing, or other income producing process, operation, facility or unit, and (2) the unadjusted basis (determined without regard to subdivision (vi) of this subparagraph) of all such assets so retired in such taxable year from such account as a direct result of the event described in *(c)(1)* of this subdivision exceeds 20 percent of the unadjusted basis of such account immediately prior to such event.

For the purposes of (*c*) of this subdivision, all accounts (other than a special basis vintage account as described in subdivision (vi) of this subparagraph) containing section 1245 property of the same vintage in the same asset guideline class, and from which a retirement as a direct result of such event occurs within the taxable year, shall be treated as a single vintage account. See subdivision (xi) of this subparagraph for special rule for item accounts. The principles of this subdivision may be illustrated by the following examples:

Example 1. Taxpayer A is a processor and distributor of dairy products. Part of taxpayer A's operation is a bottle washing facility consisting of machines X, Y, and Z, each of which is in an item vintage account of 1971. Each item vintage account has an unadjusted basis of $1,000. Taxpayer A also has a 1971 multiple asset vintage account consisting of machines E, S, and C. Machines E and S, used in processing butter, each has an unadjusted basis of $10,000. Machine C used in capping bottles has an unadjusted basis of $1,000. In 1975, taxpayer A changes to the use of paper milk cartons and disposes of all bottle washing machines (X, Y, and Z) as well as machine C which was used in capping bottles. The sales of machine C, X, Y, and Z are the direct result of the termination of a manufacturing process. However, since the total unadjusted basis of the eligible section 1245 property retired as a direct result of such event is only $4,000 (which is less than 20 percent of the total unadjusted basis of machines E, S, C, X, Y, and Z, $24,000) the sales are ordinary retirements. All the assets are in the same asset guideline class and are of the same vintage. Accordingly, machines E, S, C, X, Y, and Z are for this purpose treated as being in a single vintage account.

Example 2. The facts are the same as in example (1) except that in 1976, taxpayer A sells six of his 12 milk delivery trucks as a direct result of eliminating home deliveries to customers in the suburbs. Deliveries within the city require only six trucks. Each of the trucks has an unadjusted basis of $3,000. Six of the taxpayer's delivery trucks are in a multiple asset vintage account of 1974 and six are in a multiple asset vintage account of 1972. Neither account contains any other property. Four trucks are retired from the 1972 vintage account and two trucks are retired from the 1974 vintage account. The sales result from the curtailment of taxpayer A's home delivery operation. The unadjusted basis of the four trucks retired from the 1972 vintage exceeds 20 percent of the total unadjusted basis of the affected account. The same is true for the two trucks retired from the 1974 vintage account. The sales of the trucks are extraordinary retirements.

(*d*) The asset is section 1245 property which is retired after December 30, 1980 by a charitable contribution for which a deduction is allowable under section 170.

(iii) *Treatment of ordinary retirements.* No loss shall be recognized upon an ordinary retirement. Gain shall be recognized only to the extent specified in this subparagraph. All proceeds from ordinary retirements shall be added to the depreciation reserve of the vintage account from which the retirement occurs. See subdivision (vi) of this subparagraph for optional allocation of basis in the case of a special basis vintage account. See subdivision (ix) of this subparagraph for recognition of gain when the depreciation reserve exceeds the unadjusted basis of the vintage account. The amount of salvage value for a vintage account shall be reduced (but not below zero) as of the beginning of the taxable year by the excess of (*a*) the depreciation reserve for the account, after adjustment for depreciation allowable for such taxable year and all other adjustments prescribed by this section (other than the adjustment prescribed by subdivision (ix) of this subparagraph), over (*b*) the unadjusted basis of the account less the amount of salvage value for the account before such reduction. Thus, in the case of a vintage account with an unadjusted basis of $1,000 and a salvage value of $100, to the extent that proceeds from ordinary retirements increase the depreciation reserve above $900, the salvage value is reduced. If the proceeds increase the depreciation reserve for the account to $1,000, the salvage value is reduced to zero. The unadjusted basis of the asset retired in an ordinary retirement is not removed from the account and the depreciation reserve for the account is not reduced by the depreciation allowable for the retired asset. The previously unrecovered basis of the retired asset will be recovered through the allowance for depreciation with respect to the vintage account. See subdivision (v)(*a*) of this subparagraph for treatment of retirements on which gain or loss is not recognized in whole or in part. See subdivision (v)(*b*) of this subparagraph for treatment of retirements by disposition to a member of an affiliated group as defined in section 1504(a). See subdivision (v)(*c*) of this subparagraph for treatment of transfers between members of an affiliated group of corporations or other related parties as extraordinary retirements.

(iv) *Treatment of extraordinary retirements.* (*a*) Unless the transaction is governed by a special nonrecognition section of the Code such as 1031 or 337 or is one to which subdivision (v)(*b*) of this subparagraph applies, gain or loss shall be recognized upon an extraordinary retirement in the taxable year in which such retirement occurs subject to section 1231, section 165, and all other applicable provisions of law such as sections 1245 and 1250. If the asset which is retired in an extraordinary retirement is the only or last asset in the account, the account shall terminate and no longer be an account to which this section applies. In all other cases, the unadjusted basis of the retired asset shall be removed from the unadjusted basis of the vintage account, and the depreciation reserve established for the account shall be reduced by the depreciation allowable for the retired asset computed in the manner prescribed in paragraph (c) (1)(v)(*b*) of this section for determination of the adjusted basis of the asset. See subdivision (ix) of this subparagraph for recognition of gain in the case of an account containing section 1245 property when the depreciation reserve exceeds the unadjusted basis of the vintage account. See subdivision (iii) of this subparagraph for reduction of salvage value for such an account when the depreciation reserve exceeds the unadjusted basis of the account minus salvage value. See subdivision (v)(*b*) of this subparagraph for treatment of retirements by disposition to a member of an affiliated group as defined in section 1504(a).

(*b*) The principles of this subdivision may be illustrated by the following examples:

Example 1. Corporation X has a multiple asset vintage account of 1971 consisting of assets K, R, A, and P all of which are section 1245 property. The unadjusted basis of the account is $40,000. The unadjusted basis of asset A is $10,000. When the reserve for depreciation for the account is $20,000, asset A is sold in an extraordinary retirement for $8,000 in cash. The $10,000 unadjusted basis of asset A is removed from the account and the $5,000 depreciation allowable for asset A is removed from the reserve for depreciation. Gain in the amount of $3,000 (to which section 1245 applies) is recognized upon the sale of asset A.

Example 2. Corporation X has an item vintage account of 1972 consisting of residential apartment unit A. Unit A is section 1250 property. It is residential rental property and meets the requirements of section 167(j)(2). Corporation X adopts the declining balance method of depreciation using a rate twice the straight line rate. The asset depreciation period is 40 years. Unit A has an unadjusted basis of $200,000. On June 30, 1974, when the reserve for depreciation for the account is $19,500, unit A is sold for $220,000. Since unit A is section 1250 property, the sale is an extraordinary retirement in accordance with subdivision (ii)(*a*) of this subparagraph (without regard to subdivision (ii)(*b*) or (*c*) of this subparagraph). The adjusted basis of unit A is $180,500. Gain in the amount of $39,500 is recognized. The ''additional depreciation'' (as defined in section 1250(b)) for unit A is $9,500. Accordingly, $9,500 is in accordance with section 1250 treated as gain from the sale or exchange of an asset which is neither a capital asset nor property described in section 1231. The $30,000 balance of the gain from the sale of unit A may be gain to which section 1231 applies.

(v) *Special rule for certain retirements.* (*a*) In the case of an ordinary retirement on which gain or loss is in whole or in part not recognized because of a special nonrecognition section of the Code, such as 1031 or 337, no part of the proceeds from such retirement shall be added to the depreciation reserve of the vintage account in accordance with subdivision (iii) of this subparagraph. Instead, such retirement shall for all purposes of this section be treated as an extraordinary retirement.

(*b*) The provisions of § 1.1502–13 shall apply to a retirement. In the case of an ordinary retirement to which the provisions of § 1.1502–13 apply, no part of the proceeds from such retirement shall be added to the depreciation reserve of the vintage account in accordance with subdivision (iii) of this subparagraph. Instead, such retirement shall for all purposes of this section be treated as an extraordinary retirement.

(*c*) In a case in which property is transferred, in a transaction which would without regard to this subdivision be treated as an ordinary retirement, during the taxable year in which first placed in service to a person who bears a relationship described in section 179(d)(2) (A) or (B), such transfer shall for all purposes of this section be treated as an extraordinary retirement.

(*d*)(*1*) If, in the case of mass assets, it is impracticable for the taxpayer to maintain records from which he can establish the vintage of such assets as retirements occur, and if he adopts other reasonable recordkeeping practices, then the vintage of mass asset retirements may be determined by use of an appropriate mortality dispersion table. Such a mortality dispersion table may be based upon an acceptable sampling of the taxpayer's actual experience or other acceptable statistical or engineering techniques. Alternatively, the taxpayer may use a standard mortality dispersion table prescribed by the Commissioner for this purpose. If the taxpayer uses such standard mortality dispersion table for any taxable year of election, it must be used for all subsequent taxable years of election unless the taxpayer obtains the consent of the Commissioner to change to another dispersion table or to actual identification of retirements. For information requirements regarding mass assets, see paragraph (f)(5) of this section.

(*2*) For purposes of this section, the term "mass assets" has the same meaning as when used in paragraph (e)(4) of § 1.47–1.

(*e*) The principles of this subdivision may be illustrated by the following examples:

Example 1. Corporation X has a vintage account of 1971 consisting of machines A, B, and C, each with an unadjusted basis of $1,000. The unadjusted basis of the account is $3,000 and at the end of 1977 the reserve for depreciation is $2,100. On January 1, 1978, machine A is transferred to corporation Y solely for stock in the amount of $1,400 in a transaction to which section 351 applies. Since the adjusted basis of machine A is $300, a gain of $1,100 is realized, but no gain is recognized under section 351. Even though machine A was transferred in an ordinary retirement in accordance with (*a*) of this subdivision the rules for an extraordinary retirement are applied. The proceeds are not added to the reserve for depreciation for the account. Machine A is removed from the account, the unadjusted basis of the account is reduced by $1,000, and the reserve for depreciation for the account is reduced by $700.

Example 2. The facts are the same as in example (1) except that the consideration received for machine A is stock of corporation Y in the amount of $1,200 and cash in the amount of $200. The result is the same as in example (1) except that gain is recognized in the amount of $200 all of which is gain to which section 1245 applies.

Example 3. The facts are the same as in example (1) except that machine A is sold for $1,400 cash in an ordinary retirement and corporation X and corporation Y are includible corporations in an affiliated group as defined in section 1504(a) which files a consolidated return for 1978. Accordingly, (*b*) of this subdivision applies. The retirement is treated as an extraordinary retirement. Machine A is removed from the account, the unadjusted basis of the account is reduced by $1,000, and the reserve for depreciation for the account is reduced by $700. The gain of $1,100 is deferred gain to which § 1.1502–13 applies.

(vi) *Treatment of special basis vintage accounts.* A "special basis vintage account" is a vintage account for an amount of property improvement determined under subparagraph (2) (vii)(*a*) of this paragraph. In general, reference in this section to a "vintage account" shall include a special basis vintage account. The unadjusted basis of a special basis vintage account shall be recovered through the allowance for depreciation in accordance with this section over the asset depreciation period for the account. Except as provided in this subdivision, the unadjusted basis, adjusted basis and reserve for depreciation of such account shall not be allocated to any specific asset in the asset guideline class, and the provisions of this subparagraph shall not apply to such account. However, in the event of a sale, exchange or other disposition of "repair allowance property'' (as described in subparagraph (2)(iii) of this paragraph) in an extraordinary retirement as described in subdivision (ii) of this subparagraph (or if the asset is not in a vintage account, in an abnormal retirement as described in §1.167(a)–8), the taxpayer may, if consistently applied to all such retirements in the taxable year and adequately identified in the taxpayer's books and records, elect to allocate the adjusted basis (as of the end of the taxable year) of all special basis vintage accounts for the asset guideline class to each such retired asset in the proportion that the adjusted basis of the retired asset (as of the beginning of the taxable year) bears to the adjusted basis of all repair allowance property in the asset guideline class at the beginning of the taxable year. The election to allocate basis in accordance with this subdivision shall be made on the tax return filed for the taxable year. The principles of this subdivision may be illustrated by the following example:

Example. In addition to other property, the taxpayer has machines A, B, and C all in the same asset guideline class and each with an adjusted basis on January 1, 1977, of $10,000. The adjusted basis on January 1, 1977, of all repair allowance property (as described in subparagraph (2)(iii) of this paragraph) in the asset guideline class is $90,000. The machines are sold in an extraordinary retirement in 1977. The taxpayer is entitled to and does elect to allocate basis in accordance with this subdivision. There is also a 1972 special basis vintage account for the asset guideline class, as follows:

	Unadjusted basis	Reserve for depreciation	Dec. 31, 1977, adjusted basis
1972 special basis vintage account, for which the taxpayer selected an asset depreciation period of 10 years, adopted the straight line method, and used the half-year convention	$2,000	$1,100	$900

By application of this subdivision, the adjusted basis of machines A, B, and C is increased to $10,100 each (that is, $10,000 ÷ $90,000 × $900 = $100). The unadjusted basis, reserve for depreciation and adjusted basis of the special basis vintage account are reduced, respectively, by one-third (that is, $300 ÷ $900=⅓) in order to reflect the allocation of basis from the special basis vintage account.

(vii) *Reduction in the salvage value of a vintage account.* (*a*) A taxpayer may apply this section without reducing the salvage value for a vintage account in accordance with this subdivision or in accordance with subdivision (viii) of this subparagraph (relating to transfers to supplies or scrap). See subdivision (iii) of this subparagraph for reduction of salvage value in certain circumstances in the amount of proceeds from ordinary retirements.

(*b*) However, the taxpayer may, at his option, follow the consistent practice of reducing, as retirements occur, the salvage value for a vintage account by the amount of salvage value attributable to the retired asset, or the taxpayer may consistently follow the practice of so reducing the salvage value for a vintage account as extraordinary retirements occur while not reducing the salvage value for the account as ordinary retirements occur. If the taxpayer does not reduce the salvage value for a vintage account as ordinary retirements occur, the taxpayer may be entitled to a deduction in the taxable year in which the last asset is retired from the account in accordance with subdivision (ix) (*b*) of this subparagraph.

(*c*) For purposes of this subdivision, the portion of the salvage value for a vintage account attributable to a retired asset may be determined by multiplying the salvage value for the account by a fraction, the numerator of which is the unadjusted basis of the retired asset and the denominator of which is the unadjusted basis of the account, or any other method consistently applied which reasonably reflects that portion of the salvage value for the account originally attributable to the retired asset.

(*d*) In the case of ordinary retirements the taxpayer may—

(*1*) In the case of retirements (other than by transfer to supplies or scrap) follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and not adding the same amount to the depreciation reserve for the account, and

(*2*) In the case of retirements by transfer to supplies or scrap, follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and not adding the same amount to the depreciation reserve for the account (in which case the basis in the supplies or scrap account of the retired asset will be zero) or follow the consistent practice of reducing the salvage value for the account by the amount of salvage value attributable to the retired asset and adding the same amount to the depreciation reserve for the account (up to an amount which does not increase the depreciation reserve to an amount in excess of the unadjusted basis of the account) in which case the basis in the supplies or scrap account of the retired asset will be the amount added to the depreciation reserve for the account.

Thus, for example, in the case of an ordinary retirement by transfer of an asset to supplies or scrap, the basis of the asset in the supplies or scrap account would either be zero or the amount added to the depreciation reserve of the vintage account from which the retirement occurred. When the depreciation reserve for the account equals the unadjusted basis of the account no further adjustment to salvage value for the account will be made. See subdivision (viii) of this subparagraph for special optional rule for reduction of salvage value in the case of an ordinary retirement by transfer of an asset to supplies or scrap.

(*e*) In the event of a removal of property from a vintage account in accordance with paragraph (b)(4)(iii)(*e*), (5)(v)(*b*) or (6)(iii) of this section the salvage value for the account may be reduced by the amount of salvage value attributable to the asset removed determined as provided in (*c*) of this subdivision.

(viii) *Special optional adjustments for transfers to supplies or scrap.* If the taxpayer does not follow the consistent practice of reducing, as ordinary retirements occur, the salvage value for a vintage account in accordance with subdivision (vii) of this subparagraph, the taxpayer may (in lieu of the method described in subdivision (vii) (*c*) and (*d*) of this subparagraph) follow the consistent practice of reducing salvage value as ordinary retirements occur by transfer of assets to supplies or scrap and of determining the basis (in the supplies or scrap account) as assets retired in an ordinary retirement by transfer to supplies or scrap, in the following manner—

(*a*) The taxpayer may determine the value of the asset (not to exceed its unadjusted basis) by any reasonable method consistently applied (such as average cost, conditioned cost, or fair market value) if such method is adequately identified in the taxpayer's books and records.

(*b*) The value attributable to the asset determined in accordance with (*a*) of this subdivision shall be subtracted from the salvage value for the account (to the extent thereof) and the greater of (*1*) the amount subtracted from the salvage value for the vintage account and (*2*) the value of the asset determined in accordance with (*a*) of this subdivision, shall be added to the reserve for depreciation of this vintage account.

(*c*) The amount added to the reserve for depreciation of the vintage account in accordance with (*b*) of this subdivision shall be treated as the basis of the retired asset in the supplies or scrap account.

If the taxpayer makes the adjustments in accordance with this subdivision, the reserve for depreciation of the vintage account may exceed the unadjusted basis of the account, and in that event gain will be recognized in accordance with subdivision (ix) of this subparagraph.

(ix) *Recognition of gain or loss in certain situations.* (*a*) In the case of a vintage account for section 1245 property, if at the end of any taxable year after adjustment for depreciation allowable for such taxable year and all other adjustments prescribed by this section, the depreciation reserve established for such account exceeds the unadjusted basis of the account, the entire amount of such excess shall be recognized as gain in such taxable year. Such gain—

(*1*) Shall constitute gain to which section 1245 applies to the extent that it does not exceed the total amount of depreciation allowances in the depreciation reserve at the end of such taxable year, reduced by gain recognized pursuant to this subdivision with respect to the account previously treated as gain to which section 1245 applies, and

(*2*) May constitute gain to which section 1231 applies to the extent that it exceeds such total amount as so reduced.

In such event, the depreciation reserve shall be reduced by the amount of gain recognized, so that after such reduction the amount of the depreciation reserve is equal to the unadjusted basis of the account.

(*b*) In the case of an account for section 1245 property, if at the time the last asset in the vintage account is retired the unadjusted basis of the account exceeds the depreciation reserve for the account (after all adjustments prescribed by this section), the entire amount of such excess shall be recognized in such taxable year as a loss under section 165 or as a deduction for depreciation under section 167. If the retirement of such asset occurs by sale or exchange on which gain or loss is recognized, the amount of such excess may constitute a loss subject to section 1231. Upon retirement of the last asset in a vintage account, the account shall terminate and no longer be an account to which this section applies. See subdivision (xi) of this subparagraph for treatment of certain multiple asset and item accounts.

(*c*) The principles of this subdivision may be illustrated by the following example:

Example. The taxpayer has a vintage account for section 1245 property with an unadjusted basis of $1,000 and a depreciation reserve of $700 (of which $600 represents depreciation allowances and $100 represents the proceeds of ordinary retirements from the account). If $500 is realized during the taxable year from ordinary retirements of assets from the account, the reserve is increased to $1,200, gain is recognized to the extent of $200 (the amount by which the depreciation reserve before further adjustment exceeds $1,000) and the depreciation reserve is then decreased to $1,000. The $200 of gain constitutes gain to which section 1245 applies. If the amount realized from ordinary retirements during the year had been $1,100 instead of $500, the gain of $800 would have consisted of $600 of gain to which section 1245 applies and $200 of gain to which section 1231 may apply.

(x) *Dismantling cost.* The cost of dismantling, demolishing, or removing an asset in the process of a retirement from the vintage account shall be treated as an expense deductible in the year paid or incurred, and such cost shall not be subtracted from the depreciation reserve for the account.

(xi) *Special rule for treatment of multiple asset and item accounts.* For the purposes of subdivision (ix)(*b*) of this subparagraph, all accounts (other than a special basis vintage account as described in subdivision (vi) of this subparagraph) of the same vintage in the same asset guideline class for which the taxpayer has selected the same asset depreciation period and adopted the same method of depreciation, and which contain only section 1245 property permitted by paragraph (b)(3)(ii) of this section to be included in the same vintage account, shall be treated as a single multiple asset vintage account.

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

Example 1. (*a*)Taxpayer A has a multiple asset vintage account for selection 1245 property with an unadjusted basis of $1,000. All the assets were first placed in service by A on January 15, 1971. This account contains all of A's assets in a single asset guideline class. A elects to apply this section for 1971 and adopts the modified half-year convention. A estimates a salvage value for the account of $100 and this estimate is determined to be reasonable. (See subparagraph (1)(v) of this paragraph for limitation on adjustment of reasonable salvage value.) A adopts the straight line method of depreciation with respect to the account and selects a 10-year asset depreciation period. A does not follow a practice of reducing the salvage value for the account in the amount of salvage value attributable to each retired asset in accordance with subparagraph (3)(vii) of this paragraph. The depreciation allowance for each of the first 4 years is $100, that is $\frac{1}{10}$ multiplied by the unadjusted basis of $1,000, with reduction for salvage.

(*b*) In the fifth year of the asset depreciation period, three assets are sold in an ordinary retirement for $300. Under paragraph (c)(1)(ii) of this section and subparagraph (3)(iii) of this paragraph, the proceeds of the retirement are added to the depreciation reserve as of the beginning of the fifth year. Accordingly, the reserve as of the beginning of the fifth year is $700, that is, $400 of depreciation as of the beginning of the year plus $300 proceeds from ordinary retirements. The depreciation allowance for the fifth year is $100, that is $\frac{1}{10}$ multiplied by the unadjusted basis of $1,000, without reduction for salvage. Accordingly, the depreciation reserve at the end of the fifth year is $800.

(*c*) In the sixth year, asset X is sold in an extraordinary retirement for $30 and gain or loss is recognized. Under the first-year convention used by the taxpayer, the unadjusted basis of X, $300, is removed from the unadjusted basis of the vintage account as of the beginning of the sixth year and the depreciation reserve as of the beginning of such year is reduced to $650 by removing the depreciation applicable to asset X, $150 (see subparagraph (3)(iv) of this paragraph). Since the depreciation reserve ($650) exceeds the unadjusted basis of the account ($700) minus salvage value ($100) by $50, under subparagraph (3)(iii) of this paragraph, salvage value is reduced by $50. No depreciation is allowable for the sixth year.

(*d*) In the seventh year, an asset is sold in an ordinary retirement for $110. This would increase the reserve as of the beginning of the seventh year to $760 and under subparagraph (3)(iii) of this paragraph the salvage value is reduced to zero. Under subparagraph (3)(ix)(*a*) of this paragraph the depreciation reserve is then decreased to $700 (the unadjusted basis of the account) and $60 is reported as gain, without regard to the adjusted basis of the asset. No depreciation is allowable for the seventh year since the depreciation reserve ($700) equals the unadjusted basis of the account ($700).

(*e*)(*1*) In the eighth year, A elects to apply this section and to treat expenditures during the year for repair, maintenance, rehabilitation or improvement under subparagraph (2)(iii) and (iv)(*a*) of this paragraph (the ''guideline class repair allowance''). This results in the treatment of $300 as a property improvement for the asset guideline class. (See subparagraph (2)(vii) of this paragraph for definition of a property improvement.) The property improvement is capitalized in a special basis vintage account of the eighth taxable year (see subparagraph (2)(viii)(*a*) of this paragraph). A selects an asset depreciation period of 10 years and adopts the straight line method for the special basis vintage account. A adopts the modified half-year convention for the eighth year.

(*2*) In the eighth year, A sells asset Y in an ordinary retirement for $175. Under paragraph (c)(1)(ii) of this section and subparagraph (3)(iii) of this paragraph, $175 is added to the depreciation reserve for the account as of the beginning of the taxable year. Since the depreciation reserve for the account ($875) exceeds the unadjusted basis of the account ($700) by $175, that amount of gain is recognized under subparagraph (3)(ix) of this paragraph. Upon recognition of gain in the amount of $175, the depreciation reserve for the account is reduced to $700.

(*3*) No depreciation is allowable in the eighth year for the vintage account since the depreciation reserve ($700) equals the unadjusted basis of the account ($700). The depreciation allowable in the eighth year for the special basis vintage account is $15, that is, unadjusted basis of $300, multiplied by $\frac{1}{10}$, the asset depreciation period selected for the special basis vintage account, but limited to $15 under the modified half-year convention. (See paragraph (e)(1)(iv) of this section for treatment of $150 of the property improvement as first placed in service in the first half of the taxable year and $150 of the property improvement as first placed in service in the last half of the taxable year.)

Example 2. Taxpayer B has a 1971 multiple asset vintage account for section 1245 property with an unadjusted basis of $100,000. B selects from the asset depreciation range an asset depreciation period of 10 years and adopts the straight line method of depreciation and the modified half-year convention. B establishes a salvage value for the account of $10,000. All the assets in the account are first placed in service on January 15, 1971. B follows the practice of reducing salvage value for the account as ordinary retirements occur in accordance with subparagraph (3)(vii) of this paragraph, but does not follow the optional practice of determining the basis of assets transferred to supplies or scrap in accordance with subparagraph (3)(vii) of this paragraph. No retirements occur during the first five years. The depreciation reserve at the beginning of the sixth year is $50,000. In the sixth year an asset with an unadjusted basis of $20,000 is transferred to supplies in an ordinary retirement. By application of subparagraph (3)(vii) (*c*) and (*d*)(*2*) of this paragraph B determines the reduction in salvage value for the account attributable to such asset to be $2,000 (that is, $\$20{,}000 \div \$100{,}000 \times \$10{,}000 = \$2{,}000$).

B reduces the salvage value for the account by $2,000 and adds 2,000 to the depreciation reserve for the account. The basis of the retired asset in the supplies account is $2,000. The depreciation allowable for the account for the sixth year is $10,000. The depreciation reserve for the account at the beginning of the seventh year is $62,000. At the mid-point of the seventh year all the remaining assets in the account are sold in an ordinary retirement for $20,000, which is added to the depreciation reserve as of the beginning of the seventh year, thus increasing the reserve to $82,000. The $5,000 depreciation allowable for the account for the seventh year (one-half of a full-year's depreciation of $10,000) increases the depreciation reserve to $87,000. Under subparagraph (3)(ix)(*b*) of this paragraph, a loss of $13,000 subject to section 1231 is realized in the seventh year (that is, the excess of the unadjusted basis of $100,000 over the depreciation reserve of $87,000). No depreciation is allowable for the account after the mid-point of the seventh year since all the assets are retired and the account has terminated.

(e) *Accounting for eligible property*—(1) *Definition of first placed in service*—(i) *In general*. The term ''first placed in service'' refers to the time the property is first placed in service by the taxpayer, not to the first time the property is placed in service. Property is first placed in service when first placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity. In general, the provisions of paragraph (d)(1)(ii) and (d)(2) of §1.46–3 shall apply for the purpose of determining the date on which property is placed in service, but see subdivision (ii) of this subparagraph for special rule for certain replacement parts. In the case of a building which is intended to house machinery and equipment and which is constructed, reconstructed, or erected by or for the taxpayer and for the taxpayer's use, the building will ordinarily be placed in service on the date such construction, reconstruction, or erection is substantially complete and the building is in a condition or state of readiness and availability. Thus, for example, in the case of a factory building, such readiness and availability shall be determined without regard to whether the machinery or equipment which the building houses, or is intended to house, has been placed in service. However, in an appropriate case, as for example where the building is essentially an item of machinery or equipment, or the use of the building is so closely related to the use of the machinery or equipment that it clearly can be expected to be replaced or retired when the property it initially houses is replaced or retired, the determination of readiness or availability of the building shall be made by taking into account the readiness and availability of such machinery or equipment. The date on which depreciation begins under a convention used by the taxpayer or under a particular method of depreciation, such as the unit of production method or the retirement method, shall not determine the date on which the property is first placed in service. See paragraph (c)(2) of this section for application of a first-year convention to determine the allowance for depreciation of property in a vintage account.

(ii) *Certain replacement parts*. Property (such as replacement parts) the cost or other basis of which is deducted as a repair expense in accordance with the asset guideline repair allowance described in paragraph (d)(2)(iii) of this section shall not be treated as placed in service.

(iii) *Property improvements and excluded additions*. (*a*) Except as provided in (*b*) of this subdivision, a property improvement determined under paragraph (d)(2)(vii)(*b*) of this section, and an excluded addition (other than an excluded addition referred to in the succeeding sentence) is first placed in service when its cost is paid or incurred. The general rule in subdivision (i) of this subparagraph applies to an excluded addition described in paragraph (d) (2)(vi) (*d*), (*e*), (*f*), or (*g*) of this section.

(*b*) If a property improvement or an excluded addition to which the first sentence of (*a*) of this subdivision applies is paid or incurred in part in one taxable year and in part in the succeeding taxable year (or in part in the first half of a taxable year and in part in the last half of the taxable year) the taxpayer may at his option consistently treat such property improvements and excluded additions under the general rule in subdivision (i) of this subparagraph.

(iv) *Certain property improvements*. In the case of an amount of property improvement determined under paragraph (d)(2)(vii)(*a*) of this section, one-half of such amount is first placed in service in the first half of the taxable year in which the cost is paid or incurred and one-half is first placed in service in the last half of such taxable year.

(v) *Special rules for clearing accounts*. In the case of public utilities which consistently account for certain property through ''clearing accounts,'' the date on which such property is first placed in service shall be determined in accordance with rules to be prescribed by the Commissioner.

(2) *Special rules for transferred property.* If eligible property is first placed in service by the taxpayer during a taxable year of election, and the property is disposed of before the end of the taxable year, the election for such taxable year shall include such property unless such property is excluded in accordance with paragraph (b)(5) (iii), (iv, (v), (vi), or (vii) of this section.

(3) *Special rules in the case of certain transfers*—(i) *Transaction to which section 381(a) applies.* (*a*) In general the acquiring corporation in a transaction to which section 381(a) applies is for the purposes of this section treated as if it were the distributor or transferor corporation.

(*b*) If the distributor or transferor corporation (including any distributor or transferor corporation of any distributor or transferor corporation) has made an election to apply this section to eligible property transferred in a transaction to which section 381(a) applies, the acquiring corporation must segregate such eligible property (to which the distributor or transferor corporation elected to apply this section) into vintage accounts as nearly coextensive as possible with the vintage accounts created by the distributor or transferor corporation identified by reference to the year the property was first placed in service by the distributor or transferor corporation. The asset depreciation period for the vintage account in the hands of the distributor or transferor corporation must be used by the acquiring corporation. The method of depreciation adopted by the distributor or transferor corporation, shall be used by the acquiring corporation unless such corporation obtains the consent of the Commissioner to use another method of depreciation in accordance with paragraph (e) of §1.446–1 or changes the method of depreciation under paragraph (c)(1)(iii) of this section.

(*c*) The acquiring corporation may apply this section to the property so acquired only if the distributor or transferor corporation elected to apply this section to such property.

(*d*) See paragraph (b)(7) of this section for special rule for certain property where there is a mere change in the form of conducting a trade or business.

(ii) *Partnerships, trusts, estates, donees, and corporations.* Except as provided in subdivision (i) of this subparagraph with respect to transactions to which section 381(a) applies and subdivision (iv) of this subparagraph with respect to certain transfers between members of an affiliated group of corporations or other related parties, if eligible property is placed in service by an individual, trust, estate, partnership or corporation, the election to apply this section shall be made by the individual, trust, estate, partnership or corporation placing such property in service. For example, if a partnership places in service property contributed to the partnership by a partner, the partnership may elect to apply this section to such property. If the partnership does not make the election, this section will not apply to such property. See paragraph (b)(7) of this section for special rule for certain property where there is mere change in the form of conducting a trade or business.

(iii) *Leased property.* The asset depreciation range and the asset depreciation period for eligible property subject to a lease shall be determined without regard to the period for which such property is leased, including any extensions or renewals of such period. See paragraph (b)(5)(v) of this section for exclusion of property amortized under paragraph (b) of §1.162–11 from an election to apply this section. In the case of a lessor of property, unless there is an asset guideline class in effect for lessors of such property, the asset guideline class for such property shall be determined as if the property were owned by the lessee. However, in the case of an asset guideline class based upon the type of property (such as trucks or railroad cars) as distinguished from the activity in which used, the property shall be classified without regard to the activity of the lessee. Notwithstanding the preceding sentence, if a lease with respect to property, which would be includible in an asset guideline class based upon the type of property under the preceding sentence (such as trucks or railroad cars), is entered into after March 12, 1971, and before April 23, 1973, or a written contract to execute such a lease is entered into during such period and such contract is binding on April 23, 1973, and at all times thereafter, and if the rent or rate of return is based on a classification of such property as if it were owned by the lessee, then such property shall be classified as if it were owned by the lessee. However, the preceding sentence shall not apply if pursuant to the terms or conditions of the lease or binding contract the rent or rate of return may be adjusted to take account of a change in the period for depreciation with respect to the property resulting from inclusion of the property in an asset guideline class based upon the type of property rather than in an asset guideline class based upon the activity of the lessee. Similarly, where the terms of such a lease or contract provide that the obligation of the taxpayer to enter into the lease is subject to a condition that the property be included in an asset guideline class based upon the activity of the lessee, the contract or lease will not be considered as binding upon the taxpayer, for purposes of this subdivision. See paragraph (b)(4)(iii)(*b*) of this section for general rule for classification of property according to primary use.

(iv) *Treatment of certain transfers between members of affiliated groups or other related persons.* If section 38 property in an asset guideline class (determined without regard to whether the taxpayer elects to apply this section) is transferred by the taxpayer to a person who bears a relationship described in section 179(d)(2) (A) or (B), such property is in the same asset guideline class in the hands of transferee, and the transfer is neither described in section 381(a) nor treated as a disposition or cessation within the meaning of section 47, then the asset guideline period for such property selected by the taxpayer under this section shall not be shorter than the period used for computing the qualified investment with respect to the property under section 46(c). In a case in which the asset depreciation range for the asset guideline class which includes such property does not include the period for depreciation used by the transferor in computing the qualified investment with respect to such property, the transferee will not be permitted to include such property in an election under this section. However, in such a case, the transferor of the property may recompute the qualified investment for the year the property was placed in service using a period for depreciation which falls within the asset depreciation range.

(f) *Election with respect to eligible property*—(1) *Time and manner of election*—(i) *In general.* An election to apply this section to eligible property shall be made with the income tax return filed for the taxable year in which the property is first placed in service (see paragraph (e)(1) of this section) by the taxpayer. In the case of an affiliated group of corporations (as defined in section 1504(a)) which makes a consolidated return with respect to income tax in accordance with section 1502 and the regulations thereunder, each corporation which joins in the making of such return may elect to apply this section for a taxable year. An election to compute the allowance for depreciation under this section is a method of accounting but the consent of the Commissioner will be deemed granted to make an annual election. For election by a partnership see section 703 (b) and paragraph (e)(3)(ii) of this section. If the taxpayer does not file a timely return (taking into account extensions of the time for filing) for the taxable year in which the property is first placed in service, the election shall be filed at the time the taxpayer files his first return for that year. The election may be made with an amended return filed within the time prescribed by law (including extensions) for filing the original return for the taxable year of election. If an election is not made within the time and in the manner prescribed in this paragraph, no election may be made for such taxable year (by the filing of an amended return or in any other manner) with respect to any eligible property placed in service in the taxable year.

(ii) *Other elections under this section.* All other elections under this section may be made only within the time and in the manner prescribed by subdivision (i) of this subparagraph with respect to an election to apply this section.

(iii) *Effective date.* See paragraph (f)(6) of this section for the effective date of this paragraph.

(2) *Information required.* A taxpayer who elects to apply this section must specify in the election:

(i) That the taxpayer makes such election and consents to and agrees to apply, all the provisions of this section;

(ii) The asset guideline class for each vintage account of the taxable year;

(iii) The first-year convention adopted by the taxpayer for the taxable year of election;

(iv) Whether the special 10 percent used property rule described in paragraph (b)(5)(iii) of this section has been applied to exclude used property from the election;

(v) Whether the taxpayer elects to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section;

(vi) Whether the taxpayer elects for the taxable year to allocate the adjusted basis of a special basis vintage account in accordance with paragraph (d)(3)(vi) of this section;

(vii) Whether any eligible property for which the taxpayer was not required or permitted to make an election was excluded because of the special rules of paragraph (b)(5)(v) or (6), or paragraph (e)(3)(i) or (iv) of this section;

(viii) Whether any "section 38 property" was excluded under paragraph (b)(5)(iv) of this section from the election to apply this section;

(ix) If the taxpayer is an electric or gas utility, whether the taxpayer elects to apply this section on the basis of a composite asset guideline class in accordance with paragraph (b)(4)(iii)(*a*) of this section; and

(x) Such other information as may reasonably be required.

The information required under this subparagraph may be provided in accordance with rules prescribed by the Commissioner for reasonable grouping of assets or accounts. Form 4832 is provided for making an election and for submission of the information required. An election may be made and the information submitted only in accordance with Form 4832. An election to apply this section will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith, with the requirements of this subparagraph.

(3) *Irrevocable election.* An election to apply this section to eligible property for any taxable year may not be revoked or changed after the time for filing the election prescribed under subparagraph (1) of this paragraph has expired. No other election under this section may be revoked or changed after such time unless expressly provided for under this section. (See paragraph (b)(5)(v)(*b*) of this section for special rule.)

(4) *Special conditions to election to apply this section*—(i) *Maintenance of books and records.* The taxpayer may not elect to apply this section for a taxable year unless the taxpayer maintains the books and records required under this section. In addition to any other information required under this section, the taxpayer's books and records must specify—

(*a*) The asset depreciation period selected by the taxpayer for each vintage account;

(*b*) If the taxpayer applies the modified half-year convention, the total cost or other basis of all eligible property first placed in service in the first half of the taxable year and the total cost or other basis of all eligible property first placed in service in the last half of the taxable year;

(*c*) The unadjusted basis and salvage value for each vintage account, and the amount, if any, by which gross salvage value was decreased under section 167 (f);

(*d*) Each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance described in paragraph (d)(2)(iii) of this section;

(*e*) The amount of property improvement, determined under paragraph (d)(2)(vii)(*a*) of this section, for each asset guideline class for which the taxpayer elects to apply the asset guideline class repair allowance;

(*f*) A reasonable description of property excluded from an election to apply this section and the basis for the exclusion;

(*g*) The total unadjusted basis of all assets retired during the taxable year from each asset guideline class, and the proceeds realized during the taxable year from such retirements; and

(*h*) The vintage (that is, the taxable year in which established) of the assets retired during the year from each asset guideline class.

For purposes of paragraph (f)(4)(i) (*g*) and (*h*) of this section, all accounts of the same vintage and asset guideline class may be treated as a single account. The taxpayer must specify the information required under paragraph (f)(4)(i) (*g*) and (*h*) without regard to the retirement of an asset by transfer to a supplies account for reuse.

(ii) *Response to survey.* Taxpayers who elect to apply this section must respond to infrequent data surveys conducted by the Treasury Department. These periodic surveys, which will be conducted on the basis of scientifically sound sampling methods, are designed to obtain data (including industry asset acquisitions and retirements) used to keep the asset guideline classes and periods up to date.

(iii) *Effect of noncompliance.* An election to apply this section will not be rendered invalid under this subparagraph so long as there is substantial compliance, in good faith, with the requirements of this subparagraph.

(5) *Mass assets.* In the case of mass assets, if the taxpayer assigns retirements to vintage accounts in the manner provided in paragraph (d)(3)(v)(*c*) of this section, the following information must be supplied with form 4832:

(i) Whether the taxpayer used the standard mortality dispersion curve or a curve based upon his own experience, and

(ii) Such other reasonable information as may be required by the Commissioner.

(6) *Effective date.* The rules in this paragraph apply to elections for taxable years ending on or after December 31, 1978. In the case of an election for a taxable year ending before December 31, 1978, the rules in paragraph (f) of this section, in effect before the amendments made by T.D. 7593 approved January 11, 1979, shall apply. See 26 CFR §1.167(a)–11(f) (1977) for paragraph (f) of this section as it appeared before the amendments made by T.D. 7593.

(g) *Relationship to other provisions*—(1) *Useful life*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, an election to apply this section to eligible property constitutes an agreement under section 167(d) and this section to treat the asset depreciation period for each vintage account as the useful life of the property in such account for all purposes of the Code, including sections 46, 47, 48, 57, 163(d), 167(c), 167(f)(2), 179, 312(m), 514(a), and 4940(c). For example, since section 167(c) requires a useful life of at least 3 years and the asset depreciation period selected is treated as the useful life for purposes of section 167(c), the taxpayer may adopt a method of depreciation described in section 167(b) (2) or (3) for an account only if the asset depreciation period selected for the account is at least 3 years.

(ii) *Special rules.* (*a*) For the purposes of paragraph (d) of this section, the anticipated period of use (estimated at the close of the taxable year in which the asset is first placed in service) on the basis of which salvage value is estimated, shall be determined without regard to the asset depreciation period for the property.

(*b*) For the purposes of sections 162 and 263 and the regulations thereunder, whether an expenditure prolongs the life of an asset shall be determined on the basis of the anticipated period of use of the asset (estimated at the close of the taxable year in which the asset is first placed in service) without regard to the asset depreciation period for such asset.

(*c*) The determination whether a transaction with respect to qualified property constitutes a sale or a lease of such property shall be made without regard to the asset depreciation period for the property.

(*d*) The principles of this subdivision may be illustrated by the following example:

Example. Corporation X has assets in asset guideline class 32.3 which are used in the manufacture of stone and clay products. The asset depreciation range for assets in asset guideline class 32.3 is from 12 to 18 years. Assume that corporation X selects 14 years as the asset depreciation period for all assets in asset guideline class 32.3. Under paragraph (d)(1)(i) of this section, corporation X must estimate salvage value on the basis of the anticipated period of use of the property (determined as of the close of the taxable year in which the property is first placed in service). The anticipated period of use must also be used for purposes of sections 162 and 263 in determining whether an expenditure materially prolongs the useful life of an asset. The anticipated period of use of an asset is determined without regard to the asset depreciation period of 14 years. Corporation X has, among other assets in the asset guideline class, machines A, B, and C. Corporation X estimates the anticipated period of use of machines A, B, and C as 8 years, 14 years, and 22 years, respectively. These estimates are reasonable and will be used for estimating salvage value and for purposes of sections 162 and 263.

(2) *Section 167(d) agreements.* If the taxpayer has, prior to January 1, 1971, entered into a section 167(d) agreement which applies to any eligible property, the taxpayer will be permitted to withdraw the eligible property from the agreement provided that an election is made to apply this section to such property. The statement of intent to withdraw eligible property from such an agreement must be made in an election filed for the taxable year in which the property is first placed in service. The withdrawal, in accordance with this subparagraph, of any eligible property from a section 167(d) agreement shall not affect any other property covered by such an agreement.

(3) *Relationship to the straight line method*—(i) *In general.* For purposes of determining the amount of depreciation which would be allowable under the straight line method of depreciation, such amount shall be computed with respect to any property in a vintage account using the straight line method in the manner described in paragraph (c)(1)(i) of this section and a rate based upon the period for the vintage account selected from the asset depreciation range. Thus, for example, section 57(a)(3) requires a taxpayer to compute an amount using the straight line method of depreciation if the taxpayer uses an accelerated method of depreciation. For purposes of section 57(a)(3), the amount for property in a vintage account shall be computed using the asset depreciation period for the vintage account selected from the asset depreciation range. In the case of property to which the taxpayer does not elect to apply this section, such amount computed by using the straight line method shall be determined under §1.167(b)–1 without regard to this section.

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

Example. (*a*) Corporation X places a new asset in service to which it elects to apply this section. The cost of the asset is $200,000 and the estimated salvage value is zero. The taxpayer selects 9 years from the applicable asset depreciation range of 8 to 12 years. Corporation X adopts the double declining balance method of depreciation and thus the rate of depreciation is 22.2 percent (twice the applicable straight line rate). The depreciation allowance in the first year would be $44,400, that is, 22.2 percent of $200,000.

(*b*) Assume that the provisions of section 57(a)(3) apply to the property. The amount of the tax preference would be $22,200, that is, the excess of the depreciation allowed under this section ($44,400) over the depreciation which would have been allowable if the taxpayer had used the period selected from the asset depreciation range and the straight line rate ($22,200).

(Secs. 167(m), 85 Stat. 508 (26 U.S.C. 167(m) and 7805, 68A Stat. 917, (26 U.S.C. 7805))

[T.D. 7272, 38 FR 9967, Apr. 23, 1973]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting §1.167(a)–11, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.govinfo.gov.*

§ 1.167(a)–12 Depreciation based on class lives for property first placed in service before January 1, 1971.

(a) *In general*—(1) *Summary.* This section provides an elective class life system for determining the reasonable allowance for depreciation of certain classes of assets for taxable years ending after December 31, 1970. The system applies only to assets placed in service before January 1, 1971. Depreciation for such assets during periods prior to January 1, 1971, may have been determined in accordance with Revenue Procedure 62–21. Accordingly, rules are provided which permit taxpayers to apply the system in taxable years ending after

December 31, 1970, to such assets without the necessity of changing or regrouping their depreciation accounts other than as previously required by Revenue Procedure 62–21. The system is designed to minimize disputes between taxpayers and the Internal Revenue Service as to the useful life of assets, salvage value, and repairs. See §1.167(a)–11 for a similar system for property placed in service after December 31, 1970. See paragraph (d)(2) of §1.167(a)–11 for treatment of expenditures for the repair, maintenance, rehabilitation or improvement of certain property. The system provided by this section is optional with the taxpayer. An election under this section applies only to qualified property in an asset guideline class for which an election is made and only for the taxable year of election. The taxpayer's election is made with the income tax return for the taxable year. This section also revokes the reserve ratio test for taxable years ending after December 31, 1970, and provides transitional rules for taxpayers who after January 11, 1971, adopt Revenue Procedure 62–21 for a taxable year ending prior to January 1, 1971.

(2) *Revocation of reserve ratio test and other matters.* Except as otherwise expressly provided in this section and in paragraph (b)(5)(vi) of §1.167(a)–11, the provisions of Revenue Procedure 62–21 shall not apply to any property for any taxable year ending after December 31, 1970, whether or not the taxpayer elects to apply this section to any property. See paragraph (f) of this section for rules for the adoption of Revenue Procedure 62–21 for taxable years ending prior to January 1, 1971.

(3) *Definition of qualified property.* The term ''qualified property'' means tangible property which is subject to the allowance for depreciation provided by section 167(a), but only if—

(i) An asset guideline class and asset guideline period are in effect for such property for the taxable year, and

(ii) The property is first placed in service by the taxpayer before January 1, 1971,

(iii) The property is placed in service before January 1, 1971, but first placed in service by the taxpayer after December 31, 1970, and is not includible in an election under §1.167(a)–11 by reason of §1.167(a)–11(b)(7) (property acquired as a result of a mere change in form) or §1.167(a)–11(e)(3)(i) (certain property acquired in a transaction to which section 381(a) applies), or

(iv) The property is acquired and first placed in service by the taxpayer after December 31, 1970, pursuant to a binding written contract entered into prior to January 1, 1971, and is excluded in accordance with paragraph (b)(5)(iv) of §1.167(a)–11 from an election to apply §1.167(a)–11.

The provisions of paragraph (e)(1) of §1.167(a)–11 apply in determining whether property is first placed in service before January 1, 1971. See subparagraph (4)(ii) of this paragraph for special rules for the exclusion of property from the definition of qualified property.

(4) *Requirements of election*—(i) *In general.* An election to apply this section to qualified property must be made within the time and in the manner specified in paragraph (e) of this section. The election must specify that the taxpayer consents to and agrees to apply all the provisions of this section. The election may be made separately for each asset guideline class. Thus, a taxpayer may for the taxable year elect to apply this section to one, more than one, or all asset guideline classes in which he has qualified property. An election to apply this section for a taxable year must include all qualified property in the asset guideline class for which the election is made.

(ii) *Special rules for exclusion of property from application of this section.* (*a*) If for the taxable year of election, the taxpayer computes depreciation under section 167(k) or computes amortization under sections 169, 185, 187, 188, or paragraph (b) of §1.162–11 with respect to property, such property is not qualified property for such taxable year. If for the taxable year of election, the taxpayer computes depreciation under any method of depreciation (other than a method described in the preceding sentence) not permitted by subparagraph (5)(v) of this paragraph for any property in an asset guideline class (other than subsidiary assets excluded from an election under (*b*) of this subdivision), no property in such asset guideline class is qualified property for such taxable year.

(*b*) The taxpayer may exclude from an election to apply this section all (but not less than all) subsidiary assets. Subsidiary assets so excluded are not qualified property for such taxable year. For purposes of this subdivision the term ''subsidiary assets'' includes jigs, dies, molds, returnable containers, glassware, silverware, textile mill cam assemblies, and other equipment includable in Group One, Class 5, of Revenue Procedure 62–21 which is usually and properly accounted for separately from other property and under a method of depreciation not expressed in terms of years.

(iii) *Special rule for certain public utility property*. (*a*) In the case of public utility property described in section 167(1)(3)(A)(iii) for which no guideline life was prescribed in Revenue Procedure 62–21 (or for which reference was made in Revenue Procedure 62–21 to lives or rates established by governmental regulatory agencies) of a taxpayer which—

(*1*) Is entitled to use a method of depreciation other than a ''subsection (1) method'' of depreciation (as defined in section 167(1)(3)(F)) only if it uses the ''normalization method of accounting'' (as defined in section 167(1)(3)(G)) with respect to such property, or

(*2*) Is entitled for the taxable year to use only a ''subsection (1) method'' of depreciation, such property shall be qualified property (as defined in subparagraph (3) of this paragraph) only if the taxpayer normalizes the tax deferral resulting from the election to apply this section.

(*b*) The taxpayer will be considered to normalize the tax deferral resulting from the election to apply this section only if it computes its tax expense for purposes of establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using a period for depreciation no less than the period used for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account for the taxable year, and the taxpayer makes adjustments to a reserve to reflect the deferral of taxes resulting from the use of a period for depreciation under section 167 in accordance with an election to apply this section different from the period used for computing its depreciation expense for ratemaking purposes and for reflecting operating results in its regulated books of account for the taxable year. A determination whether the taxpayer is considered to normalize under this subdivision the tax deferral resulting from the election to apply this section shall be made in a manner consistent with the principles for determining whether a taxpayer is using the ''normalization method of accounting'' (within the meaning of section 167(1)(3)(G)). See § 1.167(l)–1(h).

(*c*) If a taxpayer, which has elected to apply this section to any qualified public utility property and is required under (*a*) of this subdivision to normalize the tax deferral resulting from the election to apply this section to such property, fails to normalize such tax deferral, the election to apply this section to such property shall terminate as of the beginning of the taxable year for which the taxpayer fails to normalize such tax deferral. Application of this section to such property for any period prior to the termination date will not be affected by this termination.

(5) *Determination of reasonable allowance for depreciation*—(i) *In general*. The allowance for depreciation of qualified property to which the taxpayer elects to apply this section shall be determined in accordance with this section. The annual allowance for depreciation is determined by using the method of depreciation adopted by the taxpayer and a rate based upon a life permitted by this section. In the case of the straight-line method of depreciation, the rate of depreciation shall be based upon the class life (or individual life if the taxpayer assigns individual depreciable lives in accordance with subdivision (iii) of this subparagraph) used by the taxpayer with respect to the assets in the asset guideline class. Such rate will be applied to the unadjusted basis of the asset guideline class (individual assets or depreciation accounts if the taxpayer assigns individual depreciable lives). In the case of the sum of the years-digits method of depreciation,

the rate of depreciation will be determined based upon the remaining life of the class (or individual remaining lives if the taxpayer assigns such lives in accordance with subdivision (iii) of this subparagraph) and is applied to the adjusted basis of the class (or individual accounts or assets) as of the beginning of the taxable year of election. The remaining life of a depreciation account is determined by dividing the unrecovered cost or other basis of the account, as computed by straight-line depreciation, by the gross cost or unadjusted basis of the account, and multiplying the result by the class life used with respect to the account. In the case of the declining balance method of depreciation, the rate of depreciation for the asset guideline class shall be based upon the class life (or individual life if the taxpayer assigns such lives in accordance with subdivision (iii) of this subparagraph). Such rate is applied to the adjusted basis of the class (or individual accounts or assets) as of the beginning of the taxable year of election.

(ii) *Reasonable allowance by reference to class lives.* The amount of depreciation for all qualified property in an asset guideline class to which the taxpayer elects to apply this section will constitute the reasonable allowance provided by section 167(a) and the depreciation for the asset guideline class will not be adjusted if—

(*a*) The taxpayer's qualified property is accounted for in one or more depreciation accounts which conform to the asset guideline class, and the depreciation for each such account is determined by using a rate based upon a life not less than the class life, or

(*b*) The taxpayer's qualified property is accounted for in one or more depreciation accounts (whether or not conforming to the asset guideline class) for which depreciation is determined at a rate based upon the taxpayer's estimate of the lives of the assets (instead of the class life) and the total amount of depreciation so determined for the asset guideline class for the taxable year of election is not more than would be permitted under (*a*) of this subdivision for such year using the method of depreciation adopted by the taxpayer for the property.

See subdivision (vii) of this subparagraph for determination of reasonable allowance if depreciation exceeds the amount permitted by this subdivision. See paragraph (b) of this section for rules regarding the determination of ''class life''. For rules for regrouping depreciation accounts to conform to the asset guideline class, see subdivision (iv) of this subparagraph.

(iii) *Consistency when individual lives are used.* If the taxpayer assigns individual depreciable lives to assets in accordance with subdivision (ii)(*b*) of this subparagraph, even though the total amount of depreciation for the asset guideline class will not be adjusted, the lives assigned to the various assets in the asset guideline class must be reasonably in proportion to their relative expected periods of use in the taxpayer's business. Thus, although the taxpayer who uses individual asset lives normally has latitude in thereby allocating the depreciation for the asset guideline class among the assets, if the lives are grossly disproportionate (as where a short life is assigned to one asset and a long life to another even though the expected periods of use are the same), the taxpayer's allocation of depreciation to particular assets or depreciation accounts may be adjusted. For example, the taxpayer's allocation may be adjusted for purposes of determining adjusted basis under section 1016(a) or in allocating depreciation to the 50-percent limitation on percentage depletion provided by section 613(a). See paragraph (d) of this section for rules regarding the use of individual asset lives for purposes of classifying retirements as normal or abnormal.

(iv) *Regrouping depreciation accounts.* Without the consent of the Commissioner, the taxpayer may for any taxable year for which he elects to apply this section to an asset guideline class, regroup his accounts for that and all succeeding taxable years to conform to the asset guideline class. Other changes in accounting, including a change from item accounts to multiple-asset accounting, may be made with the consent of the Commissioner. No depreciation accounts for which the straight line or sum of the years-digits method of depreciation is adopted may be combined under this section which would not be permitted to be combined under part III of Revenue Procedure 65–13, as in effect on January 1, 1971. Accordingly, whether or not the taxpayer adopted the guideline system of Revenue Procedure 62–21 for a taxable year to which part III of Revenue Procedure 65–13 is applicable, the depreciation allowance for any taxable year of election under this section may not exceed that amount which would have been allowed for such year if the taxpayer had used item accounts or year of acquisition accounts. Thus, for example, if a calendar year taxpayer acquired a $90 asset on the first day of each year from 1966 through 1970, placed such assets in a single multiple asset account, adopted the sum of the years-digits method of depreciation and used a 5-year depreciable life for such assets, and in 1971 uses the 5-year class life determined under paragraph (b) of this section, the depreciation allowance for such assets in 1971 under this section may not exceed $60, that is, the amount which would be allowed if the taxpayer had used year of acquisition accounts for the assets for the years 1966 through 1970.

For purposes of this subparagraph, a taxpayer's depreciation accounts conform to the asset guideline class if each depreciation account includes only assets of the same asset guideline class.

(v) *Method of depreciation.* The same method of depreciation must be applied to all property in a single depreciation account. The method of depreciation is subject to the limitations of section 167 (c), (j), and (l). Except as otherwise provided in this subdivision, the taxpayer must apply a method of depreciation described in section 167(b) (1), (2), or (3) for qualified property to which the taxpayer elects to apply this section. A method of depreciation permitted under section 167(b)(4) may be used under this section if the method was used by the taxpayer with respect to the property for his last taxable year ending before January 1, 1971, the method is expressed in terms of years, the taxpayer establishes to the satisfaction of the Commissioner that the method is both a reasonable and consistent method, and if the taxpayer applies paragraph (b)(2) of this section (relating to class lives in special situations) to determine a class life, that the method of determining such class life is consistent with the principles of Revenue Procedure 62–21 as applied to such a method. If the taxpayer has applied a method of depreciation with respect to the property which is not described in section 167(b) (1), (2), (3), or (4) (as permitted under the preceding sentence), he must change under this section to a method of depreciation described in section 167(b) (1), (2), or (3) for the first taxable year for which an election is made under this section. Other changes in depreciation method may be made with the consent of the Commissioner (see sec. 446 and the regulations thereunder). (See also sec. 167(e).)

(vi) *Salvage value.* In applying the method of depreciation adopted by the taxpayer, the annual allowance for depreciation is determined without adjustment for the salvage value of the property, except that no depreciation account may be depreciated below a reasonable salvage value for the account. See paragraph (c) of this section for definition and treatment of salvage value.

(vii) *Reasonable allowance when depreciation exceeds amount based on class life.* In the event that the total amount of depreciation claimed by the taxpayer on his income tax return, in a claim for refund, or otherwise, for an asset guideline class with respect to which an election is made under this section for the taxable year, exceeds the maximum amount permitted under subdivision (ii)(*a*) of this subparagraph—

(*a*) If the excess is established to the satisfaction of the Commissioner to be the result of a good faith mistake by the taxpayer in determining the maximum amount permitted under subdivision (ii) (*a*) of this subparagraph, the taxpayer's election to apply this section will be treated as valid and only such excess will be disallowed, and

(*b*) In all other cases, the taxpayer's election to apply this section to the asset guideline class for the taxable year is invalid and the reasonable allowance for depreciation will be determined without regard to this section. (See § 1.167(a)–1 (b) for rules regarding the estimated useful life of property.)

(b) *Determination of class lives*—(1) *Class lives in general.* The class life determined under this paragraph (without regard to any range or variance permitted with respect to class lives under §1.167(a)–11) will be applied for purposes of determining whether the allowance for depreciation for qualified property included in an election under this section is subject to adjustment. The taxpayer is not required to use the class life determined under this paragraph for purposes of determining the allowance for depreciation. Except as provided in subparagraph (2) of this paragraph, the class life of qualified property to which the taxpayer elects to apply this section is the shorter of—

(i) The asset guideline period for the asset guideline class as set forth in Revenue Procedure 72–10 as in effect on March 1, 1972 (applied without regard to any special provision therein with respect to property predominantly used outside the United States), or

(ii) The asset guideline period for the asset guideline class as set forth in any supplement or revision of Revenue Procedure 72–10, but only if and to the extent by express reference in such supplement or revision made applicable for the purpose of changing the asset guideline period or classification of qualified property to which this section applies.

See paragraph (e)(3)(iii) of this section for requirement that the election for the taxable year specify the class life for each asset guideline class. Generally, the applicable asset guideline class and asset guideline period for qualified property to which the taxpayer has elected to apply this section will not be changed for the taxable year of election to reflect any supplement or revision thereof after the taxable year. However, if expressly provided in such a supplement or revision, the taxpayer may, at his option in the manner specified therein, apply the revised or supplemented asset guideline classes or periods to such property for such taxable year and succeeding taxable years. The principles of this subparagraph may be illustrated by the following example:

Example. (i) Corporation X, a calendar year taxpayer, has assets in asset guideline class 20.4 of Revenue Procedure 72–10 which were placed in service by corporation X in 1967, 1968, and 1970. Corporation X also has assets in asset guideline class 22.1 of Revenue Procedure 72–10 which were placed in service at various times prior to 1971. Corporation X has no other qualified property. Corporation X elects to apply this section for 1971 to both classes. Assume that the class lives are determined under this subparagraph and not under subparagraph (2) of this paragraph.

(ii) The class lives for asset guideline classes 20.4 and 22.1 are their respective asset guideline periods of 12 years and 9 years in Revenue Procedure 72–10.

(iii) Accordingly, in the election for the taxable year, in accordance with paragraph (e)(3)(iii) of this section, corporation X specifies a class life of 12 years for asset guideline class 20.4 and a class life of 9 years for asset guideline class 22.1.

(2) *Class lives in special situations.* Notwithstanding subparagraph (1) of this paragraph, for the purposes of this section the class life for the asset guideline class determined under this subparagraph shall be used if such class life is shorter than the class life determined under subparagraph (1) of this paragraph. If property described in paragraph (a)(2)(iii) of this section in an asset guideline class is acquired by the taxpayer in a transaction to which section 381(a) applies, for purposes of this subparagraph such property shall be segregated from other property in the class and treated as in a separate asset guideline class, and the class life for that asset guideline class under this subparagraph shall be the shortest class life the transferor was entitled to use under this section for such property on the date of such transfer. In all other cases, the class life for the asset guideline class for purposes of this subparagraph shall be the shortest class life (within the meaning of sec. 4, part II, of Revenue Procedure 62–21) which can be justified by application of secs. 3.02(a), 3.03(a), or 3.05, part II, of Revenue Procedure 62–21 (other than the portion of such sec. 3.05 dealing with justification of a class life by reference to facts and circumstances) for the taxpayer's last taxable year ending prior to January 1, 1971.

A class life justified by application of section 3.03(a), Part II, of Revenue Procedure 62–21 shall not be shorter than can be justified under the Adjustment Table for Class Lives in Part III of such Revenue Procedure. For purposes of this subparagraph and paragraph (f)(1)(iii) of this section, the reserve ratio test is met only if the taxpayer's reserve ratio does not exceed the upper limit of the appropriate reserve ratio range or in the alternative during the transitional period there provided does not exceed the appropriate ''transitional upper limit'' in section 3, Part II, of Revenue Procedure 65–13. References to Revenue Procedure 62–21 include all morifications, amendments, and supplements thereto as of January 1, 1971. The guideline form of the reserve ratio test, as described in Revenue Procedure 65–13, may be applied for purposes of this subparagraph in a manner consistent with the rules contained in section 7, Part II, of Revenue Procedure 65–13 and sections 3.02, 3.03, and 3.05, Part II, of Revenue Procedure 62–21. The principles of this subparagraph may be illustrated by the following examples:

Example 1. Corporation X, a calendar year taxpayer, has all its assets in asset guideline class 20.4 of Revenue Procedure 72–10 which were placed in service by corporation X prior to 1971. Corporation X elects to apply this section for 1971. For taxable years 1967 through 1969, corporation X had used a class life (within the meaning of section 4, Part II, of Revenue Procedure 62–21) for asset guideline class 20.4 of 12 years. The asset guideline period in Revenue Procedure 72–10 in effect for 1971 is also 12 years. Assume that for 1969 corporation X's reserve ratio was below the appropriate reserve ratio lower limit. However, corporation X could not justify a class life shorter than the asset guideline period of 12 years for 1970 since corporation X had not used the 12-year class life for a period at least equal to one-half of 12 years. (See section 3.03(a), Part II, of Revenue Procedure 62–21.) Accordingly, the class life for asset guideline class 20.4 in 1971 is the asset guideline period of 12 years in accordance with subparagraph (1) of this paragraph.

Example 2. The facts are the same as in example (1) except that corporation X had used a class life of 10 years for guideline class 20.4 since 1967. Corporation X had not used the class life of 10 years for a period at least equal to one-half of 10 years. However, in 1968 corporation X's 10-year class life was accepted on audit by the Internal Revenue Service and corporation X met the reserve ratio test in 1970 for guideline class 20.4 using a test life of 10 years. (See section 3.05, Part II, of Revenue Procedure 62–21.) Accordingly, the class life of 10 years is justified for 1970 and the class life for 1971 is 10 years in accordance with this subparagraph. If the taxpayer's class life had not been audited and accepted for 1968, and in the absence of other circumstances, the taxpayer could not justify a class life shorter than the asset guideline period of 12 years since it had not used the 10-year class life for a period at least equal to one-half of 10 years. (See section 3.02, Part II, of Revenue Procedure 62–21.)

Example 3. Corporation Y, a calendar year taxpayer, has all its assets in asset guideline class 13.3 of Revenue Procedure 72–10 which were placed in service from 1960 through 1970. Corporation Y elects to apply this section for 1971. The asset guideline period in Revenue Procedure 72–10 in effect for 1971 is 16 years. Since 1963 corporation Y had used a class life of 16 years for asset guideline 13.3. At the end of 1969 corporation Y's reserve ratio for guideline class 13.3 was 36 percent. With a growth rate of 8 percent and a test life of 16 years the appropriate reserve ratio lower limit was 37 percent. Corporation Y's reserve ratio of 36 percent was below the lower limit of the appropriate reserve ratio range. Corporation Y had used the 16-year class life for at least eight years. A class life of 13.5 years for 1970 was justified by application of section 3.03(a), Part II, of Revenue Procedure 62–21 and the Adjustment Table for Class Lives in Part III, of Revenue Procedure 62–21. The class life for 1971 is 13.5 years in accordance with this subparagraph.

(3) *Classification of property*—(i) *In general.* Property to which this section applies shall be included in the asset guideline class for the activity in which the property is primarily used in the taxable year of election. See paragraph (d)(5) of this section for rule regarding the classification of leased property.

(ii) *Insubstantial activity.* The provisions of Revenue Produce 62–21 with respect to classification of assets used in an activity which is insubstantial may be applied under this section.

(iii) *Special rule for certain public utilities.* An electric or gas utility which in accordance with Revenue Procedure 64–21 used a composite guideline class basis for applying Revenue Procedure 62–21 for its last taxable year prior to January 1, 1971, may apply Revenue Procedure 72–10 and this section on the basis of such composite asset guideline class determined as provided in Revenue Procedure 64–21. For the purposes of this section all property in the composite guideline class shall be treated as included in a single asset guideline class.

(c) *Salvage value*—(1) *In general*—(i) *Definition of gross salvage value.* ''Gross salvage'' value is the amount (determined at or as of the time of acquisition but without regard to the application of Revenue Procedure 62–21) which is estimated will be realized upon a sale or other disposition of qualified property when it is no longer useful in the taxpayer's trade or business or in the production of his income and is to be retired from service, without reduction for the cost of removal, dismantling, demolition, or similar operations. ''Net salvage'' is gross salvage reduced by the cost of removal, dismantling, demolition, or similar operations. If a taxpayer customarily sells or otherwise disposes of property at a time when such property is still in good operating condition, the gross salvage value of such property is the amount expected to be realized upon such sale or disposition, and under certain circumstances, as where such property is customarily sold at a time when it is still relatively new, the gross salvage value may constitute a relatively large proportion of the unadjusted basis of such property.

(ii) *Definition of salvage value.* ''Salvage value'' for purposes of this section means gross or net salvage value less the amount, if any, by which reduced by application of section 167(f). Generally, as provided in section 167(f), a taxpayer may reduce the gross or net salvage value for an account by an amount which does not exceed 10 percent of the unadjusted basis of the personal property (as defined in section 167(f)(2)) in the account.

(2) *Estimation of salvage value*—(i) *In general.* For the first taxable year for which he elects to apply this section, the taxpayer must (in accordance with paragraph (e)(3)(iv)(*c*) of this section) establish salvage value for all qualified property to which the election applies. The taxpayer may (in accordance with subparagraph (1) of this paragraph) determine either gross or net salvage, but an election under this section does not constitute permission to change the manner of estimating salvage. Permission to change the manner of estimating salvage must be obtained by filing form 3115 with the Commissioner of Internal Revenue, Washington, D.C. 20224, within the time otherwise permitted for the taxable year or before September 6, 1973. Salvage value in succeeding taxable years of election will be determined by adjustments of such initial salvage value for the account, as retirements occur. This salvage value established by the taxpayer for the first taxable year of election will not be redetermined merely as a result of fluctuations in price levels or as a result of other circumstances occurring after the close of such taxable year. See paragraph (e)(3)(iv) of this section for requirements that the taxpayer specify in his election the aggregate amount of salvage value for an asset guideline class and that the taxpayer maintain records reasonably sufficient to identify the salvage value established for each depreciation account in the class.

(ii) *Salvage as limitation on depreciation.* In no case may an account be depreciated under this section below a reasonable salvage value, after taking into account any reduction in gross or net salvage value permitted by section 167(f). For example, if the salvage value of an account for 1971 is $75, the unadjusted basis of the account is $500, and the depreciation reserve is $425, no depreciation is allowable for 1971.

(iii) *Special rule for first taxable year.* If for a taxable year ending prior to January 1, 1971, the taxpayer had adopted Revenue Procedure 62–21 prior to January 12, 1971 (see paragraph (f)(2) of this section), no adjustment in the amount of depreciation allowable for any taxable year ending prior to January 1, 1971, shall be made solely by reason of establishing salvage value under this paragraph for any taxable year ending after December 31, 1970. The principles of this subdivision may be illustrated by the following example:

Example. Taxpayer A had adopted Revenue Procedure 62–21 prior to January 12, 1971, for taxable years prior to 1971. Taxpayer A had not taken into account any salvage value for account No. 1 which is one of four depreciation accounts A has in the class. The reserve ratio test has been met for all years prior to 1971 and in accordance with Revenue Procedure 62–21 no adjustments in depreciable lives or salvage values were made. At the end of A's taxable year 1970, the unadjusted basis of account No. 1 was $10,000 and the reserve for depreciation was $9,800. Pursuant to this paragraph, A establishes a salvage value of $400 for account No. 1 (determined at or as of the time of acquisition). This salvage value is determined to be correct. No depreciation is allowable for account No. 1 in 1971. No depreciation is disallowed for any taxable year prior to 1971, solely by reason of establishing salvage value under this paragraph.

(3) *Limitation on adjustment of reasonable salvage value.* The salvage value established by the taxpayer for a depreciation account will not be redetermined if it is reasonable. Since the determination of salvage value is a matter of estimation, minimal adjustments will not be made. The salvage value established by the taxpayer will be deemed to be reasonable unless there is sufficient basis for a determination of an amount of salvage value for the account which exceeds the salvage value established by the taxpayer for the account by an amount greater than 10 percent of the unadjusted basis of the account at the close of such taxable year. If the salvage value established by the taxpayer for the account is not within the 10-percent range or if the taxpayer follows the practice of understating his estimates of salvage to take advantage of this subdivision, and if there is a determination of an amount of salvage value for the account for the taxable year which exceeds the salvage value established by the taxpayer for the account for such taxable year, an adjustment will be made by increasing the salvage value established by the taxpayer for the account by an amount equal to the difference between the salvage value as determined and the salvage value established by the taxpayer for the account. For the purposes of this subdivision, a determination of salvage value shall include all determinations at all levels of audit and appellate proceedings, and as well as all final determinations within the meaning of section 1313(a)(1). This subparagraph shall apply to each such determination.

(4) *Examples.* The principles of this paragraph may be illustrated by the following examples in which it is assumed that the taxpayer has established salvage value in accordance with this paragraph and has not followed a practice of understating his estimates of salvage value:

Example 1. Taxpayer B elects to apply this section for 1971. Assets Y and Z are the only assets in a multiple asset account of 1967, the year in which the assets were acquired. The unadjusted basis of asset Y is $50,000 and the unadjusted basis of asset Z is $30,000. B estimated a gross salvage value of $55,000 at the time of acquisition. The property qualified under section 167(f)(2) and B reduced the amount of salvage taken into account by $8,000 (that is, 10 percent of $80,000, under sec. 167(f)). Thus, in accordance with this paragraph and paragraph (e)(3)(iv)(*c*) of this section, B establishes a salvage value of $47,000 for the account for 1971. Assume that there is not sufficient basis for determining a salvage value for the account greater $52,000 (that is $60,000 minus the $8,000 reduction under sec. 167(f)). Since the salvage value of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage for the account will not be redetermined.

Example 2. The facts are the same as in example (1) except that B estimated a gross salvage value of $50,000 and establishes a salvage value of $42,000 for the account (that is, $50,000 minus the $8,000 reduction under section 167(f)). There is sufficient basis for determining an amount of salvage value greater than $50,000 (that is, $58,000 minus the $8,000 reduction under section 167(f)). The salvage value of $42,000 established by B for the account can be redetermined without regard to the limitation in subparagraph (3) of this paragraph, since it is not within the 10 percent range. Upon audit of B's tax return for 1971 (a year in which the redetermination would affect the amount of depreciation allowable for the account), salvage value is determined to be $52,000 after taking into account the reduction under section 167(f). Salvage value for the account will be adjusted to $52,000.

Example 3. The facts are the same as in example (1) except that upon audit of B's tax return for 1971 the examining officer determines the salvage value to be $58,000 (that is, $66,000 minus the $8,000 reduction under section 167(f)), and proposes to adjust salvage value for the account to $58,000 which will result in disallowing an amount of depreciation for the taxable year. B does not agree with the finding of the examining officer. After receipt of a ''30-day letter,'' B waives a district conference and initiates proceedings before the Appellate Division. In consideration of the case by the Appellate Division it is concluded that there is not sufficient basis for determining an amount of salvage value for the account in excess of $55,000 (that is, $63,000 minus the $8,000 reduction under section 167(f)). Since the salvage value of $47,000 established by B for the account is within the 10 percent range, it is reasonable. Salvage value for the account will not be redetermined.

Example 4. For 1971, taxpayer C elects to apply this section to factory building X which is in an item account of 1965, the year in which the building was acquired. The unadjusted basis of factory building X is $90,000. C estimated a gross salvage value for the account of $10,000. The property did not qualify under section 167(f)(2). Thus, C establishes a salvage value of $10,000 for the account for 1971. Assume that there is not sufficient basis for determining a salvage value for the account greater than $14,000. Since the salvage value of $10,000 established by C for the account is within the 10-percent range, it is reasonable. Salvage value for the account will not be redetermined.

(d) *Accounting for qualified property*—(1) *In general.* Qualified property for which the taxpayer elects to apply this section may be accounted for in any number of item or multiple asset accounts.

(2) *Retirements of qualified property*—(i) *In general.* The provisions of this subparagraph and §1.167(a)–8 apply to retirements of qualified property to which the taxpayer elects to apply this section for the taxable year. See subdivision (iii) of this subparagraph for special rule for normal retirements.

(ii) *Adjusted basis of assets retired.* In the case of a taxpayer who depreciates qualified property in a multiple-asset account conforming to the asset guideline class at a rate based on the class life in accordance with paragraph (a)(5)(ii)(*a*) of this section, §1.167(a)–8(c) (relating to basis of assets retired) shall be applied by assuming that the class life is the average expected useful life of the assets in the account. See §1.167(a)–8, generally, for the basis of assets retired.

(iii) *Definition of normal retirements.* Notwithstanding §1.167(a)–8(b), the determination whether a retirement of qualified property is normal or abnormal shall be made in light of all the facts and circumstances, primarily with reference to the expected period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section. A retirement is not abnormal unless the taxpayer can show that the withdrawal of the asset was not due to a cause which would customarily be contemplated (in light of the taxpayer's practice and experience) in setting a depreciation rate for the assets without regard to paragraph (a)(5)(ii) of this section. Thus, for example, a retirement is normal if made within the range of years which would customarily be taken into account in setting such depreciation rate and if the asset has reached a condition at which, in the normal course of events, the taxpayer customarily retires similar assets from use in his business. A retirement may be abnormal if the asset is withdrawn at an earlier time or under other circumstances, as, for example, when the asset has been damaged by casualty or has lost its usefulness suddenly as the result of extraordinary obsolescence.

(3) *Special rules*—(i) *In general.* The provisions of this subparagraph shall apply to qualified property in a taxable year for which an election to apply this section is made.

(ii) *Repairs.* For the purpose of sections 162 and 263 and the regulations thereunder, whether an expenditure prolongs the life of an asset shall be determined by reference to the expected period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section.

(iii) *Sale and lease.* For the purpose of comparison with the term of a lease of such property, the remaining life of qualified property shall be determined by reference to the expected period of use of the asset in the taxpayer's business without regard to paragraph (a)(5)(ii) of this section.

(4) *Expected period of use.* For the purposes of subparagraphs (2) and (3) of this paragraph, the determination of the expected period of use of an asset shall be made in light of all the facts and circumstances. The expected period of use of a particular asset will not necessarily coincide with the class life used for depreciation (or with the individual asset life for depreciation under the alternative method in paragraph (a)(5)(ii) (*b*) of this section for applying the class life). Thus, for example, if the question is whether an asset has been leased for a period less than, equal to or greater than its remaining life, the determination shall be based on the remaining expected period of use of the individual asset without regard to the fact that the asset is depreciated at a rate based on the class life in accordance with paragraph (a)(5)(ii)(*a*) of this section.

(5) *Leased property.* In the case of a lessor of qualified property, unless there is an asset guideline class in effect for such lessors, the asset guideline class for such property shall be determined by reference to the activity in which such property is primarily used by the lessee. See paragraph (b)(3) of this section for general rule for classification of qualified property according to primary use. However, in the case of an asset guideline class based upon the type of property (such as trucks or railroad cars), as distinguished from the activity in which used, the property shall be classified without regard to the activity of the lessee.

(e) *Election under this section*—(1) *Consent to change in method of accounting.* An election to apply this section for a taxable year ending after December 31, 1970, is a method of accounting but the consent of the Commissioner will be deemed granted to make an annual election.

(2) *Election for taxable years ending after December 31, 1976.* For taxable years ending after December 31, 1976, the election to apply this section for a taxable year shall be made by attaching to the income tax return a statement that an election under this section is being made. If the taxpayer does not file a timely return (taking into account extensions of time for filing) for the taxable year, the election shall be made at the time the taxpayer files his first return for the taxable year. The election may be made with an amended return only if such amended return is filed no later than the time prescribed by law (including extensions thereof) for filing the return for the taxable year. A taxpayer who makes an election under this subparagraph must maintain books and records reflecting the information described in paragraph (e)(3) (ii) and (iii) of this section.

(3) *Election for taxable years ending on or before December 31, 1976.* (i) For taxable years ending on or before December 31, 1976, the election to apply this section for a taxable year may be made by filing Form 5006 with the income tax return for the taxable year. If the taxpayer does not file a timely return (taking into account extensions of time for filing) for the taxable year, the election shall be filed at the time the taxpayer files his first return for the taxable year. The election may be made with an amended return only if such amended return is filed no later than the later of (*a*) the time prescribed by law (including extensions thereof) for filing the return for the taxable year, or (*b*) November 5, 1973.

(ii) The election to apply this section for a taxable year ending on or before December 31, 1976, will be deemed to be made if the tax return (filed within the periods referred to in paragraph (e)(3)(i) of this section) contains information sufficient to establish the following:

(*a*) Each asset guideline class for which the election is intended to apply;

(*b*) The class life for each such asset guideline class and whether the class life is determined under paragraph (b)(1) or (2) of this section;

(*c*) For each asset guideline class, as of the end of the taxable year of election, (*1*) the total unadjusted basis of all qualified property, (*2*) the aggregate of the reserves for depreciation of all accounts in the asset guideline class, and (*3*) the aggregate of the salvage value established for all accounts in the asset guideline class; and

(*d*) Whether the taxpayer is an electric or gas utility using a composite asset guideline class basis in accordance with paragraph (b)(3)(iii) of this section.

If an election is deemed to be made under this subdivision (ii), the taxpayer will be deemed to have consented to apply all the provisions of this section.

(iii) A taxpayer to whom the election applies shall maintain books and records for each asset guideline class reasonably sufficient to identify the unadjusted basis, reserve for depreciation and salvage value established for each depreciation account in such asset guidelines class.

(f) *Depreciation for taxable years ending before January 1, 1971*—(1) *Adoption of Revenue Procedure 62–21*—(i) *In general.* Except as provided in subdivision (ii) of this subparagraph, a taxpayer may elect to be examined under the provisions of Revenue Procedure 62–21 for a taxable year ending before January 1, 1971, only in accordance with the rules of this paragraph. The election must specify:

(*a*) That the taxpayer makes such election and consents to, and agrees to apply, all the provisions of this paragraph;

(*b*) Each guideline class and taxable year for which the taxpayer elects to be examined under Revenue Procedure 62–21;

(*c*) The class life claimed for each such guideline class;

(*d*) The class life and the total amount of the depreciation for the guideline class claimed on the last income tax return for such taxable year filed prior to January 12, 1971 (or in case no income tax return was filed prior to January 12, 1971, on the first income tax return filed for such taxable year);

(*e*) The class life claimed and the total amount of depreciation for the guideline class under the election to apply Revenue Procedure 62–21, in accordance with this paragraph, for the taxable year; and

(*f*) If the class life or total amount of depreciation for the guideline class is different in (*d*) and (*e*) of this subdivision, a reasonable description of the computation of the class life in (*e*) of this subdivision, the amount of difference in tax liability resulting therefrom, and the amount of any refund or reduction in any deficiency in tax. The election shall be made in an amended tax return or claim for refund (or by a supplement to the tax return or claim) for the taxable year, and if the class life or total amount of depreciation for the guideline class is different in accordance with (*f*) of this subdivision, such difference shall be reflected in the amended tax return or claim for refund. Forms may be provided for making the election and submission of the information. In the case of an election made after issuance of such forms and more than 30 days after publication of notice thereof in the Internal Revenue Bulletin, the election may be made and the information submitted only in accordance with such forms. An election will not otherwise be invalid under this paragraph so long as there is substantial compliance, in good faith, with the requirements of this paragraph.

(ii) *Special rule.* The provisions of this subparagraph shall not apply to a guideline class in any taxable year for which the taxpayer has prior to January 12, 1971, adopted Revenue Procedure 62–21 for such class. See subparagraph (2) of this paragraph for determination of adoption of Revenue Procedure 62–21 prior to January 12, 1971.

(iii) *Justification of class life claimed and limitations on refunds.* If the taxpayer elects for a taxable year to be examined under the provisions of Revenue Procedure 62–21 in accordance with subdivision (i) of this subparagraph, any of the provisions of Revenue Procedure 62–21 may be applied to justify a class life claimed on the income tax return filed for such year or to offset an increase in tax liability for such year. Unless it meets the reserve ratio test, no class life will be accepted on audit which (after all other adjustments in tax liability for such year) results in a reduction (or further reduction) in the amount of tax liability shown on the income tax return (specified in subdivision (i)(*d*) of this subparagraph) for such taxable year, or results in an amount of loss carryback or carryover to any taxable year, but if it is justified under Revenue Procedure 62–21 and meets the reserve ratio test, a class life will be accepted on audit without regard to the foregoing limitations and, for example, may produce a refund or credit against tax. For example, if a class life of 9 years is otherwise justified under Revenue Procedure 62–21 for 1969, but the taxpayer does not meet the reserve ratio test for 1969 using a test life of 9 years, a class life of 9 years (or any class life justified under Revenue Procedure 62–21) will be accepted on audit under Revenue Procedure 62–21 pursuant to an election in accordance with this paragraph provided it does not result in the reduction or further reduction in tax liability or in an amount of loss carryback or carryover as described in the preceding sentence. On the other hand, for example, if a class life of 10 years is justified under Revenue Procedure 62–21 for 1969 and the taxpayer meets the reserve ratio test for 1969 using a test life of 10 years, a class life of 10 years will be accepted on audit under Revenue Procedure 62–21 pursuant to an election in accordance with this paragraph even though it results in a reduction or further reduction in tax liability or in an amount of loss carryback or carryover as described above and produces a refund of tax. For purposes of this section, the term ''audit'' includes examination of claims for refund or credit against tax.

(iv) *Definitions.* For purposes of this paragraph, the determination whether the reserve ratio test is met shall be made in accordance with that portion of paragraph (b)(2) of this section which is by express reference therein made applicable to this paragraph. In addition, the guideline form of the reserve ratio test, as described in Revenue Procedure 65–13, may be applied. For purposes of this paragraph, references to Revenue Procedure 62–21 include all modifications, amendments, and supplements thereto as of January 11, 1971. The terms ''class life'' and ''guideline class'' have the same meaning as in Revenue Procedure 62–21.

(2) *Determination whether Revenue Procedure 62–21 adopted prior to January 12, 1971*—(i) *In general.* For the purposes of this paragraph, a taxpayer will be treated as having adopted prior to January 12, 1971, Revenue Procedure 62–21 for a guideline class for a taxable year ending before January 1, 1971, only if—

(*a*) For the guideline class and taxable year, the taxpayer adopted Revenue Procedure 62–21 by expressly so indicating on the income tax return filed for such taxable year prior to January 12, 1971;

(*b*) For the guideline class and taxable year, the taxpayer adopted Revenue Procedure 62–21 prior to January 12, 1971, by expressly so indicating in a proceeding before the Internal Revenue Service (such as upon examination of the income tax return for such taxable year) and there is reasonable evidence to that effect; or

(*c*) There is other reasonable evidence that prior to January 12, 1971, the taxpayer adopted Revenue Procedure 62–21 for the guideline class and taxable year.

If not treated under (*b*) or (*c*) of this subdivision as having done so for the last taxable year ending before January 1, 1971, and if the taxpayer files his first income tax return for such taxable year after January 11, 1971, the taxpayer will be treated as having adopted Revenue Procedure 62–21 prior to January 12, 1971, for a guideline class for such taxable year if he expressly so indicated on that return, or is treated under this subparagraph as having adopted Revenue Procedure 62–21 prior to January 12, 1971, for that guideline class for the immediately preceding taxable year.

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

Example 1. Taxpayer A, an individual who uses the calendar year as his taxable year, has property in Group Three, Class 16(a), of Revenue Procedure 62–21. On A's income tax return for 1968, filed prior to January 12, 1971, he adopted Revenue Procedure 62–21 for the guideline class by so indicating under ''Summary of Depreciation'' in the appropriate schedule of Form 1040 for 1968. Under subdivision (i) (*a*) of this subparagraph, A is treated as having adopted Revenue Procedure 62–21 for the guideline class for 1968 prior to January 12, 1971.

Example 2. Taxpayer B, an individual who uses the calendar year as his taxable year, has property in Group Two, Class 5, of Revenue Procedure 62–21. B filed timely income tax returns for 1966 through 1968 but did not adopt Revenue Procedures 62–21 on any of such returns. In 1969 upon audit of B's taxable years 1966 through 1968, B exercised his option to be examined under the provisions of Revenue Procedure 62–21. The Revenue Agent's report shows that B was examined under Revenue Procedure 62–21 for taxable years 1966 through 1968. B will be treated under subdivision (ii)(*b*) of this subparagraph as having adopted Revenue Procedure 62–21 for such years prior to January 12, 1971.

Example 3. The facts are the same as in example (2) except that B did not upon examination by the Revenue Agent in 1969 exercise his option to be examined under Revenue Procedure 62–21. B has six accounts in the guideline class, Nos. 1 through 6. The Revenue Agent proposed to lengthen the depreciable lives on accounts Nos. 2 and 3 from 8 years to 12 years. In proceedings before the Appellate Division in 1970, B exercised his option to be examined under the provisions of Revenue Procedure 62–21. This is shown by correspondence between B and the Appellate Conferee as well as by other documents in the case before the Appellate Division. The case was settled on that basis before the Appellate Division without adjustment of the depreciable lives for B's accounts Nos. 2 and 3. B will be treated under subdivision (ii) (*b*) of this subparagraph as having adopted Revenue Procedure 62–21 for taxable years 1966 through 1968 prior to January 12, 1971.

Example 4. Corporation X uses the calendar year as its taxable year and has assets in Group Two, Class 5, of Revenue Procedure 62–21. Beginning in 1964, corporation X used the guideline life of 10 years as the depreciable life for all assets in the guideline class. In 1967, corporation X's taxable years 1964 through 1966 were examined and corporation X exercised its option to be examined under the provisions of Revenue Procedure 62–21. Corporation X did not adopt Revenue Procedure 62–21 on any of its income tax returns, for the years 1964 through 1970. Corporation X has not been examined since 1967, but has continued to use the guideline life of 10 years for all property in the guideline class including additions since 1966. Corporation X will be treated under subdivision (ii) (*c*) and (*d*) of this subparagraph as having adopted Revenue Procedure 62–21 prior to January 12, 1971, for taxable years 1964 through 1970.

Example 5. Corporation Y uses the calendar year as its taxable year and has asset in Group Two, Class 5, of Revenue Procedure 62–21. Since 1964, corporation Y has used various depreciable lives, based on the facts and circumstances, for different accounts in the guideline class. Corporation Y was examined in 1968 for taxable years 1965 through 1967. Corporation Y was also examined in 1970 for taxable years 1968 and 1969. Corporation Y did not exercise its option to be examined under the provisions of Revenue Procedure 62–21. Corporation Y has not adopted Revenue Procedure 62–21 on any income tax return. For taxable years 1964 through 1970, corporation Y's class life (within the meaning of section 4, Part II, of Revenue Procedure 62–21) was between 12 and 14 years. In August of 1971, corporation Y filed amended income tax returns for 1968 and 1969, and an income tax return for 1970, using a depreciable life of 10 years (equal to the guideline life) for all assets in the guideline class. Corporation Y will not be treated as having adopted Revenue Procedure 62–21 prior to January 12, 1971.

Example 6. Corporation Z uses the calendar year as its taxable year and has assets in group 2, class 5, of Revenue Procedure 62–21. Corporation Z adopted Revenue Procedure 62–21 for this guideline class by expressly so indicating on its tax return for 1966, which was filed before January 12, 1971. Corporation Z computed its allowable depreciation for 1966 as if it adopted Revenue Procedure 62–21 for this guideline class for its taxable years 1962 through 1965, although it had earlier filed its tax returns for those years without regard to Revenue Procedure 62–21. The depreciation thus claimed in 1966 was less than what would have been allowable if corporation Z first adopted Revenue Procedure 62–21 in 1966. This was the result of certain accounts becoming fully depreciated through use of Revenue Procedure 62–21 in computing depreciation for 1962 through 1965. In addition, in deferred tax accounting procedures employed before January 12, 1971, for financial reporting purposes, corporation Z calculated its tax deferrals on the basis that it had adopted Revenue Procedure 62–21 for the years 1962 through 1965. Corporation Z will be treated under subdivision (i) (*c*) of this subparagraph as having adopted Revenue Procedure 62–21 for taxable years 1962 through 1965 prior to January 12, 1971.

(Sec. 167(m), 85 Stat. 508 (26 U.S.C. 167))

[T.D. 7278, 38 FR 14923, June 7, 1973, as amended by T.D. 7315, 39 FR 20195, June 7, 1974; T.D. 7517, 42 FR 58934, Nov. 14, 1977]

§ 1.167(a)–13T Certain elections for intangible property (temporary).

For rules applying the elections under section 13261(g) (2) and (3) of the Omnibus Budget Reconciliation Act of 1993 to intangible property described in section 167(f), see § 1.197–1T.

[59 FR 11922, Mar. 15, 1994]

§ 1.167(a)–14 Treatment of certain intangible property excluded from section 197.

(a) *Overview.* This section provides rules for the amortization of certain intangibles that are excluded from section 197 (relating to the amortization of goodwill and certain other intangibles). These excluded intangibles are specifically described in § 1.197–2(c) (4), (6), (7), (11), and (13) and include certain computer software and certain other separately acquired rights, such as rights to receive tangible property or services, patents and copyrights, certain mortgage servicing rights, and rights of fixed duration or amount. Intangibles for which an amortization amount is determined under section 167(f) and intangibles otherwise excluded from section 197 are amortizable only if they qualify as property subject to the allowance for depreciation under section 167(a).

(b) *Computer software*—(1) *In general.* The amount of the deduction for computer software described in section 167(f)(1) and § 1.197–2(c)(4) is determined by amortizing the cost or other basis of the computer software using the straight line method described in § 1.167(b)–1 (except that its salvage value is treated as zero) and an amortization period of 36 months beginning on the first day of the month that the computer software is placed in service. Before determining the amortization deduction allowable under this paragraph (b), the cost or other basis of computer software that is section 179 property, as defined in section 179(d)(1)(A)(ii), must be reduced for any portion of the basis the taxpayer properly elects to treat as an expense under section 179. In addition, the cost or other basis of computer software that is qualified property under section 168(k)(2) and §1.168(k)–1 or §1.168(k)–2, as applicable, 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)–1 or §, or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)–1, must be reduced by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k) or section 1400L(b) for the computer software. If costs for developing computer software that the taxpayer properly elects to defer under section 174(b) result in the development of property subject to the allowance for depreciation under section 167, the rules of this paragraph (b) will apply to the unrecovered costs. In addition, this paragraph (b) applies to the cost of separately acquired computer software if the cost to acquire the software is separately stated and the cost is required to be capitalized under section 263(a).

(2) *Exceptions.* Paragraph (b)(1) of this section does not apply to the cost of computer software properly and consistently taken into account under §1.162–11. The cost of acquiring an interest in computer software that is included, without being separately stated, in the cost of the hardware or other tangible property is treated as part of the cost of the hardware or other tangible property that is capitalized and depreciated under other applicable sections of the Internal Revenue Code.

(3) *Additional rules.* Rules similar to those in §1.197–2 (f)(1)(iii), (f)(1)(iv), and (f)(2) (relating to the computation of amortization deductions and the treatment of contingent amounts) apply for purposes of this paragraph (b).

(c) *Certain interests or rights not acquired as part of a purchase of a trade or business*—(1) *Certain rights to receive tangible property or services.* The amount of the deduction for a right (other than a right acquired as part of a purchase of a trade or business) to receive tangible property or services under a contract or from a governmental unit (as specified in section 167(f)(2) and §1.197–2(c)(6)) is determined as follows:

(i) *Amortization of fixed amounts.* The basis of a right to receive a fixed amount of tangible property or services is amortized for each taxable year by multiplying the basis of the right by a fraction, the numerator of which is the amount of tangible property or services received during the taxable year and the denominator of which is the total amount of tangible property or services received or to be received under the terms of the contract or governmental grant. For example, if a taxpayer acquires a favorable contract right to receive a fixed amount of raw materials during an unspecified period, the taxpayer must amortize the cost of acquiring the contract right by multiplying the total cost by a fraction, the numerator of which is the amount of raw materials received under the contract during the taxable year and the denominator of which is the total amount of raw materials received or to be received under the contract.

(ii) *Amortization of unspecified amount over fixed period.* The cost or other basis of a right to receive an unspecified amount of tangible property or services over a fixed period is amortized ratably over the period of the right. (See paragraph (c)(3) of this section regarding renewals).

(iii) *Amortization in other cases.* [Reserved]

(2) *Rights of fixed duration or amount.* The amount of the deduction for a right (other than a right acquired as part of a purchase of a trade or business) of fixed duration or amount received under a contract or granted by a governmental unit (specified in section 167(f)(2) and §1.197–2(c)(13)) and not covered by paragraph (c)(1) of this section is determined as follows:

(i) *Rights to a fixed amount.* The basis of a right to a fixed amount is amortized for each taxable year by multiplying the basis by a fraction, the numerator of which is the amount received during the taxable year and the denominator of which is the total amount received or to be received under the terms of the contract or governmental grant.

(ii) *Rights to an unspecified amount over fixed duration of less than 15 years.* The basis of a right to an unspecified amount over a fixed duration of less than 15 years is amortized ratably over the period of the right.

(3) *Application of renewals.* (i) For purposes of paragraphs (c) (1) and (2) of this section, the duration of a right under a contract (or granted by a governmental unit) includes any renewal period if, based on all of the facts and circumstances in existence at any time during the taxable year in which the right is acquired, the facts clearly indicate a reasonable expectancy of renewal.

(ii) The mere fact that a taxpayer will have the opportunity to renew a contract right or other right on the same terms as are available to others, in a competitive auction or similar process that is designed to reflect fair market value and in which the taxpayer is not contractually advantaged, will generally not be taken into account in determining the duration of such right provided that the bidding produces a fair market value price comparable to the price that would be obtained if the rights were purchased immediately after renewal from a person (other than the person granting the renewal) in an arm's-length transaction.

(iii) The cost of a renewal not included in the terms of the contract or governmental grant is treated as the acquisition of a separate intangible asset.

(4) *Patents and copyrights.* If the purchase price of an interest (other than an interest acquired as part of a purchase of a trade or business) in a patent or copyright described in section 167(f)(2) and §1.197–2(c)(7) is payable on at least an annual basis as either a fixed amount per use or a fixed percentage of the revenue derived from the use of the patent or copyright, the depreciation deduction for a taxable year is equal to the amount of the purchase price paid or incurred during the year. Otherwise, the basis of such patent or copyright (or an interest therein) is depreciated either ratably over its remaining useful life or under section 167(g) (income forecast method). If a patent or copyright becomes valueless in any year before its legal expiration, the adjusted basis may be deducted in that year.

(5) *Additional rules.* The period of amortization under paragraphs (c) (1) through (4) of this section begins when the intangible is placed in service, and rules similar to those in §1.197–2(f)(2) apply for purposes of this paragraph (c).

(d) *Mortgage servicing rights*—(1) *In general.* The amount of the deduction for mortgage servicing rights described in section 167(f)(3) and §1.197–2(c)(11) is determined by using the straight line method described in §1.167(b)–1 (except that the salvage value is treated as zero) and an amortization period of 108 months beginning on the first day of the month that the rights are placed in service. Mortgage servicing rights are not depreciable to the extent the rights are stripped coupons under section 1286.

(2) *Treatment of rights acquired as a pool*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, all mortgage servicing rights acquired in the same transaction or in a series of related transactions are treated as a single asset (the pool) for purposes of determining the depreciation deduction under this paragraph (d) and any gain or loss from the sale, exchange, or other disposition of the rights. Thus, if some (but not all) of the rights in a pool become worthless as a result of prepayments, no loss is recognized by reason of the prepayment and the adjusted basis of the pool is not affected by the unrecognized loss. Similarly, any amount realized from the sale or exchange of some (but not all) of the mortgage servicing rights is included in income and the adjusted basis of the pool is not affected by the realization.

(ii) *Multiple accounts.* If the taxpayer establishes multiple accounts within a pool at the time of its acquisition, gain or loss is recognized on the sale or exchange of all mortgage servicing rights within any such account.

(3) *Additional rules.* Rules similar to those in §1.197–2(f)(1)(iii), (f)(1)(iv), and (f)(2) (relating to the computation of amortization deductions and the treatment of contingent amounts) apply for purposes of this paragraph (d).

(e) *Effective dates*—(1) *In general.* This section applies to property acquired after January 25, 2000, except that §1.167(a)–14(c)(2) (depreciation of the cost of certain separately acquired rights) and so much of §1.167(a)–14(c)(3) as relates to §1.167(a)–14(c)(2) apply to property acquired after August 10, 1993 (or July 25, 1991, if a valid retroactive election has been made under §1.197–1T).

(2) *Change in method of accounting.* See §1.197–2(l)(4) for rules relating to changes in method of accounting for property to which §1.167(a)–14 applies. However, see §1.168(k)–1(g)(4) or 1.1400L(b)–1(g)(4) for rules relating to changes in method of accounting for computer software to which the third sentence in §1.167(a)–14(b)(1) applies.

(3) *Qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or section 179 property.* This section also applies to computer software that is qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to computer software that is 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. This section also applies to computer software that is section 179 property placed in service by a taxpayer in a taxable year beginning after 2002. The language ''or §1.168(k)–2, as applicable,'' in the third sentence in paragraph (b)(1) of this section applies to computer software that is qualified property under section 168(k)(2) and placed in service by a taxpayer during or after the taxpayer's taxable year that includes September 24, 2019. However, a taxpayer may choose to apply the language ''or §1.168(k)–2, as applicable,'' in the third sentence in paragraph (b)(1) of this section for computer software that is qualified property under section 168(k)(2) and acquired and placed in service after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017. A taxpayer may rely on the language ''or §1.168(k)–2, as applicable,'' in the third sentence in paragraph (b)(1) of this section in regulation project REG–104397–18 (2018–41 I.R.B. 558) (see §601.601(d)(2)(ii)(b) of this chapter) for computer software that is qualified property under section 168(k)(2) and acquired and placed in service after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017, and ending before the taxpayer's taxable year that includes September 24, 2019..

[T.D. 8867, 65 FR 3825, Jan. 25, 2000, as amended by T.D. 9091, 68 FR 52990, Sept. 8, 2003; T.D. 9283, 71 FR 51737, Aug. 31, 2006; T.D. 9874, 84 FR 50125, Sept. 24, 2019]

§ 1.167(b)–0 Methods of computing depreciation.

(a) *In general.* Any reasonable and consistently applied method of computing depreciation may be used or continued in use under section 167. Regardless of the method used in computing depreciation, deductions for depreciation shall not exceed such amounts as may be necessary to recover the unrecovered cost or other basis less salvage during the remaining useful life of the property. The reasonableness of any claim for depreciation shall be determined upon the basis of conditions known to exist at the end of the period for which the return is made. It is the responsibility of the taxpayer to establish the reasonableness of the deduction for depreciation claimed. Generally, depreciation deductions so claimed will be changed only where there is a clear and convincing basis for a change.

(b) *Certain methods.* Methods previously found adequate to produce a reasonable allowance under the Internal Revenue Code of 1939 or prior revenue laws will, if used consistently by the taxpayer, continue to be acceptable under section 167(a). Examples of such methods which continue to be acceptable are the straight line method, the declining balance method with the rate limited to 150 percent of the applicable straight line rate, and under appropriate circumstances, the unit of production method. The methods described in section 167(b) and §§ 1.167(b)–1, 1.167(b)–2, 1.167(b)–3, and 1.167(b)–4 shall be deemed to produce a reasonable allowance for depreciation except as limited under section 167(c) and § 1.167(c)–1. See also § 1.167(e)–1 for rules relating to change in method of computing depreciation.

(c) *Application of methods.* In the case of item accounts, any method which results in a reasonable allowance for depreciation may be selected for each item of property, but such method must thereafter be applied consistently to that particular item. In the case of group, classified, or composite accounts, any method may be selected for each account. Such method must be applied to that particular account consistently thereafter but need not necessarily be applied to acquisitions of similar property in the same or subsequent years, provided such acquisitions are set up in separate accounts. See, however, § 1.167(e)–1 and section 446 and the regulations thereunder, for rules relating to changes in the method of computing depreciation, and § 1.167(c)–1 for restriction on the use of certain methods. See also § 1.167(a)–7 for definition of account.

§ 1.167(b)–1 Straight line method.

(a) *In general.* Under the straight line method the cost or other basis of the property less its estimated salvage value is deductible in equal annual amounts over the period of the estimated useful life of the property. The allowance for depreciation for the taxable year is determined by dividing the adjusted basis of the property at the beginning of the taxable year, less salvage value, by the remaining useful life of the property at such time. For convenience, the allowance so determined may be reduced to a percentage or fraction. The straight line method may be used in determining a reasonable allowance for depreciation for any property which is subject to depreciation under section 167 and it shall be used in all cases where the taxpayer has not adopted a different acceptable method with respect to such property.

(b) *Illustrations.* The straight line method is illustrated by the following examples:

Example 1. Under the straight line method items may be depreciated separately:

Year and item	Cost or other basis less salaries	Useful life (years)	Depreciation allowable		
			1954	1955	1956
1954:					
Asset A	$1,600	4	[1] $200	$400	$400
Asset B	12,000	40	[1] 150	300	300

[1] In this example it is assumed that the assets were placed in service on July 1, 1954.

Example 2. In group, classified, or composite accounting, a number of assets with the same or different useful lives may be combined into one account, and a single rate of depreciation, *i.e.*, the group, classified, or composite rate used for the entire account. In the case of group accounts, *i.e.*, accounts containing assets which are similar in kind and which have approximately the same estimated useful lives, the group rate is determined from the average of the useful lives of the assets. In the case of classified or composite accounts, the classified or composite rate is generally computed by determining the amount of one year's depreciation for each item or each group of similar items, and by dividing the total depreciation thus obtained by the total cost or other basis of the assets. The average rate so obtained is to be used as long as subsequent additions, retirements, or replacements do not substantially alter the relative proportions of different types of assets in the account. An example of the computation of a classified or composite rate follows:

Cost or other basis	Estimated useful life (years)	Annual depreciation
$10,000	5	$2,000
10,000	15	667
20,000		2,667

Average rate is 13.33 percent ($2,667 ÷ $20,000) unadjusted for salvage. Assuming the estimated salvage value is 10 percent of the cost or other basis, the rate adjusted for salvage will be 13.33 percent minus 10 percent of 13.33 percent (13.33% − 1.33%), or 12 percent.

Example 3. The use of the straight line method for group, classified, or composite accounts is illustrated by the following example: A taxpayer filing his returns on a calendar year basis maintains an asset account for which a group rate of 20 percent has been determined, before adjustment for salvage. Estimated salvage is determined to be 6⅔ percent, resulting in an adjusted rate of 18.67 percent. During the years illustrated, the initial investment, additions, retirements, and salvage recoveries, which were determined not to change the composition of the group sufficiently to require a change in rate, were assumed to have been made as follows:

1954—Initial investment of $12,000.

1957—Retirement $2,000, salvage realized $200.

1958—Retirement $2,000, salvage realized $200.

1959—Retirement $4,000, salvage realized $400.

1959—Additions $10,000.

1960—Retirement $2,000, no salvage realized.

1961—Retirement $2,000, no salvage realized.

DEPRECIABLE ASSET ACCOUNT AND DEPRECIATION COMPUTATION ON AVERAGE BALANCES

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average balance	Rate (percent)	Allowable depreciation
1954		$12,000		$12,000	$6,000	18.67	$1,120
1955	$12,000			12,000	12,000	18.67	2,240
1956	12,000			12,000	12,000	18.67	2,240
1957	12,000		$2,000	10,000	11,000	18.67	2,054
1958	10,000		2,000	8,000	9,000	18.67	1,680
1959	8,000	10,000	4,000	14,000	11,000	18.67	2,054
1960	14,000		2,000	12,000	13,000	18.67	2,427
1961	12,000		2,000	10,000	11,000	18.67	2,054

CORRESPONDING DEPRECIATION RESERVE ACCOUNT

Year	Depreciation reserve Jan. 1	Depreciation allowable	Current retirements	Salvage realized	Depreciation reserve Dec. 31
1954		$1,120			$1,120
1955	$1,120	2,240			3,360
1956	3,360	2,240			5,600
1957	5,600	2,054	$2,000	$200	5,854
1958	5,854	1,680	2,000	200	5,734
1959	5,734	2,054	4,000	400	4,188
1960	4,188	2,427	2,000		4,615
1961	4,615	2,054	2,000		4,669

§ 1.167(b)–2 Declining balance method.

(a) *Application of method.* Under the declining balance method a uniform rate is applied each year to the unrecovered cost or other basis of the property. The unrecovered cost or other basis is the basis provided by section 167(g), adjusted for depreciation previously allowed or allowable, and for all other adjustments provided by section 1016 and other applicable provisions of law. The declining balance rate may be determined without resort to formula. Such rate determined under section 167(b)(2) shall not exceed twice the appropriate straight line rate computed without adjustment for salvage. While salvage is not taken into account in determining the annual allowances under this method, in no event shall an asset (or an account) be depreciated below a reasonable salvage value. However, see section 167(f) and § 1.167(f)–1 for rules which permit a reduction in the amount of salvage value to be taken into account for certain personal property acquired after October 16, 1962. Also, see section 167(c) and § 1.167(c)–1 for restrictions on the use of the declining balance method.

(b) *Illustrations.* The declining balance method is illustrated by the following examples:

Example 1. A new asset having an estimated useful life of 20 years was purchased on January 1, 1954, for $1,000. The normal straight line rate (without adjustment for salvage) is 5 percent, and the declining balance rate at twice the normal straight line rate is 10 percent. The annual depreciation allowances for 1954, 1955, and 1956 are as follows:

Year	Basis	Declining balance rate (percent)	Depreciation allowance
1954	$1,000	10	$100
1955	900	10	90
1956	810	10	81

Example 2. A taxpayer filing his returns on a calendar year basis maintains a group account to which a 5 year life and a 40 percent declining balance rate are applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of paragraph (b) of §1.167(b)–1. Although salvage value is not taken into consideration in computing a declining balance rate, it must be recognized and accounted for when assets are retired.

DEPRECIABLE ASSET ACCOUNT AND DEPRECIATION COMPUTATION USING AVERAGE ASSET AND RESERVE BALANCES

Year	Asset balance Jan. 1	Current additions	Current retirements	Asset balance Dec. 31	Average	Average reserve before depreciation	Net depreciable balance	Rate (pct.)	Allowable depreciation
1954	....	$12,000	....	$12,000	$6,000	....	$6,000	40	$2,400
1955	$12,000	....	....	12,000	12,000	$2,400	9,600	40	3,840
1956	12,000	....	....	12,000	12,000	6,240	5,760	40	2,304
1957	12,000	....	$2,000	10,000	11,000	7,644	3,356	40	1,342
1958	10,000	....	2,000	8,000	9,000	7,186	1,814	40	726
1959	8,000	10,000	4,000	14,000	11,000	5,212	5,788	40	2,315
1960	14,000	....	2,000	12,000	13,000	4,727	8,273	40	3,309
1961	12,000	....	2,000	10,000	11,000	6,036	4,964	40	1,986

DEPRECIATION RESERVE

Year	Reserve Jan. 1	Current retirements	Salvage realized	Reserve Dec. 31, before depreciation	Average reserve before depreciation	Allowable depreciation	Reserve Dec. 31, after depreciation
1954	....	....	....	....	....	$2,400	$2,400
1955	$2,400	....	....	$2,400	$2,400	3,840	6,240
1956	6,240	....	....	6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	2,315	5,727
1960	5,727	2,000	....	3,727	4,727	3,309	7,036
1961	7,036	2,000	....	5,036	6,036	1,986	7,022

Where separate depreciation accounts are maintained by year of acquisition and there is an unrecovered balance at the time of the last retirement, such unrecovered balance may be deducted as part of the depreciation allowance for the year of such retirement. Thus, if the taxpayer had kept separate depreciation accounts by year of acquisition and all the retirements shown in the example above were from 1954 acquisitions, depreciation would be computed on the 1954 and 1959 acquisitions as follows:

1954 ACQUISITIONS

Year	Asset balance Jan. 1	Acquisitions	Current retirements	Asset balance Dec. 31	Average balance	Avg. reserve before depreciation	Net depreciable balance	Rate (percent)	Allowable depreciation
1954	....	$12,000	....	$12,000	$6,000	....	$6,000	40	$2,400
1955	$12,000	....	....	12,000	12,000	$2,400	9,600	40	3,840
1956	12,000	....	....	12,000	12,000	6,240	5,760	40	2,304
1957	12,000	....	$2,000	10,000	11,000	7,644	3,356	40	1,342
1958	10,000	....	2,000	8,000	9,000	7,186	1,814	40	726
1959	8,000	....	4,000	4,000	6,000	5,212	788	40	315
1960	4,000	....	2,000	2,000	3,000	2,727	273	40	109
1961	2,000	....	2,000	....	1,000	836	164	....	[1] 164

[1] Balance allowable as depreciation in the year of retirement of the last survivor of the 1954 acquisitions.

DEPRECIATION RESERVE FOR 1954 ACQUISITIONS

Year	Reserve Jan. 1	Current retire-ments	Salvage realized	Reserve Dec. 31, before deprecia-tion	Average reserve before depre-ciation	Allow-able de-precia-tion	Reserve Dec. 31, after de-precia-tion
1954	....	....	....	....	....	$2,400	$2,400
1955	$2,400	....	....	$2,400	$2,400	3,840	6,240
1956	6,240	....	....	6,240	6,240	2,304	8,544
1957	8,544	$2,000	$200	6,744	7,644	1,342	8,086
1958	8,086	2,000	200	6,286	7,186	726	7,012
1959	7,012	4,000	400	3,412	5,212	315	3,727
1960	3,727	2,000	....	1,727	2,727	109	1,836
1961	1,836	2,000	....	(164)	836	164	....

1959 ACQUISITIONS

Year	Asset balance Jan. 1	Acquisi-tion	Asset balance Dec. 31	Avg. balance	Reserve Dec. 31, before depre-ciation	Net de-precia-ble bal-ance	Rate percent	Allow-able de-precia-tion	Reserve Dec. 31, after de-precia-tion
1959	....	$10,000	$10,000	$5,000	None	$5,000	40	$2,000	$2,000
1960	$10,000	....	10,000	10,000	$2,000	8,000	40	3,200	5,200
1961	10,000	....	10,000	10,000	5,200	4,800	40	1,920	7,120

In the above example, the allowable depreciation on the 1954 acquisitions totals $11,200. This amount when increased by salvage realized in the amount of $800, equals the entire cost or other basis of the 1954 acquisitions ($12,000).

(c) *Change in estimated useful life.* In the declining balance method when a change is justified in the useful life estimated for an account, subsequent computations shall be made as though the revised useful life had been originally estimated. For example, assume that an account has an estimated useful life of ten years and that a declining balance rate of 20 percent is applicable. If, at the end of the sixth year, it is determined that the remaining useful life of the account is six years, computations shall be made as though the estimated useful life was originally determined as twelve years. Accordingly, the applicable depreciation rate will be 16⅔ percent. This rate is thereafter applied to the unrecovered cost or other basis.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(b)–3 Sum of the years-digits method.

(a) *Applied to a single asset*—(1) *General rule.* Under the sum of the years-digits method annual allowances for depreciation are computed by applying changing fractions to the cost or other basis of the property reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator which remains constant is the sum of all the years digits corresponding to the estimated useful life of the asset. See section 167(c) and § 1.167(c)–1 for restrictions on the use of the sum of the years-digits method.

(i) *Illustrations.* Computation of depreciation allowances on a single asset under the sum of the years-digits method is illustrated by the following examples:

Example 1. A new asset having an estimated useful life of five years was acquired on January 1, 1954, for $1,750. The estimated salvage is $250. For a taxpayer filing his returns on a calendar year basis, the annual depreciation allowances are as follows:

Year	Cost or other basis less salvage	Fraction[1]	Allow-able de-precia-tion	Depre-ciation reserve
1954	$1,500	5/15	$500	$500
1955	1,500	4/15	400	900
1956	1,500	3/15	300	1,200
1957	1,500	2/15	200	1,400

Year	Cost or other basis less salvage	Fraction[1]	Allowable depreciation	Depreciation reserve
1958	1,500	1/15	100	1,500
Unrecovered value (salvage)	....	....	....	$250

[1] The denominator of the fraction is the sum of the digits representing the years of useful life, *i.e.*, 5, 4, 3, 2, and 1, or 15.

Example 2. Assume in connection with an asset acquired in 1954 that three-fourths of a year's depreciation is allowable in that year. The following illustrates a reasonable method of allocating depreciation:

	Depreciation for 12 months	Allowable depreciation		
		1954	1955	1956
1st year	$500	(3/4) $375	(1/4) $125	
2d year	400	....	(3/4) 300	(1/4) $100
3d year	300	....	....	(3/4) 225
Total		375	425	325

(ii) *Change in useful life.* Where in the case of a single asset, a change is justified in the useful life, subsequent computations shall be made as though the remaining useful life at the beginning of the taxable year of change were the useful life of a new asset acquired at such time and with a basis equal to the unrecovered cost or other basis of the asset at that time. For example, assume that a new asset with an estimated useful life of ten years is purchased in 1954. At the time of making out his return for 1959, the taxpayer finds that the asset has a remaining useful life of seven years from January 1, 1959. Depreciation for 1959 should then be computed as though 1959 were the first year of the life of an asset estimated to have a useful life of seven years, and the allowance for 1959 would be 7/28 of the unrecovered cost or other basis of the asset after adjustment for salvage.

(2) *Remaining life*—(i) *Application.* Under the sum of the years-digits method, annual allowances for depreciation may also be computed by applying changing fractions to the unrecovered cost or other basis of the asset reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the asset (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the digits corresponding to the years of estimated remaining useful life of the asset. For decimal equivalents of such fractions, see Table I of subdivision (ii) of this subparagraph. For example, a new asset with an estimated useful life of 10 years is purchased January 1, 1954, for $6,000. Assuming a salvage value of $500, the depreciation allowance for 1954 is $1,000 ($5,500 × 0.1818, the applicable rate from Table I). For 1955, the unrecovered balance is $4,500, and the remaining life is 9 years. The depreciation allowance for 1955 would then be $900 ($4,500 × 0.2000, the applicable rate from Table I).

(ii) *Table I.* This table shows decimal equivalents of sum of the years-digits fractions corresponding to remaining lives from 1 to 100 years.

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE

Remaining life (years)	Decimal equivalent
100.0	0.0198
99.9	.0198
99.8	.0198
99.7	.0199
99.6	.0199
99.5	.0199
99.4	.0199
99.3	.0199
99.2	.0200
99.1	.0200
99.0	.0200
98.9	.0200
98.8	.0200
98.7	.0201
98.6	.0201
98.5	.0201
98.4	.0201
98.3	.0201
98.2	.0202
98.1	.0202
98.0	.0202
97.9	.0202
97.8	.0202
97.7	.0203
97.6	.0203
97.5	.0203
97.4	.0203
97.3	.0203
97.2	.0204
97.1	.0204
97.0	.0204
96.9	.0204
96.8	.0204
96.7	.0205
96.6	.0205
96.5	.0205
96.4	.0205

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equiva-lent
96.3	.0206
96.2	.0206
96.1	.0206
96.0	.0206
95.9	.0206
95.8	.0207
95.7	.0207
95.6	.0207
95.5	.0207
95.4	.0207
95.3	.0208
95.2	.0208
95.1	.0208
95.0	.0208
94.9	.0209
94.8	.0209
94.7	.0209
94.6	.0209
94.5	.0209
94.4	.0210
94.3	.0210
94.2	.0210
94.1	.0210
94.0	.0211
93.9	.0211
93.8	.0211
93.7	.0211
93.6	.0211
93.5	.0212
93.4	.0212
93.3	.0212
93.2	.0212
93.1	.0213
93.0	.0213
92.9	.0213
92.8	.0213
92.7	.0213
92.6	.0214
92.5	.0214
92.4	.0214
92.3	.0214
92.2	.0215
92.1	.0215
92.0	.0215
91.9	.0215
91.8	.0216
91.7	.0216
91.6	.0216
91.5	.0216
91.4	.0216
91.3	.0217
91.2	.0217
91.1	.0217
91.0	.0217
90.9	.0218
90.8	.0218
90.7	.0218
90.6	.0218
90.5	.0219
90.4	.0219
90.3	.0219
90.2	.0219
90.1	.0220
90.0	.0220
89.9	.0220
89.8	.0220
89.7	.0221
89.6	.0221

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equiva-lent
89.5	.0221
89.4	.0221
89.3	.0221
89.2	.0222
89.1	.0222
89.0	.0222
88.9	.0222
88.8	.0223
88.7	.0223
88.6	.0223
88.5	.0223
88.4	.0224
88.3	.0224
88.2	.0224
88.1	.0224
88.0	.0225
87.9	.0225
87.8	.0225
87.7	.0225
87.6	.0226
87.5	.0226
87.4	.0226
87.3	.0226
87.2	.0227
87.1	.0227
87.0	.0227
86.9	.0228
86.8	.0228
86.7	.0228
86.6	.0228
86.5	.0229
86.4	.0229
86.3	.0229
86.2	.0229
86.1	.0230
86.0	.0230
85.9	.0230
85.8	.0230
85.7	.0231
85.6	.0231
85.5	.0231
85.4	.0231
85.3	.0232
85.2	.0232
85.1	.0232
85.0	.0233
84.9	.0233
84.8	.0233
84.7	.0233
84.6	.0234
84.5	.0234
84.4	.0234
84.3	.0234
84.2	.0235
84.1	.0235
84.0	.0235
83.9	.0236
83.8	.0236
83.7	.0236
83.6	.0236
83.5	.0237
83.4	.0237
83.3	.0237
83.2	.0238
83.1	.0238
83.0	.0238
82.9	.0238
82.8	.0239

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
82.7	.0239
82.6	.0239
82.5	.0240
82.4	.0240
82.3	.0240
82.2	.0240
82.1	.0241
82.0	.0241
81.9	.0241
81.8	.0242
81.7	.0242
81.6	.0242
81.5	.0242
81.4	.0243
81.3	.0243
81.2	.0243
81.1	.0244
81.0	.0244
80.9	.0244
80.8	.0244
80.7	.0245
80.6	.0245
80.5	.0245
80.4	.0246
80.3	.0246
80.2	.0246
80.1	.0247
80.0	.0247
79.9	.0247
79.8	.0248
79.7	.0248
79.6	.0248
79.5	.0248
79.4	.0249
79.3	.0249
79.2	.0249
79.1	.0250
79.0	.0250
78.9	.0250
78.8	.0251
78.7	.0251
78.6	.0251
78.5	.0252
78.4	.0252
78.3	.0252
78.2	.0253
78.1	.0253
78.0	.0253
77.9	.0253
77.8	.0254
77.7	.0254
77.6	.0254
77.5	.0255
77.4	.0255
77.3	.0255
77.2	.0256
77.1	.0256
77.0	.0256
76.9	.0257
76.8	.0257
76.7	.0257
76.6	.0258
76.5	.0258
76.4	.0258
76.3	.0259
76.2	.0259
76.1	.0259
76.0	.0260

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
75.9	.0260
75.8	.0260
75.7	.0261
75.6	.0261
75.5	.0261
75.4	.0262
75.3	.0262
75.2	.0262
75.1	.0263
75.0	.0263
74.9	.0264
74.8	.0264
74.7	.0264
74.6	.0265
74.5	.0265
74.4	.0265
74.3	.0266
74.2	.0266
74.1	.0266
74.0	.0267
73.9	.0267
73.8	.0267
73.7	.0268
73.6	.0268
73.5	.0268
73.4	.0269
73.3	.0269
73.2	.0270
73.1	.0270
73.0	.0270
72.9	.0271
72.8	.0271
72.7	.0271
72.6	.0272
72.5	.0272
72.4	.0272
72.3	.0273
72.2	.0273
72.1	.0274
72.0	.0274
71.9	.0274
71.8	.0275
71.7	.0275
71.6	.0275
71.5	.0276
71.4	.0276
71.3	.0277
71.2	.0277
71.1	.0277
71.0	.0278
70.9	.0278
70.8	.0279
70.7	.0279
70.6	.0279
70.5	.0280
70.4	.0280
70.3	.0280
70.2	.0281
70.1	.0281
70.0	.0282
69.9	.0282
69.8	.0282
69.7	.0283
69.6	.0283
69.5	.0284
69.4	.0284
69.3	.0284
69.2	.0285

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
69.1	.0285
69.0	.0286
68.9	.0286
68.8	.0287
68.7	.0287
68.6	.0287
68.5	.0288
68.4	.0288
68.3	.0289
68.2	.0289
68.1	.0289
68.0	.0290
67.9	.0290
67.8	.0291
67.7	.0291
67.6	.0292
67.5	.0292
67.4	.0292
67.3	.0293
67.2	.0293
67.1	.0294
67.0	.0294
66.9	.0295
66.8	.0295
66.7	.0295
66.6	.0296
66.5	.0296
66.4	.0297
66.3	.0297
66.2	.0298
66.1	.0298
66.0	.0299
65.9	.0299
65.8	.0299
65.7	.0300
65.6	.0300
65.5	.0301
65.4	.0301
65.3	.0302
65.2	.0302
65.1	.0303
65.0	.0303
64.9	.0303
64.8	.0304
64.7	.0304
64.6	.0305
64.5	.0305
64.4	.0306
64.3	.0306
64.2	.0307
64.1	.0307
64.0	.0308
63.9	.0308
63.8	.0309
63.7	.0309
63.6	.0310
63.5	.0310
63.4	.0311
63.3	.0311
63.2	.0312
63.1	.0312
63.0	.0313
62.9	.0313
62.8	.0313
62.7	.0314
62.6	.0314
62.5	.0315
62.4	.0315

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
62.3	.0316
62.2	.0316
62.1	.0317
62.0	.0317
61.9	.0318
61.8	.0318
61.7	.0319
61.6	.0319
61.5	.0320
61.4	.0320
61.3	.0321
61.2	.0322
61.1	.0322
61.0	.0323
60.9	.0323
60.8	.0324
60.7	.0324
60.6	.0325
60.5	.0325
60.4	.0326
60.3	.0326
60.2	.0327
60.1	.0327
60.0	.0328
59.9	.0328
59.8	.0329
59.7	.0329
59.6	.0330
59.5	.0331
59.4	.0331
59.3	.0332
59.2	.0332
59.1	.0333
59.0	.0333
58.9	.0334
58.8	.0334
58.7	.0335
58.6	.0336
58.5	.0336
58.4	.0337
58.3	.0337
58.2	.0338
58.1	.0338
58.0	.0339
57.9	.0340
57.8	.0340
57.7	.0341
57.6	.0341
57.5	.0342
57.4	.0342
57.3	.0343
57.2	.0344
57.1	.0344
57.0	.0345
56.9	.0345
56.8	.0346
56.7	.0347
56.6	.0347
56.5	.0348
56.4	.0348
56.3	.0349
56.2	.0350
56.1	.0350
56.0	.0351
55.9	.0351
55.8	.0352
55.7	.0353
55.6	.0353

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
55.5	.0354
55.4	.0355
55.3	.0355
55.2	.0356
55.1	.0356
55.0	.0357
54.9	.0358
54.8	.0358
54.7	.0359
54.6	.0360
54.5	.0360
54.4	.0361
54.3	.0362
54.2	.0362
54.1	.0363
54.0	.0364
53.9	.0364
53.8	.0365
53.7	.0366
53.6	.0366
53.5	.0367
53.4	.0368
53.3	.0368
53.2	.0369
53.1	.0370
53.0	.0370
52.9	.0371
52.8	.0372
52.7	.0372
52.6	.0373
52.5	.0374
52.4	.0374
52.3	.0375
52.2	.0376
52.1	.0377
52.0	.0377
51.9	.0378
51.8	.0379
51.7	.0379
51.6	.0380
51.5	.0381
51.4	.0382
51.3	.0382
51.2	.0383
51.1	.0384
51.0	.0385
50.9	.0385
50.8	.0386
50.7	.0387
50.6	.0388
50.5	.0388
50.4	.0389
50.3	.0390
50.2	.0391
50.1	.0391
50.0	.0392
49.9	.0393
49.8	.0394
49.7	.0394
49.6	.0395
49.5	.0396
49.4	.0397
49.3	.0398
49.2	.0398
49.1	.0399
49.0	.0400
48.9	.0401
48.8	.0402

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
48.7	.0402
48.6	.0403
48.5	.0404
48.4	.0405
48.3	.0406
48.2	.0406
48.1	.0407
48.0	.0408
47.9	.0409
47.8	.0410
47.7	.0411
47.6	.0411
47.5	.0412
47.4	.0413
47.3	.0414
47.2	.0415
47.1	.0416
47.0	.0417
46.9	.0418
46.8	.0418
46.7	.0419
46.6	.0420
46.5	.0421
46.4	.0422
46.3	.0423
46.2	.0424
46.1	.0425
46.0	.0426
45.9	.0426
45.8	.0427
45.7	.0428
45.6	.0429
45.5	.0430
45.4	.0431
45.3	.0432
45.2	.0433
45.1	.0434
45.0	.0435
44.9	.0436
44.8	.0437
44.7	.0438
44.6	.0439
44.5	.0440
44.4	.0440
44.3	.0441
44.2	.0442
44.1	.0443
44.0	.0444
43.9	.0445
43.8	.0446
43.7	.0447
43.6	.0448
43.5	.0449
43.4	.0450
43.3	.0451
43.2	.0452
43.1	.0453
43.0	.0455
42.9	.0456
42.8	.0457
42.7	.0458
42.6	.0459
42.5	.0460
42.4	.0461
42.3	.0462
42.2	.0463
42.1	.0464
42.0	.0465

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
41.9	.0466
41.8	.0467
41.7	.0468
41.6	.0469
41.5	.0471
41.4	.0472
41.3	.0473
41.2	.0474
41.1	.0475
41.0	.0476
40.9	.0477
40.8	.0478
40.7	.0480
40.6	.0481
40.5	.0482
40.4	.0483
40.3	.0484
40.2	.0485
40.1	.0487
40.0	.0488
39.9	.0489
39.8	.0490
39.7	.0491
39.6	.0493
39.5	.0494
39.4	.0495
39.3	.0496
39.2	.0497
39.1	.0499
39.0	.0500
38.9	.0501
38.8	.0502
38.7	.0504
38.6	.0505
38.5	.0506
38.4	.0508
38.3	.0509
38.2	.0510
38.1	.0511
38.0	.0513
37.9	.0514
37.8	.0515
37.7	.0517
37.6	.0518
37.5	.0519
37.4	.0521
37.3	.0522
37.2	.0524
37.1	.0525
37.0	.0526
36.9	.0528
36.8	.0529
36.7	.0530
36.6	.0532
36.5	.0533
36.4	.0525
36.3	.0536
36.2	.0538
36.1	.0539
36.0	.0541
35.9	.0542
35.8	.0543
35.7	.0545
35.6	.0546
35.5	.0548
35.4	.0549
35.3	.0551
35.2	.0552

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
35.1	.0554
35.0	.0556
34.9	.0557
34.8	.0559
34.7	.0560
34.6	.0562
34.5	.0563
34.4	.0565
34.3	.0566
34.2	.0566
34.1	.0570
34.0	.0571
33.9	.0573
33.8	.0575
33.7	.0576
33.6	.0578
33.5	.0580
33.4	.0581
33.3	.0583
33.2	.0585
33.1	.0586
33.0	.0588
32.9	.0590
32.8	.0592
32.7	.0593
32.6	.0595
32.5	.0597
32.4	.0599
32.3	.0600
32.2	.0602
32.1	.0604
32.0	.0606
31.9	.0608
31.8	.0610
31.7	.0611
31.6	.0613
31.5	.0615
31.4	.0617
31.3	.0619
31.2	.0621
31.1	.0623
31.0	.0625
30.9	.0627
30.8	.0629
30.7	.0631
30.6	.0633
30.5	.0635
30.4	.0637
30.3	.0639
30.2	.0641
30.1	.0643
30.0	.0645
29.9	.0647
29.8	.0649
29.7	.0651
29.6	.0653
29.5	.0656
29.4	.0658
29.3	.0660
29.2	.0662
29.1	.0664
29.0	.0667
28.9	.0669
28.8	.0671
28.7	.0673
28.6	.0675
28.5	.0678
28.4	.0680

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
28.3	.0682
28.2	.0685
28.1	.0687
28.0	.0690
27.9	.0692
27.8	.0694
27.7	.0697
27.6	.0699
27.5	.0702
27.4	.0704
27.3	.0707
27.2	.0709
27.1	.0712
27.0	.0714
26.9	.0717
26.8	.0719
26.7	.0722
26.6	.0724
26.5	.0727
26.4	.0730
26.3	.0732
26.2	.0735
26.1	.0738
26.0	.0741
25.9	.0743
25.8	.0746
25.7	.0749
25.6	.0752
25.5	.0754
25.4	.0757
25.3	.0760
25.2	.0763
25.1	.0766
25.0	.0769
24.9	.0772
24.8	.0775
24.7	.0778
24.6	.0781
24.5	.0784
24.4	.0787
24.3	.0790
24.2	.0793
24.1	.0797
24.0	.0800
23.9	.0803
23.8	.0806
23.7	.0809
23.6	.0813
23.5	.0816
23.4	.0819
23.3	.0823
23.2	.0826
23.1	.0830
23.0	.0833
22.9	.0837
22.8	.0840
22.7	.0844
22.6	.0847
22.5	.0851
22.4	.0854
22.3	.0858
22.2	.0862
22.1	.0866
22.0	.0870
21.9	.0873
21.8	.0877
21.7	.0881
21.6	.0885

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
21.5	.0888
21.4	.0892
21.3	.0896
21.2	.0901
21.1	.0905
21.0	.0909
20.9	.0913
20.8	.0917
20.7	.0921
20.6	.0925
20.5	.0930
20.4	.0934
20.3	.0939
20.2	.0943
20.1	.0948
20.0	.0952
19.9	.0957
19.8	.0961
19.7	.0966
19.6	.0970
19.5	.0975
19.4	.0980
19.3	.0985
19.2	.0990
19.1	.0995
19.0	.1000
18.9	.1005
18.8	.1010
18.7	.1015
18.6	.1020
18.5	.1025
18.4	.1030
18.3	.1036
18.2	.1041
18.1	.1047
18.0	.1053
17.9	.1058
17.8	.1063
17.7	.1069
17.6	.1074
17.5	.1080
17.4	.1086
17.3	.1092
17.2	.1098
17.1	.1105
17.0	.1111
16.9	.1117
16.8	.1123
16.7	.1129
16.6	.1135
16.5	.1142
16.4	.1148
16.3	.1155
16.2	.1162
16.1	.1169
16.0	.1176
15.9	.1183
15.8	.1190
15.7	.1197
15.6	.1204
15.5	.1211
15.4	.1218
15.3	.1226
15.2	.1234
15.1	.1242
15.0	.1250
14.9	.1257
14.8	.1265

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
14.7	.1273
14.6	.1281
14.5	.1289
14.4	.1297
14.3	.1306
14.2	.1315
14.1	.1324
14.0	.1333
13.9	.1342
13.8	.1350
13.7	.1359
13.6	.1368
13.5	.1378
13.4	.1387
13.3	.1397
13.2	.1407
13.1	.1418
13.0	.1429
12.9	.1438
12.8	.1448
12.7	.1458
12.6	.1469
12.5	.1479
12.4	.1490
12.3	.1502
12.2	.1514
12.1	.1526
12.0	.1538
11.9	.1549
11.8	.1561
11.7	.1573
11.6	.1585
11.5	.1597
11.4	.1610
11.3	.1624
11.2	.1637
11.1	.1652
11.0	.1667
10.9	.1680
10.8	.1693
10.7	.1707
10.6	.1721
10.5	.1736
10.4	.1751
10.3	.1767
10.2	.1783
10.1	.1800
10.0	.1818
9.9	.1833
9.8	.1849
9.7	.1865
9.6	.1882
9.5	.1900
9.4	.1918
9.3	.1938
9.2	.1957
9.1	.1978
9.0	.2000
8.9	.2018
8.8	.2037
8.7	.2057
8.6	.2077
8.5	.2099
8.4	.2121
8.3	.2145
8.2	.2169
8.1	.2195
8.0	.2222

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
7.9	.2244
7.8	.2267
7.7	.2292
7.6	.2317
7.5	.2344
7.4	.2372
7.3	.2401
7.2	.2432
7.1	.2465
7.0	.2500
6.9	.2527
6.8	.2556
6.7	.2587
6.6	.2619
6.5	.2653
6.4	.2689
6.3	.2727
6.2	.2768
6.1	.2811
6.0	.2857
5.9	.2892
5.8	.2929
5.7	.2969
5.6	.3011
5.5	.3056
5.4	.3103
5.3	.3155
5.2	.3210
5.1	.3269
5.0	.3333
4.9	.3379
4.8	.3429
4.7	.3481
4.6	.3538
4.5	.3600
4.4	.3667
4.3	.3739
4.2	.3818
4.1	.3905
4.0	.4000
3.9	.4063
3.8	.4130
3.7	.4205
3.6	.4286
3.5	.4375
3.4	.4474
3.3	.4583
3.2	.4706
3.1	.4844
3.0	.5000
2.9	.5088
2.8	.5185
2.7	.5294
2.6	.5417
2.5	.5556
2.4	.5714
2.3	.5897
2.2	.6111
2.1	.6364
2.0	.6667
1.9	.6786
1.8	.6923
1.7	.7083
1.6	.7273
1.5	.7500
1.4	.7778
1.3	.8125
1.2	.8571

TABLE I—DECIMAL EQUIVALENTS FOR USE OF SUM OF THE YEARS-DIGITS METHOD, BASED ON REMAINING LIFE—Continued

Remaining life (years)	Decimal equivalent
1.1	.9167
1.0	1.0000

NOTE: For determination of decimal equivalents of remaining lives falling between those shown in the above table, the taxpayer may use the next longest life shown in the table, interpolate from the table, or use the following formula from which the table was derived.

$D = 2R \,/\, (W + 2F)(W + 1)$

where:

D = Decimal equivalent.
R = Remaining life.
W = Whole number of years in remaining life.
F = Fractional part of a year in remaining life.

If the taxpayer desires to carry his calculations of decimal equivalents to a greater number of decimal places than is provided in the table, he may use the formula. The procedure adopted must be consistently followed thereafter.

(b) *Applied to group, classified, or composite accounts*—(1) *General rule.* The sum of the years-digits method may be applied to group, classified, or composite accounts in accordance with the plan described in subparagraph (2) of this paragraph or in accordance with other plans as explained in subparagraph (3) of this paragraph.

(2) *Remaining life plan.* The remaining life plan as applied to a single asset is described in paragraph (a)(2) of this section. This plan may also be applied to group, classified, or composite accounts. Under this plan the allowance for depreciation is computed by applying changing fractions to the unrecovered cost or other basis of the account reduced by estimated salvage. The numerator of the fraction changes each year to a number which corresponds to the remaining useful life of the account (including the year for which the allowance is being computed), and the denominator changes each year to a number which represents the sum of the years digits corresponding to the years of estimated remaining useful life of the account. Decimal equivalents of such fractions can be obtained by use of Table I under paragraph (a)(2)(ii) of this section. The proper application of this method requires that the estimated remaining useful life of the account be determined each year. This determination, of course, may be made each year by analysis, *i.e.*, by determining the remaining lives for each of the components in the account, and averaging them. The estimated remaining life of any account, however, may also be determined arithmetically. For example, it may be computed by dividing the unrecovered cost or other basis of the account, as computed by straight line depreciation, by the gross cost or other basis of the account, and multiplying the result by the average life of the assets in the account. Salvage value is not a factor for the purpose of determining remaining life. Thus, if a group account with an average life of ten years had at January 1, 1958, a gross asset balance of $12,600 and a depreciation reserve computed on the straight line method of $9,450, the remaining life of the account at January 1, 1958, would be computed as follows:

$\$12{,}600 - \$9{,}450 \div \$12{,}600 \times 10$ years equals 2.50 years.

Example. The use of the sum of the years-digits method with group, classified, or composite accounts under the remaining life plan is illustrated by the following example:

A calendar year taxpayer maintains a group account to which a five-year life is applicable. Original investment, additions, retirements, and salvage recoveries are the same as those set forth in example (3) of paragraph (b) of § 1.167(b)–1.

DEPRECIATION COMPUTATIONS ON A GROUP ACCOUNT UNDER REMAINING LIFE PLAN

	1	2	3	4	5	6	7	8	9	10	11	12	13	14
					Straight line amount	Straight line reserve	Remaining life	Asset balance reduced by salvage	Current additions reduced by salvage	Salvage realized	Sum of the years digits depreciation			
											Accumulated reserve Jan. 1	Unrecovered Jan. 1	Rate based on Col. (7) from Table 1	Allowable depreciation
Year	Asset balance Jan. 1	Current additions	Current retirements	Average asset balance	Col. (4) ÷ life	Col. (5) − Col. (3) accumulated Jan. 1	[Col. (1) − Col. (6) ÷ Col. (1)] × average service life	Col. (1) × (100% − 6.67%)	Col (2) × (100% − 6.67%)		Prior reserve + Col. (14) + Col. (10) − Col. (3)	Col. (8) − Col. (11)		Col. (12) × Col. (13) + ½ Col. (9) × F[2]
1954	....	$12,000	....	$6,000	[1] $1,200	....	5.00	....	$11,200	....	....	....	0.3333	$1,866
1955	$12,000	....	....	12,000	2,400	$1,200	4.50	$11,200	....	....	$1,866	$9,334	.3600	3,360
1956	12,000	....	....	12,000	2,400	3,600	3.50	11,200	....	....	5,226	5,974	.4375	2,614
1957	12,000	....	$2,000	11,000	2,200	6,000	2.50	11,200	....	$200	7,840	3,360	.5556	1,867
1958	10,000	....	2,000	9,000	1,800	6,200	1.90	9,333	....	200	7,907	1,426	.6786	968
1959	8,000	10,000	4,000	11,000	2,200	6,000	1.25	7,466	9,333	400	7,075	391	.8125	1,874
1960	14,000	....	2,000	13,000	2,600	4,200	3.50	13,066	....	....	5,349	7,717	.4375	3,376
1961	12,000	....	2,000	11,000	2,200	4,800	3.00	11,200	....	....	6,725	4,475	.5000	2,238
1962	....	....	....	....	....	5,000	....	....	....	....	6,963			

[1] ½ year's amount.
[2] F = Rate based on average service life (0.3333 in this example).

(3) *Other plans for application of the sum of the years-digits method.* Taxpayers who wish to use the sum of the years-digits method in computing depreciation for group, classified, or composite accounts in accordance with a sum of the years digits plan other than the remaining life plan described herein may do so only with the consent of the Commissioner. Request for permission to use plans other than that described shall be addressed to the Commissioner of Internal Revenue, Washington, D.C. 20224.

§ 1.167(b)–4 Other methods.

(a) Under section 167(b)(4) a taxpayer may use any consistent method of computing depreciation, such as the sinking fund method, provided depreciation allowances computed in accordance with such method do not result in accumulated allowances at the end of any taxable year greater than the total of the accumulated allowances which could have resulted from the use of the declining balance method described in section 167(b)(2). This limitation applies only during the first two-thirds of the useful life of the property. For example, an asset costing $1,000 having a useful life of six years may be depreciated under the declining balance method in accordance with § 1.167(b)–2, at a rate of 33⅓ percent. During the first four years or ⅔ of its useful life, maximum depreciation allowances under the declining balance method would be as follows:

	Current depreciation	Accumulated depreciation	Balance
Cost of asset	....	....	$1,000
First year	$333	$333	667
Second year	222	555	445
Third year	148	703	297
Fourth year	99	802	198

An annual allowance computed by any other method under section 167(b)(4) could not exceed $333 for the first year, and at the end of the second year the total allowances for the two years could not exceed $555. Likewise, the total allowances for the three years could not exceed $703 and for the four years could not exceed $802. This limitation would not apply in the fifth and sixth years. See section 167(c) and § 1.167(c)–1 for restriction on the use of certain methods.

(b) It shall be the responsibility of the taxpayer to establish to the satisfaction of the Commissioner that a method of depreciation under section 167(b)(4) is both a reasonable and consistent method and that it does not produce depreciation allowances in excess of the amount permitted under the limitations provided in such section.

§ 1.167(c)–1 Limitations on methods of computing depreciation under section 167(b) (2), (3), and (4).

(a) *In general.* (1) Section 167(c) provides limitations on the use of the declining balance method described in section 167(b)(2), the sum of the years-digits method described in section 167(b)(3), and certain other methods authorized by section 167(b)(4). These methods are applicable only to tangible property having a useful life of three years or more. If construction, reconstruction, or erection by the taxpayer began before January 1, 1954, and was completed after December 31, 1953, these methods apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection after December 31, 1953. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after December 31, 1953, consists of all costs of the property allocable to the period after December 31, 1953, including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after December 31, 1953, or that they be new in use. If construction or erection by the taxpayer began after December 31, 1953, the entire cost or other basis of such construction or erection qualifies for these methods of depreciation. In the case of reconstruction of property, these methods do not apply to any part of the adjusted basis of such property on December 31, 1953. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(2) If the property was not constructed, reconstructed, or erected by the taxpayer, these methods apply only if it was acquired after December 31, 1953, and if the original use of the property commences with the taxpayer and commences after December 31, 1953. For the purpose of the preceding sentence, property shall be deemed to be acquired when reduced to physical possession, or control. The term ''original use'' means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired after December 31, 1953, will not be treated as being put to original use by the taxpayer even though it is put to a different use, nor will a horse acquired for breeding purposes be treated as being put to original use by the taxpayer if prior to the purchase the horse was used for racing purposes. See §§1.167(b)–2, 1.167 (b)–3, and 1.167(b)–4 for application of the various methods.

(3) Assets having an estimated average useful life of less than three years shall not be included in a group, classified, or composite account to which the methods described in §§1.167 (b)–2, 1.167(b)–3, and 1.167(b)–4 are applicable. However, an incidental retirement of an asset from such an account prior to the expiration of a useful life of three years will not prevent the application of these methods to such an account.

(4) See section 381(c)(6) and the regulations thereunder for rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions.

(5) See §§1.1502–12(g) and 1.1502–13 for provisions dealing with depreciation of property received by a member of an affiliated group from another member of the group during a consolidated return period.

(6) Except in the cases described in subparagraphs (4) and (5) of this paragraph, the methods of depreciation described in §§1.167(b)–2, 1.167(b–(3), and 1.167(b)–4 are not applicable to property in the hands of a distributee, vendee, transferee, donee, or grantee unless the original use of the property begins with such person and the conditions required by section 167(c) and this section are otherwise met. For example, these methods of depreciation may not be used by a corporation with respect to property which it acquires from an individual or partnership in exchange for its stock. Similarly, if an individual or partnership receives property in a distribution upon dissolution of a corporation, these methods of depreciation may not be used with respect to property so acquired by such individual or partnership. As a further example, these methods of depreciation may not be used by a partnership with respect to contributed property, nor by a partner with respect to partnership property distributed to him. Moreover, where a partnership is entitled to use these depreciation methods, and the optional adjustment to basis of partnership property provided by section 743 is applicable, (i) in the case of an increase in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall not be entitled to use such methods with respect to such increase, and (ii) in the case of a decrease in the adjusted basis of the partnership property under such section, the transferee partner with respect to whom such adjustment is applicable shall include in his income an amount equal to the portion of the depreciation deducted by the partnership which is attributable to such decrease.

(b) *Illustrations.* (1) The application of these methods to property constructed, reconstructed, or erected by the taxpayer after December 31, 1953, may be illustrated by the following examples:

Example 1. If a building with a total cost of $100,000 is completed after December 31, 1953, and the portion attributable to construction after December 31, 1953, is determined by engineering estimates or by cost accounting records to be $30,000, the methods referred to in paragraph (a)(1) of this section are applicable only to the $30,000 portion of the total.

Example 2. In 1954, a taxpayer has an old machine with an unrecovered cost of $1,000. If he contracts to have it reconditioned, or reconditions it himself, at a cost of an additional $5,000, only the $5,000 may be depreciated under the methods referred to in paragraph (a)(1) of this section, whether or not the materials used for reconditioning are new in use.

Example 3. A taxpayer who acquired a building in 1940 makes major maintenance or repair expenditures in 1954 of a type which must be capitalized. For these expenditures the taxpayer may use a method of depreciation different from that used on the building (for example, the methods referred to in paragraph (a)(1) of this section) only if he accounts for such expenditures separately from the account which contained the original building. In such case, the unadjusted basis on any parts replaced shall be removed from the asset account and shall be charged to the appropriate depreciation reserve account. In the alternative he may capitalize such expenditures by charging them to the depreciation reserve account for the building.

(2) The application of these methods to property which was not constructed, reconstructed, or erected by the taxpayer but which was acquired after December 31, 1953, may be illustrated by the following examples:

Example 1. A taxpayer contracted in 1953 to purchase a new machine which he acquired in 1954 and put into first use in that year. He may use the methods referred to in paragraph (a)(1) of this section, in recovering the cost of the new machine.

Example 2. A taxpayer instead of reconditioning his old machine buys a ''factory reconditioned'' machine in 1954 to replace it. He cannot apply the methods referred to in paragraph (a)(1) of this section, to any part of the cost of the reconditioned machine since he is not the first user of the machine.

Example 3. In 1954, a taxpayer buys a house for $20,000 which had been used as a personal residence and thus had not been subject to depreciation allowances. He makes a capital addition of $5,000 and rents the property to another. The taxpayer may use the methods referred to in paragraph (a)(1) of this section, only with respect to the $5,000 cost of the addition.

(c) *Election to use methods.* Subject to the limitations set forth in paragraph (a) of this section, the methods of computing the allowance for depreciation specified in section 167(b) (2), (3), and (4) may be adopted without permission and no formal election is required. In order for a taxpayer to elect to use these methods for any property described in paragraph (a) of this section, he need only compute depreciation thereon under any of these methods for any taxable year ending after December 31, 1953, in which the property may first be depreciated by him. The election with respect to any property shall not be binding with respect to acquisitions of similar property in the same year or subsequent year which are set up in separate accounts. If a taxpayer has filed his return for a taxable year ending after December 31, 1953, for which the return is required to be filed on or before September 15, 1956, an election to compute the depreciation allowance under any of the methods specified in section 167 (b) or a change in such an election may be made in an amended return or claim for refund filed on or before September 15, 1956.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7244, 37 FR 28897, Dec. 30, 1972; T.D. 8560, 59 FR 41674, Aug. 15, 1994; T.D. 8597, 60 FR 36679, July 18, 1995]

§ 1.167(d)–1 Agreement as to useful life and rates of depreciation.

After August 16, 1954, a taxpayer may, for taxable years ending after December 31, 1953, enter into an agreement with respect to the estimated useful life, method and rate of depreciation and treatment of salvage of any property which is subject to the allowance for depreciation. An application for such agreement may be made to the district director for the internal revenue district in which the taxpayer's return is required to be filed. Such application shall be filed in quadruplicate and shall contain in such detail as may be practical the following information:

(a) The character and location of the property.

(b) The original cost or other basis and date of acquisition.

(c) Proper adjustments to the basis including depreciation accumulated to the first taxable year to be covered by the agreement.

(d) Estimated useful life and estimated salvage value.

(e) Method and rate of depreciation.

(f) Any other facts and circumstances pertinent to making a reasonable estimate of the useful life of the property and its salvage value.

The agreement must be in writing and must be signed by the taxpayer and by the district director. The agreement must be signed in quadruplicate, and two of the signed copies will be returned to the taxpayer. The agreement shall set forth its effective date, the estimated remaining useful life, the estimated salvage value, and rate and method of depreciation of the property and the facts and circumstances taken into consideration in adoption of the agreement, and shall relate only to depreciation allowances for such property on and after the effective date of the agreement. Such an agreement shall be binding on both parties until such time as facts and circumstances which were not taken into account in making the agreement are shown to exist. The party wishing to modify or change the agreement shall have the responsibility of establishing the existence of such facts and circumstances. Any change in the useful life or rate specified in such agreement shall be effective only prospectively, that is, it shall be effective beginning with the taxable year in which notice of the intention to change, including facts and circumstances warranting the adjustment of useful life and rate, is sent by the party proposing the change to the other party and is sent by registered mail, if such notice is mailed before September 3, 1958, or is sent by certified mail or registered mail, if such notice is mailed after September 2, 1958. A copy of the agreement (and any modification thereof) shall be filed with the taxpayer's return for the first taxable year which is affected by the agreement (or any modification thereof). A signed copy should be retained with the permanent records of the taxpayer. For rules relating to changes in method of depreciation, see §1.167(e)–1 and section 446 and the regulations thereunder.

§ 1.167(e)–1 Change in method.

(a) *In general.* (1) Any change in the method of computing the depreciation allowances with respect to a particular account (other than a change in method permitted or required by reason of the operation of former section 167(j)(2) and §1.167(j)–3(c)) is a change in method of accounting, and such a change will be permitted only with the consent of the Commissioner, except that certain changes to the straight line method of depreciation will be permitted without consent as provided in former section 167(e)(1), (2), and (3). Except as provided in paragraphs (c) and (d) of this section, a change in method of computing depreciation will be permitted only with respect to all the assets contained in a particular account as defined in §1.167(a)–7. Any change in the percentage of the current straight line rate under the declining balance method, for example, from 200 percent of the straight line rate to any other percent of the straight line rate, or any change in the interest factor used in connection with a compound interest or sinking fund method, will constitute a change in method of depreciation. Any request for a change in method of depreciation shall be made in accordance with section 446(e) and the regulations under section 446(e). For rules covering the use of depreciation methods by acquiring corporations in the case of certain corporate acquisitions, see section 381(c)(6) and the regulations under section 381(c)(6).

(2) Paragraphs (b), (c), and (d) of this section apply to property for which depreciation is determined under section 167 (other than under section 168, section 1400I, section 1400L(c), under section 168 prior to its amendment by the Tax Reform Act of 1986 (100 Stat. 2121), or under an additional first year depreciation deduction provision (for example, section 168(k), 1400L(b), or 1400N(d))) of the Internal Revenue Code.

(b) *Declining balance to straight line.* In the case of an account to which the method described in section 167(b)(2) is applicable, a taxpayer may change without the consent of the Commissioner from the declining balance method of depreciation to the straight line method at any time during the useful life of the property under the following conditions. Such a change may not be made if a provision prohibiting such a change is contained in an agreement under section 167(d). When the change is made, the unrecovered cost or other basis (less a reasonable estimate for salvage) shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at the time. With respect to any account, this change will be permitted only if applied to all the assets in the account as defined in

§ 1.167(a)–7. If the method of depreciation described in section 167(b)(2) (the declining balance method of depreciation using a rate not exceeding 200 percent of the straight line rate) is an acceptable method of depreciation with respect to a particular account, the taxpayer may elect under this paragraph to change to the straight line method of depreciation even if with respect to that particular account the declining balance method is permitted under a provision other than section 167(b)(2). Thus, for example, in the case of section 1250 property to which section 167(j)(1) is applicable, section 167(b) does not apply, but the declining balance method of depreciation using 150 percent of the straight line rate is an acceptable method of depreciation under section 167(j)(1)(B). Accordingly, the taxpayer may elect under this paragraph to change to the straight line method of depreciation with respect to such property. Similarly, if the taxpayer acquired used property before July 25, 1969, and adopted the 150 percent declining balance method of depreciation permitted with respect to such property under § 1.167(b)–0(b), the taxpayer may elect under this paragraph to change to the straight line method of depreciation with respect to such property. The taxpayer shall furnish a statement with respect to the property which is the subject of the change showing the date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, the remaining useful life of the property, and such other information as may be required. The statement shall be attached to the taxpayer's return for the taxable year in which the change is made. A change to the straight line method must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

(c) *Change with respect to section 1245 property.* (1) In respect of his first taxable year beginning after December 31, 1962, a taxpayer may elect, without the consent of the Commissioner, to change the method of depreciation of section 1245 property (as defined in section 1245(a)(3)) from any declining balance method or sum of the years-digits method to the straight line method. With respect to any account (as defined in § 1.167(a)–7), this change may be made notwithstanding any provision to the contrary in an agreement under section 167(d), but such change shall constitute (as of the first day of such taxable year) a termination of such agreement as to all property in such account. With respect to any account, this change will be permitted only if applied to all the section 1245 property in the account. The election shall be made by a statement on, or attached to, the return for such taxable year filed on or before the last day prescribed by law, including any extensions thereof, for filing such return.

(2) When an election under this paragraph is made in respect of section 1245 property in an account, the unrecovered cost or other basis (less a reasonable estimate for salvage) of all the section 1245 property in the account shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. If there is other property in such account, the other property shall be placed in a separate account and depreciated by using the same method as was used before the change permitted by this paragraph, but the estimated useful life of such property shall be redetermined in accordance with § 1.167(b)–2, or 1.167(b)–3, whichever is applicable. The taxpayer shall maintain records which permit specific identification of the section 1245 property in the account with respect to which the election is made, and any other property in such account. The records shall also show for all the property in the account the date of acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, and the remaining useful life of the property. A change to the straight line method under this paragraph must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

(d) *Change with respect to section 1250 property.* (1) In respect of his first taxable year beginning after July 24, 1969, a taxpayer may elect, without the consent of the Commissioner, to change the method of depreciation of section 1250 property (as defined in section 1250(c)) from any declining balance method or sum of the years-digits method to the straight line method. With respect to any account (as defined in §1.167(a)–7) this change may be made notwithstanding any provision to the contrary in an agreement under section 167(d), but such change will constitute (as of the first day of such taxable year) a termination of such agreement as to all property in such account. With respect to any account, this change will be permitted only if applied to all the section 1250 property in the account. The election shall be made by a statement on, or attached to, the return for such taxable year filed on or before the last day prescribed by law, including extensions thereof, for filing such return.

(2) When an election under this paragraph is made in respect of section 1250 property in an account, the unrecovered cost or other basis (less a reasonable estimate for salvage) of all the section 1250 property in the account shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time. If there is other property in such account, the other property shall be placed in a separate account and depreciated by using the same method as was used before the change permitted by this paragraph, but the estimated useful life of such property shall be redetermined in accordance with §1.167(b)–2 or §1.167(b)–3, whichever is applicable. The taxpayer shall maintain records which permit specific identification of the section 1250 property in the account with respect to which the election is made and any other property in such account. The records shall also show for all the property in the account the date of the acquisition, cost or other basis, amounts recovered through depreciation and other allowances, the estimated salvage value, the character of the property, and the estimated remaining useful life of the property. A change to the straight line method under this paragraph must be adhered to for the entire taxable year of the change and for all subsequent taxable years unless, with the consent of the Commissioner, a change to another method is permitted.

(e) *Effective date.* This section applies on or after December 30, 2003. For the applicability of regulations before December 30, 2003, see §1.167(e)–1 in effect prior to December 30, 2003 (§1.167(e)–1 as contained in 26 CFR part 1 edition revised as of April 1, 2003).

[T.D. 6500, 25 FR 11402, Nov. 26, 1960, as amended by T.D. 6832, 30 FR 8573, July 7, 1965; T.D. 7166, 37 FR 5245, Mar. 11, 1972; T.D. 9105, 69 FR 7, Jan. 2, 2004; T.D. 9307, 71 FR 78068, Dec. 28, 2006]

§ 1.167(f)–1 Reduction of salvage value taken into account for certain personal property.

(a) *In general.* For taxable years beginning after December 31, 1961, and ending after October 16, 1962, a taxpayer may reduce the amount taken into account as salvage value in computing the allowance for depreciation under section 167(a) with respect to ‘‘personal property’’ as defined in section 167(f)(2) and paragraph (b) of this section. The reduction may be made in an amount which does not exceed 10 percent of the basis of the property for determining depreciation, as of the time as of which salvage value is required to be determined (or when salvage value is redetermined), taking into account all adjustments under section 1016 other than (1) the adjustment under section 1016(a)(2) for depreciation allowed or allowable to the taxpayer, and (2) the adjustment under section 1016(a)(19) for a credit earned by the taxpayer under section 38, to the extent such adjustment is reflected in the basis for depreciation. See paragraph (c) of §1.167(a)–1 for the definition of salvage value, the time for making the determination, the redetermination of salvage value, and the general rules with respect to the treatment of salvage value. See also section 167(g) and §1.167(g)–1 for basis for depreciation. A reduction of the amount taken into account as salvage value with respect to any property shall not be binding with respect to other property. In no event shall an asset (or an account) be depreciated below a reasonable salvage value after taking into account the reduction in salvage value permitted by section 167(f) and this section.

(b) *Definitions and special rules.* The following definitions and special rules apply for purposes of section 167(f) and this section.

(1) *Personal property.* The term ''personal property'' shall include only depreciable—

(i) Tangible personal property (as defined in section 48 and the regulations thereunder) and

(ii) Intangible personal property

which has an estimated useful life (determined at the time of acquisition) of 3 years or more and which is acquired after October 16, 1962. Such term shall not include livestock. 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. The original use of the property need not commence with the taxpayer so long as he acquired it after October 16, 1962; thus, the property may be new or used. For purposes of determining the estimated useful life, the provisions of paragraph (b) of §1.167(a)–1 shall be applied. For rules determining when property is acquired, see subparagraph (2) of this paragraph. For purposes of determining the types of intangible personal property which are subject to the allowance for depreciation, see §1.167(a)–3.

(2) *Acquired.* In determining whether property is acquired after October 16, 1962, property shall be deemed to be acquired when reduced to physical possession, or control. Property which has not been used in the taxpayer's trade or business or held for the production of income and which is thereafter converted by the taxpayer to such use shall be deemed to be acquired on the date of such conversion. In addition, property shall be deemed to be acquired if constructed, reconstructed, or erected by the taxpayer. If construction, reconstruction, or erection by the taxpayer began before October 17, 1962, and was completed after October 16, 1962, section 167(f) and this section apply only to that portion of the basis of the property which is properly attributable to such construction, reconstruction, or erection after October 16, 1962. Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications. The portion of the basis of such property attributable to construction, reconstruction, or erection after October 16, 1962, consists of all costs of the property allocable to the period after October 16, 1962, including the cost or other basis of materials entering into such work. It is not necessary that such materials be acquired after October 16, 1962, or that they be new in use. If construction or erection by the taxpayer began after October 16, 1962, the entire cost or other basis of such construction or erection qualifies for the reduction provided for by section 167(f) and this section. In the case of reconstruction of property, section 167(f) and this section do not apply to any part of the adjusted basis of such property on October 16, 1962. For purposes of this section, construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(c) *Illustrations.* The provisions of paragraphs (a) and (b) of this section may be illustrated by the following examples:

Example 1. Taxpayer A purchases a new asset for use in his business on January 1, 1963, for $10,000. The asset qualifies for the investment credit under section 38 and for the additional first-year depreciation allowance under section 179. A is entitled to an investment credit of $700 (7% × $10,000) and elects to take an additional first-year depreciation allowance of $2,000 (20% × $10,000). The basis for depreciation (determined in accordance with the provisions of section 167(g) and §1.167(g)–1) is computed as follows:

Purchase price		$10,000
Less: Adjustment required for taxable years beginning before Jan. 1, 1964, under section 1016(a)(19), for the investment credit	$700	
Adjustment required under section 1016(a)(2) for the additional first-year depreciation allowance	2,000	
	2,700	
Basis for depreciation for the taxable year 1963		7,300

However, the basis of the property for determining depreciation as of the time as of which salvage value is required to be determined is $10,000, the purchase price of the property. A files his income tax returns on a calendar year basis and uses the straight line method of depreciation. A estimates that he will use the asset in his business for 10 years after which it will have a salvage value of $500, which is less than $1,000 (10% × $10,000, the basis of the property for determining depreciation as of the time as of which salvage value is required to be determined). For the taxable year 1963 A may deduct $730 as the depreciation allowance. As of January 1, 1964, the basis of the asset is increased by $700 in accordance with paragraph (d) of §1.48–7. In computing his total depreciation allowance on the asset, A may reduce the amount taken into account as salvage value to zero and may claim depreciation deductions (including the additional first-year depreciation allowance) totaling $10,000. See paragraph (d) of §1.48–7 for the computation of depreciation for taxable years beginning after December 31, 1963, where there is an increase in basis of property subject to the investment credit.

Example 2. Assume the same facts as in example (1) except that A in a subsequent taxable year redetermines the estimate of the useful life of the asset and at the same time also redetermines the estimate of salvage value. Assume also that at such time the only reductions reflected in the basis are for depreciation allowed or allowable. Accordingly, the reduction under section 167(f) and this section will be computed with regard to the purchase price and not the unrecovered basis for depreciation at the time of the redetermination.

Example 3. Assume the same facts as in example (1) except that A estimates that the asset will have a salvage value of $1,200 at the end of its useful life. In computing his depreciation for the asset, A may reduce the amount to be taken into account as salvage value to $200 ($1,200 − $1,000). Accordingly, A may claim depreciation deductions (including the additional first-year depreciation allowance) totaling $9,800, *i.e.*, the purchase price of the property ($10,000) less the amount taken into account as salvage value ($200).

Example 4. Assume the same facts as in example (1) except that the taxpayer had taken into account salvage value of only $200 but that the estimated salvage value had actually been $700. The amount of salvage value taken into account by the taxpayer is permissible since the reduction of salvage value by $500 ($700 − $200) would be within the limit provided for in section 167 (f), *i.e.*, $1,000 (10% × $10,000).

Example 5. On January 1, 1963, taxpayer B, a taxicab operator, traded his old taxicab plus cash for a new one, which had an estimated useful life of three years, in a transaction qualifying as a nontaxable exchange. The old taxicab had an adjusted basis of $2,500. B was allowed $3,000 for his old taxicab and paid $1,000 in cash. The basis of the new taxicab for determining depreciation (as determined under section 167(g) and §1.167(g)–1) is the adjusted basis of the old taxicab at the time of trade-in ($2,500) plus the additional cash paid out ($1,000), or $3,500. In computing his depreciation allowance on the new taxicab, B may reduce the amount taken into account as salvage value by $350 (10% of $3,500).

Example 6. Taxpayer C purchases a new asset for use in his business on January 1, 1963, for $10,000. At the time of purchase, the asset has an estimated useful life of 10 years and an estimated salvage value of $1,500. C elects to compute his depreciation allowance for the asset by the declining balance method of depreciation, using a rate of 20% which is twice the normal straight line rate of 10% (without adjustment for salvage value). C files his income tax returns on a calendar year basis. In computing his depreciation allowance for the year 1966, C changes his method of determining the depreciation allowance for the asset from the declining balance method to the straight line method (in which salvage value is accounted for in determining the annual depreciation allowances) in accordance with the provisions of section 167(e) and paragraph (b) of §1.167(e)–1. He also wishes to reduce the amount of salvage value taken into account in accordance with the provisions of section 167(f) and this section. At the close of the year 1966, the only reductions reflected in the basis of the asset are for depreciation allowances. Thus, C may reduce the amount of salvage value taken into account by $1,000 (10% × $10,000, the basis of the asset when it was acquired), and, therefore, will account for salvage value of only $500 in computing his depreciation allowance for the asset in 1966 and subsequent years.

Example 7. Taxpayer D purchases a station wagon for his personal use on January 1, 1962, for $4,500. On January 1, 1963, D converts the use of the station wagon to his business, and at that time it has an estimated useful life of 4 years, an estimated salvage value of $500, and a basis of $3,000 (as determined under section 167 (g) and §1.167 (g)–1). Thus, for purposes of section 167 (f) and this section, D is deemed to have acquired the station wagon on January 1, 1963. D elects the straight line method of depreciation in computing the depreciation allowance for the station wagon and also wishes to reduce the amount of salvage value taken into account in accordance with the provisions of section 167(f) and this section. Accordingly, D may reduce the amount of salvage value taken into account by $300 (10% of $3,000). D files his income tax returns on a calendar year basis. His depreciation allowance for the year 1963 would be computed as follows:

Basis for depreciation		$3,000
Less:		
Salvage value	$500	
Reduction permitted by section 167(f)	300	
		200
Amount to be depreciated over the useful life		2,800

D's depreciation allowance on the station wagon for the year 1963 would be $700 ($2,800 divided by 4, the remaining useful life).

[T.D. 6712, 29 FR 3654, Mar. 24, 1964, as amended by T.D. 6838, 30 FR 9064, July 20, 1965]

§ 1.167(g)–1 Basis for depreciation.

The basis upon which the allowance for depreciation is to be computed with respect to any property shall be the adjusted basis provided in section 1011 for the purpose of determining gain on the sale or other disposition of such property. In the case of property which has not been used in the trade or business or held for the production of income and which is thereafter converted to such use, the fair market value on the date of such conversion, if less than the adjusted basis of the property at that time, is the basis for computing depreciation.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated, T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(h)–1 Life tenants and beneficiaries of trusts and estates.

(a) *Life tenants.* In the case of property held by one person for life with remainder to another person, the deduction for depreciation shall be computed as if the life tenant were the absolute owner of the property so that he will be entitled to the deduction during his life, and thereafter the deduction, if any, shall be allowed to the remainderman.

(b) *Trusts.* If property is held in trust, the allowable deduction is to be apportioned between the income beneficiaries and the trustee on the basis of the trust income allocable to each, unless the governing instrument (or local law) requires or permits the trustee to maintain a reserve for depreciation in any amount. In the latter case, the deduction is first allocated to the trustee to the extent that income is set aside for a depreciation reserve, and any part of the deduction in excess of the income set aside for the reserve shall be apportioned between the income beneficiaries and the trustee on the basis of the trust income (in excess of the income set aside for the reserve) allocable to each. For example:

(1) If under the trust instrument or local law the income of a trust computed without regard to depreciation is to be distributed to a named beneficiary, the beneficiary is entitled to the deduction to the exclusion of the trustee.

(2) If under the trust instrument or local law the income of a trust is to be distributed to a named beneficiary, but the trustee is directed to maintain a reserve for depreciation in any amount, the deduction is allowed to the trustee (except to the extent that income set aside for the reserve is less than the allowable deduction). The same result would follow if the trustee sets aside income for a depreciation reserve pursuant to discretionary authority to do so in the governing instrument.

No effect shall be given to any allocation of the depreciation deduction which gives any beneficiary or the trustee a share of such deduction greater than his pro rata share of the trust income, irrespective of any provisions in the trust instrument except as otherwise provided in this paragraph when the trust instrument or local law requires or permits the trustee to maintain a reserve for depreciation.

(c) *Estates.* In the case of an estate the allowable deduction shall be apportioned between the estate and the heirs legatees, and devisees on the basis of income of the estate which is allocable to each.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated, T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(i)–1 Depreciation of improvements in the case of mines, etc.

Property used in the trade or business or held for the production of income which is subject to the allowance for depreciation provided in section 611 shall be treated for all purposes of the Code as if it were property subject to the allowance for depreciation under section 167. The preceding sentence shall not limit the allowance for depreciation otherwise allowable under section 611.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960. Redesignated, T.D. 6712, 29 FR 3653, Mar. 24, 1964]

§ 1.167(l)–1 Limitations on reasonable allowance in case of property of certain public utilities.

(a) *In general*—(1) *Scope*. Section 167(l) in general provides limitations on the use of certain methods of computing a reasonable allowance for depreciation under section 167(a) with respect to ''public utility property'' (see paragraph (b) of this section) for all taxable years for which a Federal income tax return was not filed before August 1, 1969. The limitations are set forth in paragraph (c) of this section for ''pre-1970 public utility property'' and in paragraph (d) of this section for ''post-1969 public utility property.'' Under section 167(l), a taxpayer may always use a straight line method (or other ''subsection (l) method'' as defined in paragraph (f) of this section). In general, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(l) for any taxpayer if the taxpayer uses a ''normalization method of regulated accounting'' (described in paragraph (h) of this section). In certain cases, the use of a method of depreciation other than a subsection (l) method is not prohibited by section 167(l) if the taxpayer used a ''flow-through method of regulated accounting'' described in paragraph (i) of this section) for its ''July 1969 regulated accounting period'' (described in paragraph (g) of this section) whether or not the taxpayer uses either a normalization or a flow-through method of regulated accounting after its July 1969 regulated accounting period. However, in no event may a method of depreciation other than a subsection (l) method be used in the case of pre-1970 public utility property unless such method of depreciation is the ''applicable 1968 method'' (within the meaning of paragraph (e) of this section). The normalization requirements of section 167(l) with respect to public utility property defined in section 167(l)(3)(A) pertain only to the deferral of Federal income tax liability resulting from the use of an accelerated method of depreciation for computing the allowance for depreciation under section 167 and the use of straight line depreciation for computing tax expense and depreciation expense for purposes of establishing cost of services and for reflecting operating results in regulated books of account. Regulations under section 167(l) do not pertain to other book-tax timing differences with respect to State income taxes, F.I.C.A. taxes, construction costs, or any other taxes and items. The rules provided in paragraph (h)(6) of this section are to insure that the same time period is used to determine the deferred tax reserve amount resulting from the use of an accelerated method of depreciation for cost of service purposes and the reserve amount that may be excluded from the rate base or included in no-cost capital in determining such cost of services. The formula provided in paragraph (h)(6)(ii) of this section is to be used in conjunction with the method of accounting for the reserve for deferred taxes (otherwise proper under paragraph (h)(2) of this section) in accordance with the accounting requirements prescribed or approved, if applicable, by the regulatory body having jurisdiction over the taxpayer's regulated books of account. The formula provides a method to determine the period of time during which the taxpayer will be treated as having received amounts credited or charged to the reserve account so that the disallowance of earnings with respect to such amounts through rate base exclusion or treatment as no-cost capital will take into account the factor of time for which such amounts are held by the taxpayer. The formula serves to limit the amount of such disallowance.

(2) *Methods of depreciation*. For purposes of section 167(l), in the case of a declining balance method each different uniform rate applied to the unrecovered cost or other basis of the property is a different method of depreciation. For purposes of section 167(l), a change in a uniform rate of depreciation due to a change in the useful life of the property or a change in the taxpayer's unrecovered cost or other basis for the property is not a change in the method of depreciation. The use of

''guideline lives'' or ''class lives'' for Federal income tax purposes and different lives on the taxpayer's regulated books of account is not treated for purposes of section 167(l) as a different method of depreciation. Further, the use of an unrecovered cost or other basis or salvage value for Federal income tax purposes different from the basis or salvage value used on the taxpayer's regulated books of account is not treated as a different method of depreciation.

(3) *Application of certain other provisions to public utility property.* For rules with respect to application of the investment credit to public utility property, see section 46(e). For rules with respect to the application of the class life asset depreciation range system, including the treatment of the use of ''class lives'' for Federal income tax purposes and different lives on the taxpayer's regulated books of account, see §1.167(a)–11 and §1.167(a)–12.

(4) *Effect on agreements under section 167(d).* If the taxpayer has entered into an agreement under section 167(d) as to any public utility property and such agreement requires the use of a method of depreciation prohibited by section 167(l), such agreement shall terminate as to such property. The termination, in accordance with this subparagraph, shall not affect any other property (whether or not public utility property) covered by the agreement.

(5) *Effect of change in method of depreciation.* If, because the method of depreciation used by the taxpayer with respect to public utility property is prohibited by section 167(l), the taxpayer changes to a method of depreciation not prohibited by section 167(l), then when the change is made the unrecovered cost or other basis shall be recovered through annual allowances over the estimated remaining useful life determined in accordance with the circumstances existing at that time.

(b) *Public utility property*—(1) *In general.* Under section 167(l)(3)(A), property is ''public utility property'' during any period in which it is used predominantly in a ''section 167(l) public utility activity''. The term ''section 167(l) public utility activity'' means the trade or business of the furnishing or sale of—

(i) Electrical energy, water, or sewage disposal services,

(ii) Gas or steam through a local distribution system,

(iii) Telephone services,

(iv) Other communication services (whether or not telephone services) if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(v) Transportation of gas or steam by pipeline,

if the rates for such furnishing or sale, as the case may be, are regulated, *i.e.*, have been established or approved by a regulatory body described in section 167(l)(3)(A). The term ''regulatory body described in section 167(l)(3)(A)'' means a State (including the District of Columbia) or political subdivision thereof, any agency or instrumentality of the United States, or a public service or public utility commission or other body of any State or political subdivision thereof similar to such a commission. The term ''established or approved'' includes the filing of a schedule of rates with a regulatory body which has the power to approve such rates, even though such body has taken no action on the filed schedule or generally leaves undisturbed rates filed by the taxpayer involved.

(2) *Classification of property.* If property is not used solely in a section 167(l) public utility activity, such property shall be public utility property if its predominant use is in a section 167(l) public utility activity. The predominant use of property for any period shall be determined by reference to the proper accounts to which expenditures for such property are chargeable under the system of regulated accounts required to be used for the period for which the determination is made and in accordance with the principles of §1.46–3(g)(4) (relating to credit for investment in certain depreciable property). Thus, for example, for purposes of determining whether property is used predominantly in the trade or business of the furnishing or sale of transportation of gas by pipeline, or furnishing or sale of gas through a local distribution system, or both, the rules prescribed in §1.46–3(g)(4) apply,

except that accounts 365 through 371, inclusive (Transmission Plant), shall be added to the accounts enumerated in subdivision (i) of such paragraph (g)(4).

(c) *Pre-1970 public utility property*—(1) *Definition.* (i) Under section 167(l)(3)(B), the term ''pre-1970 public utility property'' means property which was public utility property at any time before January 1, 1970. If a taxpayer acquires pre-1970 public utility property, such property shall be pre-1970 public utility property in the hands of the taxpayer even though such property may have been acquired by the taxpayer in an arm's-length cash sale at fair market value or in a tax-free exchange. Thus, for example, if corporation X which is a member of the same controlled group of corporations (within the meaning of section 1563(a)) as corporation Y sells pre-1970 public utility property to Y, such property is pre-1970 public utility property in the hands of Y. The result would be the same if X and Y were not members of the same controlled group of corporations.

(ii) If the basis of public utility property acquired by the taxpayer in a transaction is determined in whole or in part by reference to the basis of any of the taxpayer's pre-1970 public utility property by reason of the application of any provision of the code, and if immediately after the transaction the adjusted basis of the property acquired is less than 200 percent of the adjusted basis of such pre-1970 public utility property immediately before the transaction, the property acquired is pre-1970 public utility property.

(2) *Methods of depreciation not prohibited.* Under section 167(l)(1), in the case of pre-1970 public utility property, the term ''reasonable allowance'' as used in section 167(a) means, for a taxable year for which a Federal income tax return was not filed before August 1, 1969, and in which such property is public utility property, an allowance (allowable without regard to section 167(l)) computed under—

(i) A subsection (l) method, or

(ii) The applicable 1968 method (other than a subsection (l) method) used by the taxpayer for such property, but only if—

(*a*) The taxpayer uses in respect of such taxable year a normalization method of regulated accounting for such property,

(*b*) The taxpayer used a flow-through method of regulated accounting for such property for its July 1969 regulated accounting period, or

(*c*) The taxpayer's first regulated accounting period with respect to such property is after the taxpayer's July 1969 regulated accounting period and the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service. See paragraph (e)(5) of this section for determination of same (or similar) kind.

(3) *Flow-through method of regulated accounting in certain cases.* See paragraph (e)(6) of this section for treatment of certain taxpayers with pending applications for change in method of accounting as being deemed to have used a flow-through method of regulated accounting for the July 1969 regulated accounting period.

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

Example 1. Corporation X, a calendar-year taxpayer subject to the jurisdiction of a regulatory body described in section 167(l)(3)(A), used the straight line method of depreciation (a subsection (l) method) for all of its public utility property for which depreciation was allowable on its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return). Assume that under paragraph (e) of this section, X's applicable 1968 method is a subsection (l) method with respect to all of its public utility property. Thus, with respect to its pre-1970 public utility property, X may only use a straight line method (or any other subsection (l) method) of depreciation for all taxable years after 1967.

Example 2. Corporation Y, a calendar-year taxpayer subject to the jurisdiction of the Federal Power Commission, is engaged exclusively in the transportation of gas by pipeline. On its Federal income tax return for 1967 (the latest taxable year for which Y, prior to August 1, 1969, filed a return), Y used the declining balance method of depreciation using a rate of 150 percent of the straightline rate for all of its nonsection 1250 public utility property with respect to which depreciation was allowable. Assume that with respect to all of such property, Y's applicable 1968 method under paragraph (e) of this section is such 150 percent declining balance method. Assume that Y used a normalization method of regulated accounting for all relevant regulated accounting periods. If Y continues to use a normalization method of regulated accounting, Y may compute its reasonable allowance for purposes of section 167(a) using such 150 percent declining balance method for its nonsection 1250 pre-1970 public utility property for all taxable years beginning with 1968, provided the use of such method is allowable without regard to section 167(l). Y may also use a subsection (l) method for any of such pre-1970 public utility property for all taxable years beginning after 1967. However, because each different uniform rate applied to the basis of the property is a different method of depreciation, Y may not use a declining balance method of depreciation using a rate of twice the straight line rate for any of such pre-1970 public utility property for any taxable year beginning after 1967.

Example 3. Assume the same facts as in example (2) except that with respect to all of its nonsection 1250 pre-1970 public utility property accounted for in its July 1969 regulated accounting period Y used a flow-through method of regulated accounting for such period. Assume further that such property is the property on the basis of which the applicable 1968 method is established for pre-1970 public utility property of the same kind, but having a first regulated accounting period after the taxpayer's July 1969 regulated accounting period. Beginning with 1968, with respect to such property Y may compute its reasonable allowance for purposes of section 167(a) using the declining balance method of depreciation and a rate of 150 percent of the straight line rate, whether it uses a normalization or flow-through method of regulated accounting after its July 1969 regulated accounting period, provided the use of such method is allowable without regard to section 167(l).

(d) *Post-1969 public utility property*—(1) *In general.* Under section 167(l)(3)(C), the term "post-1969 public utility property" means any public utility property which is not pre-1970 public utility property.

(2) *Methods of depreciation not prohibited.* Under section 167(l)(2), in the case of post-1969 public utility property, the term "reasonable allowance" as used in section 167(a) means, for a taxable year, an allowance (allowable without regard to section 167(l)) computed under—

(i) A subsection (l) method,

(ii) A method of depreciation otherwise allowable under section 167 if, with respect to the property, the taxpayer uses in respect of such taxable year a normalization method of regulated accounting, or

(iii) The taxpayer's applicable 1968 method (other than a subsection (l) method) with respect to the property in question, if the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period for the property of the same (or similar) kind most recently placed in service, provided that the property in question is not property to which an election under section 167(l)(4)(A) applies. See §1.167(l)(2) for rules with respect to an election under section 167(l)(4)(A). See paragraph (e)(5) of this section for definition of same (or similar) kind.

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

Example 1. Corporation X is engaged exclusively in the trade or business of the transportation of gas by pipeline and is subject to the jurisdiction of the Federal Power Commission. With respect to all its public utility property, X's applicable 1968 method (as determined under paragraph (e) of this section) is the straight line method of depreciation. X may determine its reasonable allowance for depreciation under section 167(a) with respect to its post-1969 public utility property under a straight line method (or other subsection (l) method) or, if X uses a normalization method of regulated accounting, any other method of depreciation, provided that the use of such other method is allowable under section 167 without regard to section 167(l).

Example 2. Assume the same facts as in example (1) except that with respect to all of X's post-1969 public utility property the applicable 1968 method (as determined under paragraph (e) of this section) is the declining balance method using a rate of 150 percent of the straight line rate. Assume further that all of X's pre-1970 public utility property was accounted for in its July 1969 regulated accounting period, and that X used a flow-through method of regulated accounting for such period. X may determine its reasonable allowance for depreciation under section 167 with respect to its post-1969 public utility property by using the straight line method of depreciation (or any other subsection (l) method), by using any method otherwise allowable under section 167 (such as a declining balance method) if X uses a normalization method of regulated accounting, or, by using the declining balance method using a rate of 150 percent of the straight line rate, whether or not X uses a normalization or a flow-through method of regulated accounting.

(e) *Applicable 1968 method*—(1) *In general*. Under section 167(l)(3)(D), except as provided in subparagraphs (3) and (4) of this paragraph, the term ''applicable 1968 method'' means with respect to any public utility property—

(i) The method of depreciation properly used by the taxpayer in its Federal income tax return with respect to such property for the latest taxable year for which a return was filed before August 1, 1969,

(ii) If subdivision (i) of this subparagraph does not apply, the method of depreciation properly used by the taxpayer in its Federal income tax return for the latest taxable year for which a return was filed before August 1, 1969, with respect to public utility property of the same kind (or if there is no property of the same kind, property of the most similar kind) most recently placed in service before the end of such latest taxable year, or

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, a subsection (l) method.

If, on or after August 1, 1969, the taxpayer files an amended return for the taxable year referred to in subdivisions (i) and (ii) of this subparagraph, such amended return shall not be taken into consideration in determining the applicable 1968 method. The term ''applicable 1968 method'' if such new method results to any public utility property, for the year of change and subsequent years, a method of depreciation otherwise allowable under section 167 to which the taxpayer changes from an applicable 1968 method if such new method results in a lesser allowance for depreciation for such property under section 167 in the year of change and the taxpayer secures the Commissioner's consent to the change in accordance with the procedures of section 446(e) and §1.446–1.

(2) *Placed in service*. For purposes of this section, property is placed in service on the date on which the period for depreciation begins under section 167. See, for example, §1.167(a)–10(b) and §1.167(a)–11(c)(2). If under an averaging convention property which is placed in service (as defined in §1.46–3(d)(ii)) by the taxpayer on different dates is treated as placed in service on the same date, then for purposes of section 167(l) the property shall be treated as having been placed in service on the date the period for depreciation with respect to such property would begin under section 167 absent such averaging convention. Thus, for example, if, except for the fact that the averaging convention used assumes that all additions and retirements made during the first half of the year were made on the first day of the year, the period of depreciation for two items of public utility property would begin on January 10 and March 15, respectively, then for purposes of determining the property of the same (or similar) kind most recently placed in service, such items of property shall be treated as placed in service on January 10 and March 15, respectively.

(3) *Certain section 1250 property*. If a taxpayer is required under section 167(j) to use a method of depreciation other than its applicable 1968 method with respect to any section 1250 property, the term ''applicable 1968 method'' means the method of depreciation allowable under section 167(j) which is the most nearly comparable method to the applicable 1968 method determined under subparagraph (1) of this paragraph. For example, if the applicable 1968 method on new section 1250 property is the declining balance method using 200 percent of the straight line rate, the most nearly comparable method allowable for new section 1250 property under section 167(j) would be the declining balance method using 150 percent of the straight line rate. If the applicable 1968 method determined under subparagraph (1) of this paragraph is the sum of the years-digits method, the term ''most nearly comparable method'' refers to any method of depreciation allowable under section 167(j).

(4) *Applicable 1968 method in certain cases*. (i)(*a*) Under section 167(l)(3)(E), if the taxpayer evidenced within the time

and manner specified in (*b*) of this subdivision (i) the intent to use a method of depreciation under section 167 (other than its applicable 1968 method as determined under subparagraph (1) or (3) of this paragraph or a subsection (l) method) with respect to any public utility property, such method of depreciation shall be deemed to be the taxpayer's applicable 1968 method with respect to such public utility property and public utility property of the same (or most similar) kind subsequently placed in service.

(*b*) Under this subdivision (i), the intent to use a method of depreciation under section 167 is evidenced—

(*1*) By a timely application for permission for a change in method of accounting filed by the taxpayer before August 1, 1969, or

(*2*) By the use of such method of depreciation in the computation by the taxpayer of its tax expense for purposes of reflecting operating results in its regulated books of account for its July 1969 regulated accounting period, as established in the manner prescribed in paragraph (g)(1) (i), (ii), or (iii) of this section.

(ii)(*a*) If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the applicable 1968 method with respect to such property shall be determined by reference to the treatment in respect of such property in the hands of the transferor.

(*b*) For purposes of this subdivision (ii), the term ''related person'' means a person who is related to another person if either immediately before or after the transfer—

(*1*) The relationship between such persons would result in a disallowance of losses under section 267 (relating to disallowance of losses, etc., between related taxpayers) or section 707(b) (relating to losses disallowed, etc., between partners and controlled partnerships) and the regulations thereunder, or

(*2*) Such persons are members of the same controlled group of corporations, as defined in section 1563(a) (relating to definition of controlled group of corporations), except that ''more than 50 percent'' shall be substituted for ''at least 80 percent'' each place it appears in section 1563(a) and the regulations thereunder.

(5) *Same or similar*. The classification of property as being of the same (or similar) kind shall be made by reference to the function of the public utility to which the primary use of the property relates. Property which performs the identical function in the identical manner shall be treated as property of the same kind. The determination that property is of a similar kind shall be made by reference to the proper account to which expenditures for the property are chargeable under the system of regulated accounts required to be used by the taxpayer for the period in which the property in question was acquired. Property, the expenditure for which is chargeable to the same account, is property of the most similar kind. Property, the expenditure for which is chargeable to an account for property which serves the same general function, is property of a similar kind. Thus, for example, if corporation X, a natural gas company, subject to the jurisdiction of the Federal Power Commission, had property properly chargeable to account 366 (relating to transmission plant structures and improvements) acquired an additional structure properly chargeable to account 366, under the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective September 1, 1968, the addition would constitute property of the same kind if it performed the identical function in the identical manner. If, however, the addition did not perform the identical function in the identical manner, it would be property of the most similar kind.

(6) *Regulated method of accounting in certain cases.* Under section 167(l)(4)(B), if with respect to any pre-1970 public utility property the taxpayer filed a timely application for change in method of accounting referred to in subparagraph (4)(i)(*b*)(*1*) of this paragraph and

with respect to property of the same (or similar) kind most recently placed in service the taxpayer used a flow-through method of regulated accounting for its July 1969 regulated accounting period, then for purposes of section 167(l)(1)(B) and paragraph (c) of this section the taxpayer shall be deemed to have used a flow-through method of regulated accounting with respect to such pre-1970 public utility property.

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

Example 1. Corporation X is a calendar-year taxpayer. On its Federal income tax return for 1967 (the latest taxable year for which X, prior to August 1, 1969, filed a return) X used a straight line method of depreciation with respect to certain public utility property placed in service before 1965 and used the declining balance method of depreciation using 200 percent of the straight line rate (double declining balance) with respect to the same kind of public utility property placed in service after 1964. In 1968 and 1970, X placed in service additional public utility property of the same kind. The applicable 1968 method with respect to the above described public utility property is shown in the following chart:

Property held in 1970	Placed in service	Method on 1967 return	Applicable 1968 method
Group 1	Before 1965	Straight line ..	Straight line.
Group 2	After 1964 and before 1968.	Double declining balance.	Double declining balance.
Group 3	After 1967 and before 1969.	....	Do.
Group 4	After 1968	....	Do.

Example 2. Corporation Y is a calendar-year taxpayer engaged exclusively in the trade or business of the furnishing of electrical energy. In 1954, Y placed in service hydroelectric generators and for all purposes Y has taken straight line depreciation with respect to such generators. In 1960, Y placed in service fossil fuel generators and for all purposes since 1960 has used the declining balance method of depreciation using a rate of 150 percent of the straight line rate (computed without reduction for salvage) with respect to such generators. After 1960 and before 1970 Y did not place in service any generators. In 1970, Y placed in service additional hydroelectric generators. The applicable 1968 method with respect to the hydroelectric generators placed in service in 1970 would be the straight line method because it was the method used by Y on its return for the latest taxable year for which Y filed a return before August 1, 1969, with respect to property of the same kind (*i.e.*, hydroelectric generators) most recently placed in service.

Example 3. Assume the same facts as in example (2), except that the generators placed in service in 1970 were nuclear generators. The applicable 1968 method with respect to such generators is the declining balance method using a rate of 150 percent of the straight line rate because, with respect to property of the most similar kind (fossil fuel generators) most recently placed in service, Y used such declining balance method on its return for the latest taxable year for which it filed a return before August 1, 1969.

(f) *Subsection (l) method*. Under section 167(l)(3)(F), the term ''subsection (l) method'' means a reasonable and consistently applied ratable method of computing depreciation which is allowable under section 167(a), such as, for example, the straight line method or a unit of production method or machine-hour method. The term ''subsection (l) method'' does not include any declining balance method (regardless of the uniform rate applied), sum of the years-digits method, or method of depreciation which is allowable solely by reason of section 167(b)(4) or (j)(1)(C).

(g) *July 1969 regulated accounting period*—(1) *In general*. Under section 167(l)(3)(I), the term ''July 1969 regulated accounting period'' means the taxpayer's latest accounting period ending before August 1, 1969, for which the taxpayer regularly computed, before January 1, 1970, its tax expense for purposes of reflecting operating results in its regulated books of account. The computation by the taxpayer of such tax expense may be established by reference to the following:

(i) The most recent periodic report of a period ending before August 1, 1969, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer's regulated books of account which was filed with such body before January 1, 1970 (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for a period ending before August 1, 1969, but only if such report was distributed to the shareholders before January 1, 1970, and if the taxpayer's stocks or securities are traded in an established securities market during such period. For purposes of this subdivision, the term ''established securities market'' has the meaning assigned to such term in §1.453–3(d)(4).

(iii) If subdivisions (i) and (ii) of this subparagraph do not apply, entries made to the satisfaction of the district director before January 1, 1970, in its regulated books of account for its most recent accounting period ending before August 1, 1969.

(2) *July 1969 method of regulated accounting in certain acquisitions.* If public utility property is acquired in a transaction in which its basis in the hands of the transferee is determined in whole or in part by reference to its basis in the hands of the transferor by reason of the application of any provision of the Code, or in a transfer (including any purchase for cash or in exchange) from a related person, then in the hands of the transferee the method of regulated accounting for such property's July 1969 regulated accounting period shall be determined by reference to the treatment in respect of such property in the hands of the transferor. See paragraph (e)(4)(ii) of this section for definition of ''related person''.

(3) *Determination date.* For purposes of section 167(l), any reference to a method of depreciation under section 167(a), or a method of regulated accounting, taken into account by the taxpayer in computing its tax expense for its July 1969 regulated accounting period shall be a reference to such tax expense as shown on the periodic report or report to shareholders to which subparagraph (1) (i) or (ii) of this paragraph applies or the entries made on the taxpayer's regulated books of account to which subparagraph (1)(iii) of this paragraph applies. Thus, for example, assume that regulatory body A having jurisdiction over public utility property with respect to X's regulated books of account requires X to reflect its tax expense in such books using the same method of depreciation which regulatory body B uses for determining X's cost of service for ratemaking purposes. If in 1971, in the course of approving a rate change for X, B retroactively determines X's cost of service for ratemaking purposes for X's July 1969 regulated accounting period using a method of depreciation different from the method reflected in X's regulated books of account as of January 1, 1970, the method of depreciation used by X for its July 1969 regulated accounting period would be determined without reference to the method retroactively used by B in 1971.

(h) *Normalization method of accounting*—(1) *In general.* (i) Under section 167(l), a taxpayer uses a normalization method of regulated accounting with respect to public utility property—

(*a*) If the same method of depreciation (whether or not a subsection (l) method) is used to compute both its tax expense and its depreciation expense for purposes of establishing cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, and

(*b*) If to compute its allowance for depreciation under section 167 it uses a method of depreciation other than the method it used for purposes described in (*a*) of this subdivision, the taxpayer makes adjustments consistent with subparagraph (2) of this paragraph to a reserve to reflect the total amount of the deferral of Federal income tax liability resulting from the use with respect to all of its public utility property of such different methods of depreciation.

(ii) In the case of a taxpayer described in section 167(l) (1) (B) or (2) (C), the reference in subdivision (i) of this subparagraph shall be a reference only to such taxpayer's ''qualified public utility property''. See §1.167(l)–2(b) for definition of ''qualified public utility property''.

(iii) Except as provided in this subparagraph, the amount of Federal income tax liability deferred as a result of the use of different method of depreciation under subdivision (i) of this subparagraph is the excess (computed without regard to credits) of the amount the tax liability would have been had a subsection (l) method been used over the amount of the actual tax liability. Such amount shall be taken into account for the taxable year in which such different methods of depreciation are used. If, however, in respect of any taxable year the use of a method of depreciation other than a subsection (l) method for purposes of determining the taxpayer's reasonable allowance under section 167(a) results in a net operating loss carryover (as determined under section 172) to a year succeeding such taxable year which would not have arisen (or an increase in such carryover which would not have arisen) had the taxpayer determined his reasonable allowance under section 167(a) using a subsection (l) method, then the amount and time of the deferral of tax liability shall be taken into account in such appropriate time and manner as is satisfactory to the district director.

(2) *Adjustments to reserve.* (i) The taxpayer must credit the amount of deferred Federal income tax determined under subparagraph (1)(i) of this paragraph for any taxable year to a reserve for deferred taxes, a depreciation reserve, or other reserve account. The taxpayer need not establish a separate reserve account for such amount but the amount of deferred tax determined under subparagraph (1) (i) of this paragraph must be accounted for in such a manner so as to be readily identifiable. With respect to any account, the aggregate amount allocable to deferred tax under section 167(l) shall not be reduced except to reflect the amount for any taxable year by which Federal income taxes are greater by reason of the prior use of different methods of depreciation under subparagraph (1)(i) of this paragraph. An additional exception is that the aggregate amount allocable to deferred tax under section 167(l) may be properly adjusted to reflect asset retirements or the expiration of the period for depreciation used in determining the allowance for depreciation under section 167(a).

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

Example 1. Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Federal Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting. With respect to such property, X has not made any election under §1.167(a)–11 (relating to depreciation based on class lives and asset depreciation ranges). In 1972, X places in service public utility property with an unadjusted basis of $2 million, and an estimated useful life of 20 years. X uses the declining balance method of depreciation with a rate twice the straight line rate. If X uses a normalization method of regulated accounting, the amount of depreciation allowable under section 167(a) with respect to such property for 1972 computed under the double declining balance method would be $200,000. X computes its tax expense and depreciation expense for purposes of determining its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection (l) method). A depreciation allowance computed in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, X used a normalization method of regulated accounting for 1972 with respect to property placed in service that year if for 1972 it added to a reserve $48,000 as taxes deferred as a result of the use by X of a method of depreciation for Federal income tax purposes different from that used for establishing its cost of service for rate-making purposes and for reflecting operating results in its regulated books of account.

Example 2. Assume the same facts as in example (1), except that X elects to apply §1.167(a)–11 with respect to all eligible property placed in service in 1972. Assume further that all property X placed in service in 1972 is eligible property. One hudnred percent of the asset guideline period for such property is 22 years and the asset depreciation range is from 17.5 years to 26.5 years. X uses the double declining balance method of depreciation, selects an asset depreciation period of 17.5 years, and applies the half-year convention (described in §1.167(a)–11(c)(2)(iii)). In 1972, the depreciation allowable under section 167(a) with respect to property placed in service in 1972 is $114,285 (determined without regard to the normalization requirements in §1.167(a)–11(b)(6) and in section 167(l)). X computes its tax expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation (a subsection (l) method), an estimated useful life of 22 years (that is, 100 percent of the asset guideline period), and the half-year convention. A depreciation allowance computed in this manner is $45,454. Assuming a tax rate of 48 percent, the amount that X must add to a reserve for 1972 with respect to property placed in service that year in order to qualify as using a normalization method of regulated accounting under section 167(l) (3) (G) is $27,429 and the amount in order to satisfy the normalization requirements of §1.167(a)–11(b)(6) is $5,610. X determined such amounts as follows:

(1) Depreciation allowance on tax return (determined without regard to section 167(l) and § 1.167(a)–11(b) (6))	$114,285
(2) Line (1), recomputed using a straight line method	57,142
(3) Difference in depreciation allowance attributable to different methods (line (1) minus line (2))	$57,143
(4) Amount to add to reserve under this paragraph (48 percent of line (3))	27,429
(5) Amount in line (2)	$57,142
(6) Line (5), recomputed by using an estimated useful life of 22 years and the half-year convention	45,454
(7) Difference in depreciation allowance attributable to difference in depreciation periods	$11,688
(8) Amount to add to reserve under § 1.167(a)–11(b) (6) (ii) (48 percent of line (7))	5,610

If, for its depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account, X had used a period in excess of the asset guideline period of 22 years, the total amount in lines (4) and (8) in this example would not be changed.

Example 3. Corporation Y, a calendar-year taxpayer which is engaged in furnishing electrical energy, made the election provided by section 167(l) (4) (a) with respect to its ''qualified public utility property'' (as defined in §1.167(l)–2(b)). In 1971, Y placed in service qualified public utility property which had an adjusted basis of $2 million, estimated useful life of 20 years, and no salvage value. With respect to property of the same kind most recently placed in service, Y used a flow-through method of regulated accounting for its July 1969 regulated accounting period and the applicable 1968 method is the declining balance method of depreciation using 200 percent of the straight line rate. The amount of depreciation allowable under the double declining balance method with respect to the qualified public utility property would be $200,000. Y computes its tax expense and depreciation expense for purposes of determining its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account using the straight line method of depreciation. A depreciation allowance with respect to the qualified public utility property determined in this manner is $100,000. The excess of the depreciation allowance determined under the double declining balance method ($200,000) over the depreciation expense computed using the straight line method ($100,000) is $100,000. Thus, assuming a tax rate of 48 percent, Y used a normalization method of regulated accounting for 1971 if for 1971 it added to a reserve $48,000 as tax deferred as a result of the use by Y of a method of depreciation for Federal income tax purposes with respect to its qualified public utility property which method was different from that used for establishing its cost of service for ratemaking purposes and for reflecting operating results in its regulated books of account for such property.

Example 4. Corporation Z, exclusively engaged in a public utility activity did not use a flow-through method of regulated accounting for its July 1969 regulated accounting period. In 1971, a regulatory body having jurisdiction over all of Z's property issued an order applicable to all years beginning with 1968 which provided, in effect, that Z use an accelerated method of depreciation for purposes of section 167 and for determining its tax expenses for purposes of reflecting operating results in its regulated books of account. The order further provided that Z normalize 50 percent of the tax deferral resulting from the use of the accelerated method of depreciation and that Z flow-through 50 percent of the tax deferral resulting therefrom. Under section 167(l), the method of accounting provided in the order would not be a normalization method of regulated accounting because Z would not be permitted to normalize 100 percent of the tax deferral resulting from the use of an accelerated method of depreciation. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

Example 5. Assume the same facts as in example (4) except that the order of the regulatory body provided, in effect, that Z normalize 100 percent of the tax deferral with respect to 50 percent of its public utility property and flow-through the tax savings with respect to the other 50 percent of its property. Because the effect of such an order would allow Z to flow-through a portion of the tax savings resulting from the use of an accelerated method of depreciation, Z would not be using a normalization method of regulated accounting with respect to any of its properties. Thus, with respect to its public utility property for purposes of section 167, Z may only use a subsection (l) method of depreciation.

(3) *Establishing compliance with normalization requirements in respect of operating books of account.* The taxpayer may establish compliance with the requirement in subparagraph (1)(i) of this paragraph in respect of reflecting operating results, and adjustments to a reserve, in its operating books of account by reference to the following:

(i) The most recent periodic report for a period beginning before the end of the taxable year, required by a regulatory body described in section 167(l)(3)(A) having jurisdiction over the taxpayer's regulated operating books of account which was filed with such body before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for such taxable year (whether or not such body has jurisdiction over rates).

(ii) If subdivision (i) of this subparagraph does not apply, the taxpayer's most recent report to its shareholders for the taxable year but only if (*a*) such report was distributed to the shareholders before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year and (*b*) the taxpayer's stocks or securities are traded in an established securities market during such taxable year. For purposes of this subdivision, the term ''established securities market'' has the meaning assigned to such term in § 1.453–3(d)(4).

(iii) If neither subdivision (i) nor (ii) of this subparagraph applies, entries made to the satisfaction of the district director before the due date (determined with regard to extensions) of the taxpayer's Federal income tax return for the taxable year in its regulated books of account for its most recent period beginning before the end of such taxable year.

(4) *Establishing compliance with normalization requirements in computing cost of service for ratemaking purposes.* (i) In the case of a taxpayer which used a flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter, with respect to all or a portion of its pre-1970 public utility property, if a regulatory body having jurisdiction to establish the rates of such taxpayer as to such property (or a court which has jurisdiction over such body) issues an order of general application (or an order of specific application to the taxpayer) which states that such regulatory body (or court) will permit a class of taxpayers of which such taxpayer is a member (or such taxpayer) to use the normalization method of regulated accounting to establish cost of service for ratemaking purposes with respect to all or a portion of its public utility property, the taxpayer will be presumed to be using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to the public utility property to which such order applies. In the event that such order is in any way conditional, the preceding sentence shall not apply until all of the conditions contained in such order which are applicable to the taxpayer have been fulfilled. The taxpayer shall establish to the satisfaction of the Commissioner or his delegate that such conditions have been fulfilled.

(ii) In the case of a taxpayer which did not use the flow-through method of regulated accounting for its July 1969 regulated accounting period or thereafter (including a taxpayer which used a subsection (l) method of depreciation to compute its allowance for depreciation under section 167(a) and to compute its tax expense for purposes of reflecting operating results in its regulated books of account), with respect to any of its public utility property, it will be presumed that such taxpayer is using the same method of depreciation to compute both its tax expense and its depreciation expense for purposes of establishing its cost of service for ratemaking purposes with respect to its post-1969 public utility property. The presumption described in the preceding sentence shall not apply in any case where there is (*a*) an expression of intent (regardless of the manner in which such expression of intent is indicated) by the regulatory body (or bodies), having jurisdiction to establish the rates of such taxpayer, which indicates that the policy of such regulatory body is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or by a class of taxpayers of which such taxpayer is a member, or (*b*) a decision by a court having jurisdiction over such regulatory body which decision is in any way inconsistent with the use of the normalization method of regulated accounting by such taxpayer or a class of taxpayers of which such taxpayer is a member. The presumption shall be applicable on January 1, 1970, and shall, unless rebutted, be effective until an inconsistent expression of intent is indicated by such regulatory body or by such court. An example of such an inconsistent expression of intent is the case of a regulatory body which has, after the July 1969 regulated accounting period and before January 1, 1970, directed public utilities subject to its ratemaking jurisdiction to use a flow-through method of regulated accounting, or has issued an order of general application which states that such agency will direct a class of public utilities of which the taxpayer is a member to use a flow-through method of regulated accounting. The presumption described in this subdivision may be rebutted by evidence that the flow-through method of regulated accounting is being used by the taxpayer with respect to such property.

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

Example 1. Corporation X is a calendar-year taxpayer and its ''applicable 1968 method'' is a straight line method of depreciation. Effective January 1, 1970, X began collecting rates which were based on a sum of the years-digits method of depreciation and a normalization method of regulated accounting which rates had been approved by a regulatory body having jurisdiction over X. On October 1, 1971, a court of proper jurisdiction annulled the rate order prospectively, which annulment was not appealed, on the basis that the regulatory body had abused its discretion by determining the rates on the basis of a normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X's use of the sum of the years-digits method of depreciation for purposes of section 167 on such return was proper. For 1971, the presumption is in effect through September 30. During 1971, X may use the sum of the years-digits method of depreciation for purposes of section 167 from January 1 through September 30, 1971. After September 30, 1971, and for taxable years after 1971, X must use a straight line method of depreciation until the inconsistent court decision is no longer in effect.

Example 2. Assume the same facts as in example (1), except that pursuant to the order of annulment, X was required to refund the portion of the rates attributable to the use of the normalization method of regulated accounting. As there was no inconsistent expression of intent during 1970 or prior to the due date of X's return for 1970, X has the benefit of the presumption with respect to its use of the sum of the years-digits method of depreciation for purposes of section 167, but because of the retroactive nature of the rate order X must file an amended return for 1970 using a straight line method of depreciation. As the inconsistent decision by the court was handed down prior to the due date of X's Federal income tax return for 1971, for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. X must file its Federal income tax returns for such years using a straight line method of depreciation.

Example 3. Assume the same facts as in example (2), except that the annulment order was stayed pending appeal of the decision to a court of proper appellate jurisdiction, X has the benefit of the presumption as described in example (2) for the year 1970, but for 1971 and thereafter the presumption of subdivision (ii) of this subparagraph does not apply. Further, X must file an amended return for 1970 using a straight line method of depreciation and for 1971 and thereafter X must file its returns using a straight line method of depreciation unless X and the district director have consented in writing to extend the time for assessment of tax for 1970 and thereafter with respect to the issue of normalization method of regulated accounting for as long as may be necessary to allow for resolution of the appeal with respect to the annulment of the rate order.

(5) *Change in method of regulated accounting.* The taxpayer shall notify the district director of a change in its method of regulated accounting, an order by a regulatory body or court that such method be changed, or an interim or final rate determination by a regulatory body which determination is inconsistent with the method of regulated accounting used by the taxpayer immediately prior to the effective date of such rate determination. Such notification shall be made within 90 days of the date that the change in method, the order, or the determination is effective. In the case of a change in the method of regulated accounting, the taxpayer shall recompute its tax liability for any affected taxable year and such recomputation shall be made in the form of an amended return where necessary unless the taxpayer and the district director have consented in writing to extend the time for assessment of tax with respect to the issue of normalization method of regulated accounting.

(6) *Exclusion of normalization reserve from rate base.* (i) Notwithstanding the provisions of subparagraph (1) of this paragraph, a taxpayer does not use a normalization method of regulated accounting if, for ratemaking purposes,

the amount of the reserve for deferred taxes under section 167(l) which is excluded from the base to which the taxpayer's rate of return is applied, or which is treated as no-cost capital in those rate cases in which the rate of return is based upon the cost of capital, exceeds the amount of such reserve for deferred taxes for the period used in determining the taxpayer's tax expense in computing cost of service in such ratemaking.

(ii) For the purpose of determining the maximum amount of the reserve to be excluded from the rate base (or to be included as no-cost capital) under subdivision (i) of this subparagraph, if solely an historical period is used to determine depreciation for Federal income tax expense for ratemaking purposes, then the amount of the reserve account for the period is the amount of the reserve (determined under subparagraph (2) of this paragraph) at the end of the historical period. If solely a future period is used for such determination, the amount of the reserve account for the period is the amount of the reserve at the beginning of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during such period. If such determination is made by reference both to an historical portion and to a future portion of a period, the amount of the reserve account for the period is the amount of the reserve at the end of the historical portion of the period and a pro rata portion of the amount of any projected increase to be credited or decrease to be charged to the account during the future portion of the period. The pro rata portion of any increase to be credited or decrease to be charged during a future period (or the future portion of a part-historical and part-future period) shall be determined by multiplying any such increase or decrease by a fraction, the numerator of which is the number of days remaining in the period at the time such increase or decrease is to be accrued, and the denominator of which is the total number of days in the period (or future portion).

(iii) The provisions of subdivision (i) of this subparagraph shall not apply in the case of a final determination of a rate case entered on or before May 31, 1973. For this purpose, a determination is final if all rights to request a review, a rehearing, or a redetermination by the regulatory body which makes such determination have been exhausted or have lapsed. The provisions of subdivision (ii) of this subparagraph shall not apply in the case of a rate case filed prior to June 7, 1974 for which a rate order is entered by a regulatory body having jurisdiction to establish the rates of the taxpayer prior to September 5, 1974, whether or not such order is final, appealable, or subject to further review or reconsideration.

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

Example 1. Corporation X is exclusively engaged in the transportation of gas by pipeline subject to the jurisdiction of the Z Power Commission. With respect to its post-1969 public utility property, X is entitled under section 167(l)(2)(B) to use a method of depreciation other than a subsection (l) method if it uses a normalization method of regulated accounting. With respect to X the Z Power Commission for purposes of establishing cost of service uses a recent consecutive 12-month period ending not more than 4 months prior to the date of filing a rate case adjusted for certain known changes occurring within a 9-month period subsequent to the base period. X's rate case is filed on January 1, 1975. The year 1974 is the recorded test period for X's rate case and is the period used in determining X's tax expense in computing cost of service. The rates are contemplated to be in effect for the years 1975, 1976, and 1977. The adjustments for known changes relate only to wages and salaries. X's rate base at the end of 1974 is $145,000,000. The amount of the reserve for deferred taxes under section 167(l) at the end of 1974 is $1,300,000, and the reserve is projected to be $4,400,000 at the end of 1975, $6,500,000 at the end of 1976, and $9,800,000 at the end of 1977. X does not use a normalization method of regulated accounting if the Z Power Commission excludes more than $1,300,000 from the rate base to which X's rate of return is applied. Similarly, X does not use a normalization method of regulated accounting if, instead of the above, the Z Power Commission, in determining X's rate of return which is applied to the rate base, assigns to no-cost capital an amount that represents the reserve account for deferred tax that is greater than $1,300,000.

Example 2. Assume the same facts as in example (1) except that the adjustments for known changes in cost of service made by the Z Power Commission include an additional depreciation expense that reflects the installation of new equipment put into service on January 1, 1975. Assume further that the reserve for deferred taxes under section 167(l) at the end of 1974 is $1,300,000 and that the monthly net increases for the first 9 months of 1975 are projected to be:

January 1–31	$310,000
February 1–28	300,000
March 1–31	300,000
April 1–30	280,000
May 1–31	270,000
June 1–30	260,000
July 1–31	260,000
August 1–31	250,000
September 1–30	240,000
	$2,470,000

For its regulated books of account X accrues such increases as of the last day of the month but as a matter of convenience credits increases or charges decreases to the reserve account on the 15th day of the month following the whole month for which such increase or decrease is accrued. The maximum amount that may be excluded from the rate base is $2,470,879 (the amount in the reserve at the end of the historical portion of the period ($1,300,000) and a pro rata portion of the amount of any projected increase for the future portion of the period to be credited to the reserve ($1,170,879)). Such pro rata portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$310,000 × 243/273 =	$275,934
300,000 × 215/273 =	236,264
300,000 × 184/273 =	202,198
280,000 × 154/273 =	157,949
270,000 × 123/273 =	121,648
260,000 × 93/273 =	88,571
260,000 × 62/273 =	59,048
250,000 × 31/273 =	28,388
240,000 × 1/273=	879
	$1,170,879

Example 3. Assume the same facts as in example (1) except that for purposes of establishing cost of service the Z Power Commission uses a future test year (1975). The rates are contemplated to be in effect for 1975, 1976, and 1977. Assume further that plant additions, depreciation expense, and taxes are projected to the end of 1975 and that the reserve for deferred taxes under section 167(l) is $1,300,000 for 1974 and is projected to be $4,400,000 at the end of 1975. Assume also that the Z Power Commission applies the rate of return to X's 1974 rate base of $145,000,000. X and the Z Power Commission through negotiation arrive at the level of approved rates. X uses a normalization method of regulated accounting only if the settlement agreement, the rate order, or record of the proceedings of the Z Power Commission indicates that the Z Power Commission did not exclude an amount representing the reserve for deferred taxes from X's rate base ($145,000,000) greater than $1,300,000 plus a pro rata portion of the projected increases and decreases that are to be credited or charged to the reserve account for 1975. Assume that for 1975 quarterly net increases are projected to be:

1st quarter	$910,000
2nd quarter	810,000
3rd quarter	750,000
4th quarter	630,000
Total	$3,100,000

For its regulated books of account X will accrue such increases as of the last day of the quarter but as a matter of convenience will credit increases or charge decreases to the reserve account on the 15th day of the month following the last month of the quarter for which such increase or decrease will be accrued. The maximum amount that may be excluded from the rate base is $2,591,480 (the amount of the reserve at the beginning of the period ($1,300,000) plus a pro rata portion ($1,291,480) of the $3,100,000 projected increase to be credited to the reserve during the period). Such portion is computed (without regard to the date such increase will actually be posted to the account) as follows:

$910,000 × 276/365=	$688,110
810,000 × 185/365=	410,548
750,000 × 93/365=	191,096
630,000 × 1/365=	1,726
	$1,291,480

(i) *Flow-through method of regulated accounting.* Under section 167(l)(3)(H), a taxpayer uses a flow-through method of regulated accounting with respect to public utility property if it uses the same method of depreciation (other than a subsection (l) method) to compute its allowance for depreciation under section 167 and to compute its tax expense for purposes of reflecting operating results in its regulated books of account unless such method is the same method used by the taxpayer to determine its depreciation expense for purposes of reflecting operating results in its regulated books of account. Except as provided in the preceding sentence, the method of depreciation used by a taxpayer with respect to public utility property for purposes of determining cost of service for ratemaking purposes or rate base for ratemaking purposes shall not be considered in determining whether the taxpayer used a flow-through method of regulated accounting. A taxpayer may establish use of a flow-through method of regulated accounting in the same manner that compliance with normalization requirements in respect of operating books of account may be established under paragraph (h)(4) of this section.

[T.D. 7315, 39 FR 20195, June 7, 1974]

§ 1.167(l)–2 Public utility property; election as to post-1969 property representing growth in capacity.

(a) *In general.* Section 167(l)(2) prescribes the methods of depreciation which may be used by a taxpayer with respect to its post-1969 public utility property. Under section 167(l)(2) (A) and (B) the taxpayer may use a subsection (l) method of depreciation (as defined in section 167(l)(3)(F)) or any other method of depreciation which is otherwise allowable under section 167 if, in conjunction with the use of such other method, such taxpayer uses the normalization method of accounting (as defined in section 167(l)(3)(G)). Paragraph (2)(C) of section 167(l) permits a taxpayer which used the flow-through method of accounting for its July 1969 accounting period (as these terms are defined in section 167(l)(3) (H) and (I), respectively) to use its applicable 1968 method of depreciation with respect to certain property. Section 167(l)(3)(D) describes the term ''applicable 1968 method''. Accordingly, a regulatory agency is not precluded by section 167(l) from requiring such a taxpayer subject to its jurisdiction to continue to use the flow-through method of accounting unless the taxpayer makes the election pursuant to section 167(l)(4)(A) and this section. Whether or not the election is made, if such a regulatory agency permits the taxpayer to change from the flow-through method of accounting, subsection (l)(2) (A) or (B) would apply and such taxpayer could, subject to the provisions of section 167(e) and the regulations thereunder (relating to change in method), use a subsection (l) method of depreciation or, if the taxpayer uses the normalization method of accounting, any other method of depreciation otherwise allowable under section 167.

(1) *Election.* Under subparagraph (A) of section 167(l)(4), if the taxpayer so elects, the provisions of paragraph (2)(C) of section 167(l) shall not apply to its qualified public utility property (as such term is described in paragraph (b) of this section). In such case the taxpayer making the election shall use a method of depreciation prescribed by section 167(l)(2) (A) or (B) with respect to such property.

(2) *Property to which election shall apply.* (i) Except as provided in subdivision (ii) of this subparagraph the election provided by section 167(l)(4)(A) shall apply to all of the qualified public utility property of the taxpayer.

(ii) In the event that the taxpayer wishes the election provided by section 167(l)(4)(A) to apply to only a portion of its qualified public utility property, it must clearly identify the property to be subject to the election in the statement of election described in paragraph (e) of this section. Where all property which performs a certain function is included within the election, the election shall apply to all future acquisitions of qualified public utility property which perform the same function. Where only certain property within a functional group of property is included within the election, the election shall apply only to property which is of the same kind as the included property.

(iii) The provisions of subdivision (ii) of this subparagraph may be illustrated by the following examples:

Example 1. Corporation *A*, an electric utility company, wishes to have the election provided by section 167(l)(4)(A) apply only with respect to its production plant. A statement that the election shall apply only with respect to production plant will be sufficient to include within the election all of the taxpayer's qualified production plant of any kind. All public utility property of the taxpayer other than production plant will not be subject to the election.

Example 2. Corporation *B*, an electric utility company, wishes to have the election provided by section 167(l)(4)(A) apply only with respect to nuclear production plant. A statement which clearly indicates that only nuclear production plant will be included in the election will be sufficient to exclude from the election all public utility property other than nuclear production plant.

(b) *Qualified public utility property*—(1) *Definition.* For purposes of this section the term ''qualified public utility property'' means post-1969 public utility property to which section 167(l)(2)(C) applies, or would apply if the election described in section 167(l)(4)(A) had not been made, to the extent that such property constitutes property which increases the productive or operational capacity of the taxpayer with respect to the goods or services described in section 167(l)(3)(A) and does not represent the replacement of existing capacity. In the event that particular assets which are post-1969 public utility property both replace existing public utility property and increase the productive or operational capacity of the taxpayer, only that portion of each such asset which is properly allocable, pursuant to the provisions of subparagraph (3)(v) of this paragraph or paragraph (c)(2) of this section (as the case may be), to increasing the productive or operational capacity of the taxpayer shall be qualified public utility property.

(2) *Limitation on use of formula method.* A taxpayer which makes the election with respect to all of its post-1969 public utility property may determine the amount of its qualified public utility property by using the formula method described in paragraph (c) of this section or, where the taxpayer so chooses, it may use any other method based on engineering data which is satisfactory to the Commissioner. A taxpayer which chooses to include only a portion of its post-1969 public utility property in the election described in paragraph (a)(1) of this section shall, in a manner satisfactory to the Commissioner and consistent with the provisions of subparagraph (3) of this paragraph, use a method based on engineering data. If a taxpayer uses the formula method described in paragraph (c) of this section, it must continue to use such method with respect to additions made in subsequent taxable years. The taxpayer may change from an engineering method to the formula method described in paragraph (c) of this section by filing a statement described in paragraph (h) of this section if it could have used such formula method for the prior taxable year.

(3) *Measuring capacity under an engineering method in the case of a general election.* (i) The provisions of this subparagraph apply in the case of an election made with respect to all of the post-1969 public utility property of the taxpayer.

(ii) A taxpayer which uses a method based on engineering data to determine the portion of its additions for a taxable year which constitutes qualified public utility property shall make such determination with reference to its ''adjusted capacity'' as of the first day of the taxable year during which such additions are placed in service. For purposes of this subparagraph, the term ''adjusted capacity'' means the taxpayer's capacity as of January 1, 1970, adjusted upward in the manner described in subdivision (iii) of this subparagraph for each taxable year ending after December 31, 1969, and before the first day of the taxable year during which the additions described in the preceding sentence are placed in service.

(iii) The adjustment described in this subdivision for each taxable year shall be equal to the number of units of capacity by which additions for the taxable year of public utility property with respect to which the election had been made exceed the number of units of capacity of retirements for such taxable year of public utility property with respect to which the flow-through method of accounting was being used at the time of their retirement. If for any taxable year the computation in the preceding sentence results in a negative amount, such negative amount shall be taken into account as a reduction in the amount of the adjustment (computed without regard to this sentence) in succeeding taxable years.

(iv) The provisions of this subparagraph may be illustrated by the following table which assumes that the taxpayer's adjusted capacity as of January 1, 1970, was 5,000 units:

1	2	3	4	5	6	7
Year	Additions	Flow-through retirements	Net additions	Adjusted capacity [1]	Actual capacity	Units of qualified additions [1 2]
1970	1000	700	300	5000	5300	300
1971	300	500	(200)	5300	5100	
1972	500	200	300	5300	5400	100

1	2	3	4	5	6	7
Year	Additions	Flow-through retirements	Net additions	Adjusted capacity [1]	Actual capacity	Units of qualified additions [1 2]
1973	400	800	(400)	5400	5000	
1974	600	400	200	5400	5200	
1975	800	300	500	5400	5700	300

[1] Capacity as of Jan. 1, 1970, plus amounts in column 7 for years prior to the year for which determination is being made.
[2] Column 6 minus column 5.

(v) The qualified portion of the basis for depreciation (as defined in section 167(g)) of each asset or group of assets (if group or composite accounting is used by the taxpayer) subject to the election shall be determined using the following ratio:

Qualified portion of basis of asset ÷ Total basis of asset = Units of qualified additions computed in column 7 on chart ÷ Units of capacity of additions computed in column 2 on chart.

(c) *Formula method of determining amount of property subject to election*—(1) *In general.* The following formula method may be used to determine the amount of qualified public utility property:

Step 1. Find the total cost (within the meaning of section 1012) to the taxpayer of additions during the taxable year of all post-1969 public utility property with respect to which section 167(l)(2)(C) would apply if the election had not been made.

Step 2. Aggregate the cost (within the meaning of section 1012) to the taxpayer of all retirements during the taxable year of public utility property with respect to which the flow-through method of accounting was being used at the time of their retirement.

Step 3. Subtract the figure reached in step 2 from the figure reached in step 1.

In the event that the figure reached in step 2 exceeds the figure reached in step 1 such excess shall be carried forward to the next taxable year and shall be aggregated with the cost (within the meaning of section 1012) to the taxpayer of all retirements referred to in step 2 for such next taxable year.

(2) *Allocation of bases.* The amount of qualified public utility property as determined in accordance with the formula method described in subparagraph (1) of this paragraph shall be allocated to the basis for depreciation (as defined in section 167(g)) of each asset or group of assets (if group or composite accounting is used by the taxpayer) subject to the election using the following ratio:

Amount of qualified additions computed in step 3 ÷ Amount of total additions computed in step 1 = Qualified portion of basis of asset ÷ Total basis of asset.

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

Example 1. Corporation *A*, a telephone company subject to the jurisdiction of the Federal Communications Commission, elected, pursuant to the provisions of section 167(l)(4)(A) and this section, with respect to all of its qualified post-1969 public utility property to have the provisions of paragraph (2) (C) of section 167(l) not apply. In 1971 the Corporation added new underground cable with a cost (within the meaning of section 1012) to it of $4 million to its underground cable account. In the same year it retired public utility property with a cost (within the meaning of section 1012) to Corporation *A* of $1.5 million. The flow-through method of accounting was being used with respect to all of the retired property at the time of retirement. Using the formula method described in paragraph (c) of this section, the amount of qualified underground cable would be determined as follows:

	Million
Step 1. Aggregate cost of flow-through additions	$4.0
Step 2. Cost of all flow-through retirements	1.5
Step 3. Figure reached in step 1 less figure reached in step 2	2.5

The amount of qualified public utility property to which section 167(l)(2)(C) will not apply is $2.5 million. Pursuant to the provisions of paragraph (c)(2) of this section, the amount of qualified public utility property would be allocated to the basis for depreciation (as defined in section 167(g)) of an asset with a total basis for depreciation of $2 million as follows:

$2.5 million (figure in step 3)/$4 million (figure in step 1) = Qualified portion of basis of asset/$2 million Qualified portion of basis of asset = $1.25 million.

Example 2. In 1972 Corporation *A* (the corporation described in example (1)) added underground cable with a cost (within the meaning of section 1012) to it of $1 million. In the same year the cost (within the meaning of section 1012) to the corporation of retirements of public utility property with respect to which the flow-through method of accounting was being used was $3 million. There were no other additions or retirements. The amount of qualified public utility property would be determined as follows:

	Million
Step 1. Aggregate cost of flow-through additions	$1.0
Step 2. Cost of all flow-through retirements	3.0
Step 3. Figure reached in step 1 less figure reached in step 2	(2.0)

Since retirements of flow-through public utility property for the year 1972 exceeded additions made during such year, the excess retirements, $2.0 million, must be carried forward to be aggregated with retirements for 1973.

Example 3. Corporation *B*, a gas pipeline company subject to the jurisdiction of the Federal Power Commission, made the election provided by section 167(l)(4)(A) and this section with respect to all of its post-1969 public utility property. Corporation *B* chose to use an engineering data method of determining which property was subject to the election provided by this section. In 1970, the corporation replaced a portion of its pipeline with respect to which the flow-through method of accounting was being used at the time of its retirement which had a peak capacity on January 1, 1970, of 100,000 thousand cubic feet (M c.f.) per day at a pressure of 14.73 pounds per square inch absolute (p.s.i.a.) with pipe with a capacity of 125,000 M c.f. per day at 14.73 p.s.i.a. Assuming that there were no other additions or retirements, using an engineering data method one-fifth of the new pipeline would be property subject to the election of this section effective for its taxable year beginning on January 1, 1971.

Example 4. In 1970 Corporation *C* (with the same characteristics as the corporation described in example (3)) extended its pipeline 5 miles further than it extended on January 1, 1970. Assuming that there were no other additions or retirements, the entire extension would be property subject to the election provided by this section effective for its taxable year beginning on January 1, 1971.

Example 5. As a result of a change of service areas between two corporations, in 1970 Corporation *D* (with the same characteristics as the corporation described in example (3)) retired a pipeline running north and south and replaced it with a pipeline of equal length and capacity running east and west. No part of the pipeline running east and west is property subject to the election.

(e) *Manner of making election.* The election described in paragraph (a) of this section shall be made by filing, in duplicate, with the Commissioner of Internal Revenue, Washington, D.C. 20224, Attention, T:I:E, a statement of such election.

(f) *Content of statement.* The statement described in paragraph (e) of this section shall indicate that an election is being made under section 167(l) of the Internal Revenue Code of 1954, and it shall contain the following information:

(1) The name, address, and taxpayer identification number of the taxpayer,

(2) Whether the taxpayer will use the formula method of determining the amount of its qualified public utility property described in paragraph (c) of this section, or an engineering method, and

(3) Where the taxpayer wishes to include only a portion of its public utility property in the election pursuant to the provisions of paragraph (a)(2) of this section, a description sufficient to clearly identify the property to be included.

(g) *Time for making election.* The election permitted by this section shall be made by filing the statement described in paragraph (e) of this section not later than Monday, June 29, 1970.

(h) *Change of method of determining amount of qualified property.* Where a taxpayer which has elected pursuant to the provisions of section 167(l)(4)(A) wishes to change, pursuant to the provisions of paragraph (b)(2) of this section, from an engineering data method of determining which of its property is qualified public utility property to the formula method described in paragraph (c) of this section, it may do so by filing a statement to that effect at the time that it files its income tax return, with the district director or director of the regional service center, with whom the taxpayer's income tax return is required to be filed.

(i) *Revocability of election.* An election made under section 167(l) shall be irrevocable.

(j) *Effective date.* The election prescribed by section 167(l)(4)(A) and this section shall be effective for taxable years beginning after December 31, 1970.

[T.D. 7045, 35 FR 8933, June 10, 1970. Redesignated by T.D. 7315, 39 FR 20195, June 7, 1974]

§ 1.167(l)–3 Multiple regulation, asset acquisitions, reorganizations, etc.

(a) *Property not entirely subject to jurisdiction of one regulatory body*—(1) *In general.* If a taxpayer which uses a method of depreciation other than a subsection (l) method of depreciation is required by a regulatory body having jurisdiction over less than all of its property to use, or not to use, a method of regulated accounting (*i.e.*, normalization or flow-through), such taxpayer shall be considered as using, or not using, such method of regulated accounting only with respect to property subject to the jurisdiction of such regulatory body. In the case of property which is contained in a multiple asset account, the provisions of § 1.167(a)–7(c) and § 1.167 (a)–11(c)(1)(iv) apply to prohibit depreciating a single account by two or more different methods.

(2) *Jurisdiction of regulatory body.* For purposes of this paragraph, a regulatory body is considered to have jurisdiction over property of a taxpayer if expenses with respect to the property are included in cost of service as determined by the regulatory body for ratemaking purposes or for reflecting operating results in its regulated books of account. For example, if regulatory body A, having jurisdiction over 60 percent of an item of X corporation's public utility property, required X to use the flow-through method of regulated accounting in circumstances which would bar X from using a method of depreciation under section 167(a) other than a subsection (l) method, and if regulatory body B, having jurisdiction over the remaining 40 percent of such item of property does not so require X to use the flow-through method of regulated accounting (or if the remaining 40 percent is not subject to the jurisdiction of any regulatory body), then with respect to 60 percent of the adjusted basis of the property X is prohibited from using a method of depreciation for purposes of section 167(a) other than a subsection (1) method. If in such example, A, having jurisdiction over 60 percent of X's public utility property, had jurisdiction over 100 percent of a particular generator, then with respect to the generator X would be prohibited from using a method of depreciation other than a subsection (l) method.

(3) *Public utility property subject to more than one regulatory body.* If a regulatory body having jurisdiction over public utility property with respect to the taxpayer's regulated books of account requires the taxpayer to reflect its tax expense in such books in the manner used by the regulatory body having jurisdiction over the public utility property for purposes of determining the taxpayer's cost of service for ratemaking purposes, the rules of subparagraphs (1) and (2) of this paragraph shall apply.

(b) *Leasing transactions*—(1) *Leased property.* Public utility property as defined in paragraph (b) of § 1.167(l)–1 includes property which is leased by a taxpayer where the leasing of such property is part of the lessor's section 167(l) public utility activity. Thus, such leased property qualifies as public utility property even though the predominant use of such property by the lessee is in other than a section 167(l) public utility activity. Further, leased property qualifies as public utility property under section 167(l) even though the leasing is not part of the lessor's public utility activity if the predominant use of such property by the lessee or any sublessee is in a section 167(l) public utility activity. However, the limitations of section 167(l) apply to a taxpayer only if such taxpayer is subject to the jurisdiction of a regulatory body described in a section 167(l)(3)(A). For example, if a financial institution purchases property which it then leases to a lessee which uses such property predominantly in a section 167(l) public utility activity, the property qualifies as public utility property. However, because the financial institution's rates for leasing the property are not subject to the jurisdiction of a regulatory body described in section 167(l)(3)(A), the provisions of section 167(l) do not apply to the depreciation deductions taken with respect to the property by the financial institution. For possible application of section 167(l) to the lessee, see subparagraph (2) of this paragraph.

(2) *Certain rental payments.* Under section 167(l)(5), if a taxpayer leases property which is public utility property and the regulatory body having jurisdiction over such property for purposes of determining the taxpayer's operating results in its regulated books of account or for ratemaking purposes allows only an amount of such lessee's expenses with respect to the lease which is less than the amount which the taxpayer deducts for purposes of its Federal income tax liability, then a portion of the difference between such amounts shall not be allowed as a deduction by the taxpayer for purposes of its Federal income tax liability in such manner and time as the Commissioner or his delegate may determine consistent with the principles of §1.167(l)–1 and this section applicable as to when a method of depreciation other than a subsection (1) method may be used for purposes of section 167(a).

(c) *Certain partnership arrangements.* Under section 167(l)(5), if property held by a partnership is not public utility property in the hands of the partnership but would be public utility property if an election was made under section 761 to be excluded from partnership treatment, then section 167(l) shall be applied by treating the partners as directly owning the property in proportion to their partnership interests.

(d) *Cross reference.* See §1.167(l)–1(c)(1) for treatment of certain property as ''pre-1970 public utility property'' and §1.167(l)–1(e)(4)(ii) for applicable 1968 method in the case of property acquired in certain transactions.

[T.D. 7315, 39 FR 20202, June 7, 1974]

§ 1.167(l)–4 Public utility property; election to use asset depreciation range system.

(a) *Application of section 167(l) to certain property subject to asset depreciation range system.* If the taxpayer elects to compute depreciation under the asset depreciation range system described in §1.167(a)–11 with respect to certain public utility property placed in service after December 31, 1970, see §1.167(a)–11(b) (6).

(Sec. 167 of the Internal Revenue Code of 1954 (26 U.S.C. 167) and sec. 7805 of the Internal Revenue Code of 1954 (26 U.S.C. 7805))

[T.D. 7128, 36 FR 11939, June 23, 1971. Redesignated by T.D. 7315, 39 FR 20203, June 7, 1974]

§ 1.167(m)–1 Class lives.

(a) For rules regarding the election to use the class life system authorized by section 167(m), see the provisions of §1.167(a)–11.

(Sec. 167(m), 85 Stat. 508 (26 U.S.C. 167))

[T.D. 7272, 38 FR 9986, Apr. 23, 1973]

§ 1.168–5 Special rules.

(a) *Retirement-replacement-betterment (RRB) property*—(1) *RRB replacement property placed in service before January 1, 1985.* (i) Except as provided in paragraph (a)(1)(ii) of this section, the recovery deduction for the taxable year for retirement-replacement-betterment (RRB) replacement property (as defined in paragraph (a)(3) of this section) placed in service before January 1, 1985, shall be (in lieu of the amount determined under section 168(b)) an amount determined by applying to the unadjusted basis (as defined in section 168(d)(1) and the regulations thereunder) of such property the applicable percentage determined in accordance with the following table:

If the recovery year is:	And the year the property is placed in service is:			
	1981	1982	1983	1984
	The applicable percentage is:			
1	100	50	33	25
2	....	50	45	38
3	....	....	22	25
4	....	....	....	12

(ii) The provisions of paragraph (a)(1)(i) of this section do not apply to any taxpayer who did not use the RRB method of depreciation under section 167 as of December 31, 1980. In such case, RRB replacement property placed in service by the taxpayer after December 31, 1980, shall be treated as other 5-year recovery property under section 168.

(2) *RRB replacement property placed in service after December 31, 1984.* RRB replacement property placed in service

after December 31, 1984, is treated as other 5-year recovery property under section 168.

(3) *RRB replacement property defined.* RRB replacement property, for purposes of section 168, means replacement track material (including rail, ties, other track material, and ballast) installed by a railroad (including a railroad switching or terminal company) if—

(i) The replacement is made pursuant to a scheduled program for replacement.

(ii) The replacement is made pursuant to observations by maintenance-of-way personnel of specific track material needing replacement.

(iii) The replacement is made pursuant to the detection by a rail-test car of specific track material needing replacement, or

(iv) The replacement is made as a result of a casualty.

Replacements made as a result of a casualty shall be RRB replacement property only to the extent that, in the case of each casualty, the replacement cost with respect to the replacement track material exceeds $50,000.

(4) *Recovery of adjusted basis of RRB property as of December 31, 1980.* The taxpayer shall recover the adjusted basis of RRB property (as defined in section 168(g)(6)) as of December 31, 1980, over a period of not less than 5 years and not more than 50 years, using a rate of recovery consistent with any method described in section 167(b), including the method described in section 167(b)(2), switching to the method described in section 167(b)(3) at a time to maximize the deduction. For purposes of determining the recovery allowance under this subparagraph, salvage value shall be disregarded and, in the case of a taxpayer that depreciated RRB property placed in service before January 1, 1981, using the RRB method consistently for all periods after February 28, 1913, the adjusted basis of RRB property is the adjusted basis for purposes of determining the deduction for retirements under the RRB method, with no adjustment for depreciation sustained prior to March 1, 1913.

(5) *RRB property (which is not RRB replacement property) placed in service after December 31, 1980.* Property placed in service by the taxpayer after December 31, 1980, which is not RRB replacement property and which, under the taxpayer's method of depreciation as of December 31, 1980, would have been depreciated by the taxpayer under the RRB method, is treated as other property under section 168.

(b)–(f) [Reserved]

[T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§ 1.168(a)–1 Modified accelerated cost recovery system.

(a) Section 168 determines the depreciation allowance for tangible property that is of a character subject to the allowance for depreciation provided in section 167(a) and that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143). Except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule, the provisions of section 168 are mandatory for all eligible property. The allowance for depreciation under section 168 constitutes the amount of depreciation allowable under section 167(a). The determination of whether tangible property is property of a character subject to the allowance for depreciation is made under section 167 and the regulations under section 167.

(b) This section is applicable on and after February 27, 2004.

[T.D. 9314, 72 FR 9248, Mar. 1, 2007]

§ 1.168(b)–1 Definitions.

(a) *Definitions.* For purposes of section 168 and the regulations under section 168, the following definitions apply:

(1) *Depreciable property* is property that is of a character subject to the allowance for depreciation as determined under section 167 and the regulations under section 167.

(2) *MACRS property* is tangible, depreciable property that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143) and subject to section 168, except

for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule.

(3) *Unadjusted depreciable basis* is the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under section 179, section 179C, section 181, or any similar provision, and for any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations under the Code (other than section 1016(a)(2) and (3)) (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)). For property subject to a lease, see section 167(c)(2).

(4) *Adjusted depreciable basis* is the unadjusted depreciable basis of the property, as defined in §1.168(b)–1(a)(3), less the adjustments described in section 1016(a)(2) and (3).

(5) *Qualified improvement property.* (i) Is any improvement that is section 1250 property to an interior portion of a building, as defined in §1.48–1(e)(1), that is nonresidential real property, as defined in section 168(e)(2)(B), if the improvement is placed in service by the taxpayer after the date the building was first placed in service by any person and if—

(A) For purposes of section 168(e)(6), the improvement is made by the taxpayer and is placed in service by the taxpayer after December 31, 2017;

(B) For purposes of section 168(k)(3) as in effect on the day before amendment by section 13204(a)(4)(B) of the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054 (December 22, 2017)) (''Act''), the improvement is acquired by the taxpayer before September 28, 2017, the improvement is placed in service by the taxpayer before January 1, 2018, and the improvement meets the original use requirement in section 168(k)(2)(A)(ii) as in effect on the day before amendment by section 13201(c)(1) of the Act; or

(C) For purposes of section 168(k)(3) as in effect on the day before amendment by section 13204(a)(4)(B) of the Act, the improvement is acquired by the taxpayer after September 27, 2017; the improvement is placed in service by the taxpayer after September 27, 2017, and before January 1, 2018; and the improvement meets the requirements in section 168(k)(2)(A)(ii) as amended by section 13201(c)(1) of the Act; and

(ii) Does not include any qualified improvement for which an expenditure is attributable to—

(A) The enlargement, as defined in §1.48–12(c)(10), of the building;

(B) Any elevator or escalator, as defined in §1.48–1(m)(2); or

(C) The internal structural framework, as defined in §1.48–12(b)(3)(iii), of the building.

(b) *Applicability date*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, this section is applicable on or after February 27, 2004.

(2) *Application of paragraph (a)(5) of this section and addition of ''section 181'' in paragraph (a)(3) of this section*—(i) *In general.* Except as provided in paragraphs (b)(2)(ii) through (iv) of this section, paragraph (a)(5) of this section and the language ''section 181,'' in the second sentence in paragraph (a)(3) of this section are applicable on or after September 24, 2019.

(ii) *Early application of paragraph (a)(5) of this section and addition of ''section 181'' in paragraph (a)(3) of this section.* A taxpayer may choose to apply paragraph (a)(5) of this section and the language ''section 181,'' in the second sentence in paragraph (a)(3) of this section for the taxpayer's taxable years ending on or after September 28, 2017.

(iii) *Early application of regulation project REG–104397–18.* A taxpayer may rely on the provisions of paragraph (a)(5) of this section in regulation project REG–104397–18 (2018–41 I.R.B 558) (see §601.601(d)(2)(ii)(b) of this chapter) for the taxpayer's taxable years ending on or after September 28, 2017, and ending before the taxpayer's taxable year that includes September 24, 2019.

(iv) *Addition of language in paragraph (a)(5)(i)(A) of this section.* The language ''is made by the taxpayer and'' in paragraph (a)(5)(i)(A) of this section applies to property placed in service by the taxpayer after December 31, 2017.

[T.D. 9314, 72 FR 9248, Mar. 1, 2007, as amended by T.D. 9874, 84 FR 50126, Sept. 24, 2019; T.D. 9916, 85 FR 71752, Nov. 10, 2020]

§ 1.168(d)–0 Table of contents for the applicable convention rules.

This section lists the major paragraphs in § 1.168(d)–1.

§ 1.168(d)–1 Applicable conventions—Half-year and mid-quarter conventions.

[T.D. 8444, 57 FR 48981, Oct. 29, 1992]

§ 1.168(d)–1 Applicable conventions—half-year and mid-quarter conventions.

(a) *In general.* Under section 168(d), the half-year convention applies to depreciable property (other than certain real property described in section 168(d)(2)) placed in service during a taxable year, unless the mid-quarter convention applies to the property. Under section 168(d)(3)(A), the mid-quarter convention applies to depreciable property (other than certain real property described in section 168(d)(2)) placed in service during a taxable year if the aggregate basis of property placed in service during the last three months of the taxable year exceeds 40 percent of the aggregate basis of property placed in service during the taxable year (''the 40-percent test''). Thus, if the depreciable property is placed in service during a taxable year that consists of three months or less, the mid-quarter convention applies to the property. Under section 168(d)(3)(b)(i), the depreciable basis of nonresidential real property, residential rental property, and any railroad grading or tunnel bore is disregarded in applying the 40-percent test. For rules regarding property that is placed in service and disposed of in the same taxable year, see paragraph (b)(3) of this section. For the definition of ''aggregate basis of property,'' see paragraph (b)(4) if this section.

(b) *Additional rules for determining whether the mid-quarter convention applies and for applying the applicable convention*—(1) *Property described in section 168(f).* In determining whether the 40-percent test is testified for a taxable year, the depreciable basis of property described in section 168(f) (property to which section 168 does not apply) is not taken into account.

(2) *Listed property.* The depreciable basis of listed property (as defined in section 280F(d)(4) and the regulations thereunder) placed in service during a taxable year is taken into account (unless otherwise excluded) in applying the 40-percent test.

(3) *Property placed in service and disposed of in the same taxable year.* (i) Under section 168(d)(3)(B)(ii), the depreciable basis of property placed in service and disposed of in the same taxable year is not taken into account in determining whether the 40-percent test is satisfied. However, the depreciable basis of property placed in service, disposed of, subsequently reacquired, and again placed in service, by the taxpayer in the same taxable year must be taken into account in applying the 40-percent test, but the basis of the property is only taken into account on the later of the dates that the property is placed in service by the taxpayer during the taxable year. Further, see §§ 1.168(i)–6(c)(4)(v)(B) and 1.168(i)–6(f) for rules relating to property placed in service and exchanged or involuntarily converted during the same taxable year.

(ii) The applicable convention, as determined under this section, applies to all depreciable property (except nonresidential real property, residential rental property, and any railroad grading or tunnel bore) placed in service by the taxpayer during the taxable year, excluding property placed in service and disposed of in the same taxable year. However, see §§ 1.168(i)–6(c)(4)(v)(A) and 1.168(i)–6(f) for rules relating to MACRS property that has a basis determined under section 1031(d) or section 1033(b). No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year. However, see § 1.168(k)–1(f)(1) for rules relating to qualified property or 50-percent bonus depreciation property, and § 1.1400L(b)–1(f)(1) for rules relating to qualified New York Liberty Zone property, that is placed in service by the taxpayer in the same taxable year in which either a partnership is terminated as a result of a technical termination under section 708(b)(1)(B) or the property is transferred in a transaction described in section 168(i)(7). Further, see § 1.168(k)–2(g)(1) for rules relating to qualified property under section 168(k), as amended by the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054 (December 22, 2017)), that is placed in service by the taxpayer in the same taxable year in which either a partnership is terminated as a result of a technical termination under section 708(b)(1)(B) or the property is transferred in a transaction described in section 168(i)(7).

(4) *Aggregate basis of property*. For purposes of the 40-percent test, the term ''aggregate basis of property'' means the sum of the depreciable bases of all items of depreciable property that are taken into account in applying the 40-percent test. ''Depreciable basis'' means the basis of depreciable property for purposes of determining gain under sections 1011 through 1024. The depreciable basis for the taxable year the property is placed in service reflects the reduction in basis for—

(i) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179;

(ii) Any adjustment to basis under section 48(q); and

(iii) The percentage of the taxpayer's use of the property for the taxable year other than in the taxpayer's trade or business (or for the production of income), but is determined before any reduction for depreciation under section 167(a) for that taxable year.

(5) *Special rules for affiliated groups*—(i) In the case of a consolidated group (as defined in § 1.1502–1(h)), all members of the group that are included on the consolidated return are treated as one taxpayer for purposes of applying the 40-percent test. Thus, the depreciable bases of all property placed in service by members of a consolidated group during a consolidated return year are taken into account (unless otherwise excluded) in applying the 40-percent test to determine whether the mid-quarter convention applies to property placed in service by the members during the consolidated return year. The 40-percent test is applied separately to the depreciable bases of property placed in service by any member of an affiliated group that is not included in a consolidated return of the taxable year in which the property is placed in service.

(ii) In the case of a corporation formed by a member or members of a consolidated group and that is itself a member of the consolidated group (''newly-formed subsidiary''), the depreciable bases of property placed in service by the newly-formed subsidiary in the consolidated return year in which it is formed is included with the depreciable bases of property placed in service during the consolidated return year by the other members of the consolidated group in applying the 40-percent test. If depreciable property is placed in service by a newly-formed subsidiary during the consolidated return year in which it was formed, the newly-formed subsidiary is considered as being in existence for the entire consolidated return year for purposes of applying the applicable convention to determine when the recovery period begins.

(iii) The provisions of paragraph (b)(5)(ii) of this section are illustrated by the following example.

Example. Assume a member of a consolidated group that files its return on a calendar-year basis forms a subsidiary on August 1. The subsidiary places depreciable property in service on August 5. If the mid-quarter convention applies to property placed in service by the members of the consolidated group (including the newly-formed subsidiary), the property placed in service by the subsidiary on August 5 is deemed placed in service on the mid-point of the third quarter of the consolidated return year (*i.e.*, August 15). If the mid-quarter convention does not apply, the property is deemed placed in service on the mid-point of the consolidated return year (*i.e.*, July 1).

(iv) In the case of a corporation that joins or leaves a consolidated group, the depreciable bases of property placed in service by the corporation joining or leaving the group during the portion of the consolidated return year that the corporation is a member of the consolidated group is included with the depreciable bases of property placed in service during the consolidated return year by the other members in applying the 40-percent test. The depreciable bases of property placed in service by the joining or leaving member in the taxable year before it joins or after it leaves the consolidated group is not taken into account by the consolidated group in applying the 40-percent test for the consolidated return year. If a corporation leaves a consolidated group and joins another consolidated group, each consolidated group takes into account, in applying the 40-percent test, the depreciable bases of property placed in service by the corporation while a member of the group.

(v) The provisions of paragraph (b)(5)(iv) of this section are illustrated by the following example.

Example. Assume Corporations A and B file a consolidated return on a calendar-year basis. Corporation C, also a calendar-year taxpayer, enters the consolidated group on July 1 and is included on the consolidated return for that taxable year. The depreciable bases of property placed in service by C during the period of July 1 to December 31 is included with the depreciable bases of property placed in service by A and B during the entire consolidated return year in applying the 40-percent test. The depreciable bases of property placed in service by C from January 1 to June 30 is not taken into account by the consolidated group in applying the 40-percent test. If C was a member of another consolidated group during the period from January 1 to June 30, that consolidated group would include the depreciable bases of property placed in service by C during that period.

(vi) A corporation that joins or leaves a consolidated group during a consolidated year is considered as being a member of the consolidated group for the entire consolidated return year for purposes of applying the applicable convention to determine when the recovery period begins for depreciable property placed in service by the corporation during the portion of the consolidated return year that the corporation is a member of the group.

(vii) If depreciable property is placed in service by a corporation in the taxable year ending immediately before it joins a consolidated group or beginning immediately after it leaves a consolidated group, the applicable convention is applied to the property under either the full taxable year rules or the short taxable year rules, as applicable.

(viii) The provisions of paragraphs (d)(5)(vi) and (vii) of this section are illustrated by the following example.

Example. Assume that on July 1, C, a calendar-return corporation, joins a consolidated group that files a return on a calendar-year basis. The short taxable year rules apply to C for the period of January 1 to June 30. However, in applying the applicable convention to determine when the recovery period begins for depreciable property placed in service for the period of July 1 to December 31, C is considered as being a member of the consolidated group for the entire consolidated return year. Thus, if the half-year convention applies to depreciable property placed in service by the consolidated group (taking into account the depreciable bases of property placed in service by C after June 30), the property is deemed placed in service on the mid-point of the consolidated return year (*i.e.*, July 1, if the group did not have a short taxable year).

(ix) In the case of a transfer of depreciable property between members of a consolidated group, the following special rules apply for purposes of applying the 40-percent test. Property that is placed in service by one member of a consolidated group and transferred to another member of the same group is considered as placed in service on the date that it is placed in service by the transferor member, and the date it is placed in service by the transferee member is disregarded. In the case of multiple transfers of property between members of a consolidated group, the property is considered as placed in service on the date that the first member places the property in service, and the dates it is placed in service by other members are disregarded. The depreciable basis of the transferred property that is taken into account in applying the 40-percent test is the depreciable basis of the property in the hands of the transferor member (as determined under paragraph (b)(4) of this section), or, in the case of multiple transfers of property between members, the depreciable basis in the hands of the first member that placed the property in service.

(x) The provisions of paragraph (b)(5)(ix) of this section are illustrated by the following example.

Example. Assume the ABC consolidated group files its return on a calendar-year basis. A, a member of the consolidated group, purchases depreciable property costing $50,000 and places the property in service on January 5, 1991. On December 1, 1991, the property is transferred for $75,000 to B, another member of the consolidated group. In applying the 40-percent test to the members of the consolidated group for 1991, the property is considered as placed in service on January 5, the date that A placed the property in service, and the depreciable basis of the property that is taken into account is $50,000.

(6) *Special rule for partnerships and S corporations.* In the case of property placed in service by a partnership or an S corporation, the 40-percent test is generally applied at the partnership or corporate level. However, if a partnership or an S corporation is formed or availed of for the principal purpose of either avoiding the application of the mid-quarter convention or having the mid-quarter convention apply where it otherwise would not, the 40-percent test is applied at the partner, shareholder, or other appropriate level.

(7) *Certain nonrecognition transaction*—(i) Except as provided in paragraph (b)(6) of this section, if depreciable property is transferred in a transaction described in section 168(i)(7)(B)(i) (other than in a transaction between members of a consolidated group) in the same taxable year that the property is placed in service by the transferor, the 40-percent test is applied by treating the transferred property as placed in service by the transferee on the date of transfer. Thus, if the aggregate basis of property (including the transferred property) placed in service by the transferee during the last three months of its taxable year exceeds 40 percent of the aggregate basis of property (including the transferred property) placed in service by the transferee during the taxable year, the mid-quarter convention applies to the transferee's depreciable property, including the transferred property. The depreciable basis of the transferred property is not taken into account by the transferor in applying the 40-percent test for the taxable year that the transferor placed the property in service.

(ii) In applying the applicable convention to determine when the recovery period for the transferred property begins, the date on which the transferor placed the property in service must be used. Thus, for example, if the mid-quarter convention applies, the recovery period for the transferred property begins on the mid-point of the quarter of the taxable year that the transferor placed the property in service. If the transferor placed the transferred property in service in a short taxable year, then for purposes of applying the applicable convention and allocating the depreciation deduction between the transferor and the transferee, the transferor is treated as having a full 12-month taxable year commencing on the first day of the short taxable year. The depreciation deduction for the transferor's taxable year in which the property was placed in service is allocated between the transferor and the transferee based on the number of months in the transferor's taxable year that each party held the property in service. For purposes of allocating the depreciation deduction, the transferor takes into account the month in which the property was placed in service but does not take into account the month in which the property was transferred. The transferee is allocated the remaining portion of the depreciation deduction for the transferor's taxable year in which the property was transferred. For the remainder of the transferee's current taxable year (if the transferee has a different taxable year than the transferor) and for subsequent taxable years, the depreciation deduction for the transferee is calculated by allocating to the transferee's taxable year the depreciation attributable to each recovery year, or portion thereof, that falls within the transferee's taxable year. However, see § 1.168(k)–2(g)(1)(iii) for a special rule regarding the allocation of the additional first year depreciation deduction in the case of certain contributions of property to a partnership under section 721.

(iii) If the applicable convention for the transferred property has not been determined by the time the transferor files its income tax return for the year of transfer because the transferee's taxable year has not ended, the transferor may use either the mid-quarter or the half-year convention in determining the depreciation deduction for the property. However, the transferor must specify on the depreciation form filed for the taxable year that the applicable convention has not been determined for the property. If the transferee determines that a different convention applies to the transferred property, the transferor should redetermine the depreciation deduction on the property, and, within the period of limitation, should file an amended income tax return for the taxable year and pay any additional tax due plus interest.

(iv) The provisions of the paragraph (b)(7) are illustrated by the following example.

Example. (i) During 1991, C, a calendar-year taxpayer, purchases satellite equipment costing $100,000, and computer equipment costing $15,000. The satellite equipment is placed in service in January, and the computer equipment in February. On October 1, C transfers the computer equipment to Z Partnership in a transaction described in section 721. During 1991, Z, a calendar-year partnership, purchases 30 office desks for a total of $15,000. The desks are placed in service in June. These are the only items of depreciable property placed in service by C and Z during 1991.

(ii) In applying the 40-percent test, because C transferred the computer equipment in a transaction described in section 168(i)(7)(B)(i) in the same taxable year that C placed it in service, the computer equipment is treated as placed in service by the transferee, Z, on the date of transfer, October 1. The 40-percent test is satisfied with respect to Z, because the computer equipment is placed in service during the last three months of Z's taxable year and its basis ($15,000) exceeds 40 percent of the aggregate basis of property placed in service by Z during the taxable year (desks and computer equipment with an aggregate basis of $30,000).

(iii) In applying the mid-quarter convention to determine when the computer equipment is deemed to be placed in service, the date on which C placed the property in service is used. Accordingly, because C placed the computer equipment in service during the first quarter of its taxable year, the computer equipment is deemed placed in service on February 15, 1991, the mid-point of the first quarter of C's taxable year. The depreciation deduction allowable for C's 1991 taxable year, $5,250 ($15,000 × 40 percent × 10.5⁄12), is allocated between C and Z based on the number of months in C's taxable year that C and Z held the property in service. Thus, because the property was in service for 11 months during C's 1991 taxable year and C held it for 8 of those 11 months, C is allocated $3,818 (8⁄11 × $5,250). Z is allocated $1,432, the remaining 3⁄11 of the $5,250 depreciation deduction for C's 1991 taxable year. For 1992, Z's depreciation deduction for the computer equipment is $3,900, the sum of the remaining 1.5 months of depreciation deduction for the first recovery year and 10.5 months of depreciation deduction for the second recovery year (($15,000 × 40 percent × 1.5⁄12) + ($9,000 × 40 [percent × 10.5⁄12)).

(c) *Disposition of property subject to the half-year or mid-quarter convention*—(1) *In general.* If depreciable property is subject to the half-year (or mid-quarter) convention in the taxable year in which it is placed in service, it also is subject to the half-year (or mid-quarter) convention in the taxable year in which it is disposed of.

(2) *Example.* The provisions of paragraph (c)(1) of this section are illustrated by the following example.

Example. In October 1991, B, a calendar-year taxpayer, purchases and places in service a light general purpose truck costing $10,000. B does not elect to expense any part of the cost of the truck, and this is the only item of depreciable property placed in service by B during 1991. The 40-percent test is satisfied and the mid-quarter convention applies, because the truck is placed in service during the last three months of the taxable year and no other assets are placed in service in that year. In April 1993 (prior to the end of the truck's recovery period), B sells the truck. The mid-quarter convention applies in determining the depreciation deduction for the truck in 1993, the year of disposition.

(d) *Effective dates*—(1) *In general.* This section applies to depreciable property placed in service in taxable years ending after January 30, 1991. For depreciable property placed in service after

December 31, 1986, in taxable years ending on or before January 30, 1991, a taxpayer may use a method other than the method provided in this section in applying the 40-percent test and the applicable convention, provided the method is reasonable and is consistently applied to the taxpayer's property.

(2) *Qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property.* This section also applies to qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. The last sentences in paragraphs (b)(3)(ii) and (b)(7)(ii) of this section apply to qualified property under section 168(k)(2) placed in service by a taxpayer during or after the taxpayer's taxable year that includes September 24, 2019. However, a taxpayer may choose to apply the last sentences in paragraphs (b)(3)(ii) and (b)(7)(ii) of this section to qualified property under section 168(k)(2) acquired and placed in service after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017. A taxpayer may rely on the last sentences in paragraphs (b)(3)(ii) and (b)(7)(ii) of this section in regulation project REG–104397–18 (2018–41 I.R.B. 558) (see §601.601(d)(2)(ii)(b) of this chapter) for qualified property under section 168(k)(2) acquired and placed in service after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017, and ending before the taxpayer's taxable year that includes September 24, 2019.

(3) *Like-kind exchanges and involuntary conversions.* The last sentence in paragraph (b)(3)(i) and the second sentence in paragraph (b)(3)(ii) of this section apply to exchanges to which section 1031 applies, and involuntary conversions to which section 1033 applies, of MACRS property for which the time of disposition and the time of replacement both occur after February 27, 2004.

[T.D. 8444, 57 FR 48981, Oct. 29, 1992, as amended by T.D. 9091, 68 FR 52991, Sept. 8, 2003; T.D. 9115, 69 FR 9533, Mar. 1, 2004; T.D. 9283, 71 FR 51737, Aug. 31, 2006; T.D. 9314, 72 FR 9248, Mar. 1, 2007; T.D. 9874, 84 FR 50127, Sept. 24, 2019]

§ 1.168(h)–1 Like-kind exchanges involving tax-exempt use property.

(a) *Scope.* (1) This section applies with respect to a direct or indirect transfer of property among related persons, including transfers made through a qualified intermediary (as defined in §1.1031(k)–1(g)(4)) or other unrelated person, (a transfer) if—

(i) Section 1031 applies to any party to the transfer or to any related transaction; and

(ii) A principal purpose of the transfer or any related transaction is to avoid or limit the application of the alternative depreciation system (within the meaning of section 168(g)).

(2) For purposes of this section, a person is related to another person if they bear a relationship specified in section 267(b) or section 707(b)(1).

(b) *Allowable depreciation deduction for property subject to this section*—(1) *In general.* Property (tainted property) transferred directly or indirectly to a taxpayer by a related person (related party) as part of, or in connection with, a transaction in which the related party receives tax-exempt use property (related tax-exempt use property) will, if the tainted property is subject to an allowance for depreciation, be treated in the same manner as the related tax-exempt use property for purposes of determining the allowable depreciation deduction under section 167(a). Under this paragraph (b), the tainted property is depreciated by the taxpayer over the remaining recovery period of, and using the same depreciation method and convention as that of, the related tax-exempt use property.

(2) *Limitations*—(i) *Taxpayer's basis in related tax-exempt use property.* The rules of this paragraph (b) apply only with respect to so much of the taxpayer's basis in the tainted property as does not exceed the taxpayer's adjusted basis in the related tax-exempt use

property prior to the transfer. Any excess of the taxpayer's basis in the tainted property over its adjusted basis in the related tax-exempt use property prior to the transfer is treated as property to which this section does not apply. This paragraph (b)(2)(i) does not apply if the related tax-exempt use property is not acquired from the taxpayer (e.g., if the taxpayer acquires the tainted property for cash but section 1031 nevertheless applies to the related party because the transfer involves a qualified intermediary).

(ii) *Application of section 168(i)(7).* This section does not apply to so much of the taxpayer's basis in the tainted property as is subject to section 168(i)(7).

(c) *Related tax-exempt use property.* (1) For purposes of paragraph (b) of this section, related tax-exempt use property includes—

(i) Property that is tax-exempt use property (as defined in section 168(h)) at the time of the transfer; and

(ii) Property that does not become tax-exempt use property until after the transfer if, at the time of the transfer, it was intended that the property become tax-exempt use property.

(2) For purposes of determining the remaining recovery period of the related tax-exempt use property in the circumstances described in paragraph (c)(1)(ii) of this section, the related tax-exempt use property will be treated as having, prior to the transfer, a lease term equal to the term of any lease that causes such property to become tax-exempt use property.

(d) *Examples.* The following examples illustrate the application of this section. The examples do not address common law doctrines or other authorities that may apply to recharacterize or alter the effects of the transactions described therein. Unless otherwise indicated, parties to the transactions are not related to one another.

Example 1. (i) X owns all of the stock of two subsidiaries, B and Z. X, B and Z do not file a consolidated federal income tax return. On May 5, 1995, B purchases an aircraft (*FA*) for $1 million and leases it to a foreign airline whose income is not subject to United States taxation and which is a tax-exempt entity as defined in section 168(h)(2). On the same date, Z owns an aircraft (*DA*) with a fair market value of $1 million, which has been, and continues to be, leased to an airline that is a United States taxpayer. Z's adjusted basis in DA is $0. The next day, at a time when each aircraft is still worth $1 million, B transfers FA to Z (subject to the lease to the foreign airline) in exchange for DA (subject to the lease to the airline that is a United States taxpayer). Z realizes gain of $1 million on the exchange, but that gain is not recognized pursuant to section 1031(a) because the exchange is of like-kind properties. Assume that a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system. Following the exchange, Z has a $0 basis in FA pursuant to section 1031(d). B has a $1 million basis in DA.

(ii) B has acquired property from Z, a related person; Z's gain is not recognized pursuant to section 1031(a); Z has received tax-exempt use property as part of the transaction; and a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system. Accordingly, the transaction is within the scope of this section. Pursuant to paragraph (b) of this section, B must recover its $1 million basis in DA over the remaining recovery period of, and using the same depreciation method and convention as that of, FA, the related tax-exempt use property.

(iii) If FA did not become tax-exempt use property until after the exchange, it would still be related tax-exempt use property and paragraph (b) of this section would apply if, at the time of the exchange, it was intended that FA become tax-exempt use property.

Example 2. (i) X owns all of the stock of two subsidiaries, B and Z. X, B and Z do not file a consolidated federal income tax return. B and Z each own identical aircraft. B's aircraft (*FA*) is leased to a tax-exempt entity as defined in section 168(h)(2) and has a fair market value of $1 million and an adjusted basis of $500,000. Z's aircraft (*DA*) is leased to a United States taxpayer and has a fair market value of $1 million and an adjusted basis of $10,000. On May 1, 1995, B and Z exchange aircraft, subject to their respective leases. B realizes gain of $500,000 and Z realizes gain of $990,000, but neither person recognizes gain because of the operation of section 1031(a). Moreover, assume that a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system.

(ii) As in *Example 1,* B has acquired property from Z, a related person; Z's gain is not recognized pursuant to section 1031(a); Z has received tax-exempt use property as part of the transaction; and a principal purpose of the transfer of DA to B or of FA to Z is to avoid the application of the alternative depreciation system. Thus, the transaction is within the scope of this section even though B has held tax-exempt use property for a period of time and, during that time, has used the alternative depreciation system with respect to such property. Pursuant to paragraph (b) of this section, B, which has a substituted basis determined pursuant to section 1031(d) of $500,000 in DA, must depreciate the aircraft over the remaining recovery period of FA, using the same depreciation method and convention. Z holds tax-exempt use property with a basis of $10,000, which must be depreciated under the alternative depreciation system.

(iii) Assume the same facts as in paragraph (i) of this *Example 2*, except that B and Z are members of an affiliated group that files a consolidated federal income tax return. Of B's $500,000 basis in DA, $10,000 is subject to section 168(i)(7) and therefore not subject to this section. The remaining $490,000 of basis is subject to this section. But see §1.1502–80(f) making section 1031 inapplicable to intercompany transactions occurring in consolidated return years beginning on or after July 12, 1995.

(e) *Effective date.* This section applies to transfers made on or after April 20, 1995.

[T.D. 8667, 61 FR 18676, Apr. 29, 1996]

§ 1.168(i)–0 Table of contents for the general asset account rules.

This section lists the major paragraphs contained in §1.168(i)–1.

§ 1.168(i)–1 General asset accounts.

(3) Manner of making election.
(m) Effective/applicability dates.

[T.D. 8566, 59 FR 51371, Oct. 11, 1994, as amended by T.D. 9115, 69 FR 9534, Mar. 1, 2004; T.D. 9132, 69 FR 33842, June 17, 2004; T.D. 9314, 72 FR 9249, Mar. 1, 2007; T.D. 9564, 76 FR 81085, Dec. 27, 2011; 77 FR 75016, Dec. 19, 2012; T.D. 9689, 79 FR 48667, Aug. 18, 2014]

§ 1.168(i)–1 General asset accounts.

(a) *Scope.* This section provides rules for general asset accounts under section 168(i)(4). The provisions of this section apply only to assets for which an election has been made under paragraph (l) of this section.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Unadjusted depreciable basis* has the same meaning given such term in § 1.168(b)–1(a)(3).

(2) *Unadjusted depreciable basis of the general asset account* is the sum of the unadjusted depreciable bases of all assets included in the general asset account.

(3) *Adjusted depreciable basis of the general asset account* is the unadjusted depreciable basis of the general asset account less the adjustments to basis described in section 1016(a)(2) and (3).

(4) *Building* has the same meaning as that term is defined in § 1.48–1(e)(1).

(5) *Expensed cost* is the amount of any allowable credit or deduction treated as a deduction allowable for depreciation or amortization for purposes of section 1245 (for example, a credit allowable under section 30 or a deduction allowable under section 179, section 179A, or section 190). Expensed cost does not include any additional first year depreciation deduction.

(6) *Mass assets* is a mass or group of individual items of depreciable assets—

(i) That are not necessarily homogenous;

(ii) Each of which is minor in value relative to the total value of the mass or group;

(iii) Numerous in quantity;

(iv) Usually accounted for only on a total dollar or quantity basis;

(v) With respect to which separate identification is impracticable; and

(vi) Placed in service in the same taxable year.

(7) *Portion of an asset* is any part of an asset that is less than the entire asset as determined under paragraph (e)(2)(viii) of this section.

(8) *Remaining adjusted depreciable basis of the general asset account* is the unadjusted depreciable basis of the general asset account less the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, for the general asset account.

(9) *Structural component* has the same meaning as that term is defined in § 1.48–1(e)(2).

(c) *Establishment of general asset accounts*—(1) *Assets eligible for general asset accounts*—(i) *General rules.* Assets that are subject to either the general depreciation system of section 168(a) or the alternative depreciation system of section 168(g) may be accounted for in one or more general asset accounts. An asset is included in a general asset account only to the extent of the asset's unadjusted depreciable basis. However, an asset is not to be included in a general asset account if the asset is used both in a trade or business or for the production of income and in a personal activity at any time during the taxable year in which the asset is placed in service by the taxpayer or if the asset is placed in service and disposed of during the same taxable year.

(ii) *Special rules for assets generating foreign source income.* (A) Assets that generate foreign source income, both United States and foreign source income, or combined gross income of a foreign sales corporation (as defined in former section 922), domestic international sales corporation (as defined in section 992(a)), or possession corporation (as defined in section 936) and its related supplier may be included in a general asset account if the requirements of paragraph (c)(2)(i) of this section are satisfied. If, however, the inclusion of these assets in a general asset account results in a substantial distortion of income, the Commissioner may disregard the general asset account election and make any reallocations of income or expense necessary to clearly reflect income.

(B) A general asset account shall be treated as a single asset for purposes of applying the rules in § 1.861–9T(g)(3) (relating to allocation and apportionment of interest expense under the asset method). A general asset account that generates income in more than one grouping of income (statutory and residual) is a multiple category asset (as defined in §1.861–9T(g)(3)(ii)), and the income yield from the general asset account must be determined by applying the rules for multiple category assets as if the general asset account were a single asset.

(2) *Grouping assets in general asset accounts*—(i) *General rules.* If a taxpayer makes the election under paragraph (l) of this section, assets that are subject to the election are grouped into one or more general asset accounts. Assets that are eligible to be grouped into a single general asset account may be divided into more than one general asset account. Each general asset account must include only assets that—

(A) Have the same applicable depreciation method;

(B) Have the same applicable recovery period;

(C) Have the same applicable convention; and

(D) Are placed in service by the taxpayer in the same taxable year.

(ii) *Special rules.* In addition to the general rules in paragraph (c)(2)(i) of this section, the following rules apply when establishing general asset accounts—

(A) Assets subject to the mid-quarter convention may only be grouped into a general asset account with assets that are placed in service in the same quarter of the taxable year;

(B) Assets subject to the mid-month convention may only be grouped into a general asset account with assets that are placed in service in the same month of the taxable year;

(C) Passenger automobiles for which the depreciation allowance is limited under section 280F(a) must be grouped into a separate general asset account;

(D) Assets not eligible for any additional first year depreciation deduction, including assets for which the taxpayer elected not to deduct the additional first year depreciation, provided by, for example, section 168(k), section 168(l), section 168(m), section 168(n), section 1400L(b), or section 1400N(d), must be grouped into a separate general asset account;

(E) Assets eligible for the additional first year depreciation deduction may only be grouped into a general asset account with assets for which the taxpayer claimed the same percentage of the additional first year depreciation (for example, 30 percent, 50 percent, or 100 percent);

(F) Except for passenger automobiles described in paragraph (c)(2)(ii)(C) of this section, listed property (as defined in section 280F(d)(4)) must be grouped into a separate general asset account;

(G) Assets for which the depreciation allowance for the placed-in-service year is not determined by using an optional depreciation table (for further guidance, see section 8 of Rev. Proc. 87–57, 1987–2 CB 687, 693 (see §601.601(d)(2) of this chapter)) must be grouped into a separate general asset account;

(H) Mass assets that are or will be subject to paragraph (j)(2)(i)(D) of this section (disposed of or converted mass asset is identified by a mortality dispersion table) must be grouped into a separate general asset account; and

(I) Assets subject to paragraph (h)(2)(iii)(A) of this section (change in use results in a shorter recovery period or a more accelerated depreciation method) for which the depreciation allowance for the year of change (as defined in §1.168(i)–4(a)) is not determined by using an optional depreciation table must be grouped into a separate general asset account.

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

Example 1. In 2014, J, a proprietorship with a calendar year-end, purchases and places in service one item of equipment that costs $550,000. This equipment is section 179 property and also is 5-year property under section 168(e). On its Federal tax return for 2014, J makes an election under section 179 to expense $25,000 of the equipment's cost and makes an election under paragraph (l) of this section to include the equipment in a general asset account. As a result, the unadjusted depreciable basis of the equipment is $525,000. In accordance with paragraph (c)(1) of this section, J must include only $525,000 of the equipment's cost in the general asset account.

Example 2. In 2014, K, a proprietorship with a calendar year-end, purchases and places in service 100 items of equipment. All of these items are 5-year property under section

168(e), are not listed property, and are not eligible for any additional first year depreciation deduction. On its Federal tax return for 2014, K does not make an election under section 179 to expense the cost of any of the 100 items of equipment and does make an election under paragraph (l) of this section to include the 100 items of equipment in a general asset account. K depreciates its 5-year property placed in service in 2014 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. In accordance with paragraph (c)(2) of this section, K includes all of the 100 items of equipment in one general asset account.

Example 3. The facts are the same as in *Example 2*, except that K decides not to include all of the 100 items of equipment in one general asset account. Instead and in accordance with paragraph (c)(2) of this section, K establishes 100 general asset accounts and includes one item of equipment in each general asset account.

Example 4. L, a calendar-year corporation, is a wholesale distributer. In 2014, L places in service the following properties for use in its wholesale distribution business: Computers, automobiles, and forklifts. On its Federal tax return for 2014, L does not make an election under section 179 to expense the cost of any of these items of equipment and does make an election under paragraph (l) of this section to include all of these items of equipment in a general asset account. All of these items are 5-year property under section 168(e) and are not eligible for any additional first year depreciation deduction. The computers are listed property, and the automobiles are listed property and are subject to section 280F(a). L depreciates its 5-year property placed in service in 2014 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. Although the computers, automobiles, and forklifts are 5-year property, L cannot include all of them in one general asset account because the computers and automobiles are listed property. Further, even though the computers and automobiles are listed property, L cannot include them in one general asset account because the automobiles also are subject to section 280F(a). In accordance with paragraph (c)(2) of this section, L establishes three general asset accounts: One for the computers, one for the automobiles, and one for the forklifts.

Example 5. M, a fiscal-year corporation with a taxable year ending June 30, purchases and places in service ten items of new equipment in October 2014, and purchases and places in service five other items of new equipment in February 2015. On its Federal tax return for the taxable year ending June 30, 2015, M does not make an election under section 179 to expense the cost of any of these items of equipment and does make an election under paragraph (l) of this section to include all of these items of equipment in a general asset account. All of these items of equipment are 7-year property under section 168(e), are not listed property, and are property described in section 168(k)(2)(B). All of the ten items of equipment placed in service in October 2014 are eligible for the 50-percent additional first year depreciation deduction provided by section 168(k)(1). All of the five items of equipment placed in service in February 2015 are not eligible for any additional first year depreciation deduction. M depreciates its 7-year property placed in service for the taxable year ending June 30, 2015, using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 7-year recovery period, and the half-year convention. Although the 15 items of equipment are depreciated using the same depreciation method, recovery period, and convention, M cannot include all of them in one general asset account because some of items of equipment are not eligible for any additional first year depreciation deduction. In accordance with paragraph (c)(2) of this section, M establishes two general asset accounts: one for the ten items of equipment eligible for the 50-percent additional first year depreciation deduction and one for the five items of equipment not eligible for any additional first year depreciation deduction.

(d) *Determination of depreciation allowance*—(1) *In general.* Depreciation allowances are determined for each general asset account. The depreciation allowances must be recorded in a depreciation reserve account for each general asset account. The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a).

(2) *Assets in general asset account are eligible for additional first year depreciation deduction.* If all the assets in a general asset account are eligible for the additional first year depreciation deduction, the taxpayer first must determine the allowable additional first year depreciation deduction for the general asset account for the placed-in-service year and then must determine the amount otherwise allowable as a depreciation deduction for the general asset account for the placed-in-service year and any subsequent taxable year. The allowable additional first year depreciation deduction for the general asset account for the placed-in-service

year is determined by multiplying the unadjusted depreciable basis of the general asset account by the additional first year depreciation deduction percentage applicable to the assets in the account (for example, 30 percent, 50 percent, or 100 percent). The remaining adjusted depreciable basis of the general asset account then is depreciated using the applicable depreciation method, recovery period, and convention for the assets in the account.

(3) *No assets in general asset account are eligible for additional first year depreciation deduction.* If none of the assets in a general asset account are eligible for the additional first year depreciation deduction, the taxpayer must determine the allowable depreciation deduction for the general asset account for the placed-in-service year and any subsequent taxable year by using the applicable depreciation method, recovery period, and convention for the assets in the account.

(4) *Special rule for passenger automobiles.* For purposes of applying section 280F(a), the depreciation allowance for a general asset account established for passenger automobiles is limited for each taxable year to the amount prescribed in section 280F(a) multiplied by the excess of the number of automobiles originally included in the account over the number of automobiles disposed of during the taxable year or in any prior taxable year in a transaction described in paragraph (e)(3)(iii) (disposition of an asset in a qualifying disposition), paragraph (e)(3)(iv) (transactions subject to section 168(i)(7)), paragraph (e)(3)(v) (transactions subject to section 1031 or section 1033), paragraph (e)(3)(vi) (technical termination of a partnership), paragraph (e)(3)(vii) (anti-abuse rule), paragraph (g) (assets subject to recapture), or paragraph (h)(1) (conversion to any personal use) of this section.

(e) *Dispositions from a general asset account*—(1) *Scope and definition*—(i) *In general.* This paragraph (e) provides rules applicable to dispositions of assets included in a general asset account. For purposes of this paragraph (e), an asset in a general asset account is disposed of when ownership of the asset is transferred or when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. A disposition also occurs when an asset is transferred to a supplies, scrap, or similar account, or when a portion of an asset is disposed of as described in paragraph (e)(1)(ii) of this section. If a structural component, or a portion thereof, of a building is disposed of in a disposition described in paragraph (e)(1)(ii) of this section, a disposition also includes the disposition of such structural component or such portion thereof.

(ii) *Disposition of a portion of an asset.* For purposes of applying paragraph (e) of this section, a disposition includes a disposition of a portion of an asset in a general asset account as a result of a casualty event described in section 165, a disposition of a portion of an asset in a general asset account for which gain, determined without regard to section 1245 or section 1250, is not recognized in whole or in part under section 1031 or section 1033, a transfer of a portion of an asset in a general asset account in a transaction described in section 168(i)(7)(B), a sale of a portion of an asset in a general asset account, or a disposition of a portion of an asset in a general asset account in a transaction described in paragraph (e)(3)(vii)(B) of this section. For other transactions, a disposition includes a disposition of a portion of an asset in a general asset account only if the taxpayer makes the election under paragraph (e)(3)(ii) of this section to terminate the general asset account in which that disposed portion is included or makes the election under paragraph (e)(3)(iii) of this section for that disposed portion.

(2) *General rules for a disposition*—(i) *No immediate recovery of basis.* Except as provided in paragraph (e)(3) of this section, immediately before a disposition of any asset in a general asset account or a disposition of a portion of such asset as described in paragraph (e)(1)(ii) of this section, the asset or the portion of the asset, as applicable, is treated as having an adjusted depreciable basis (as defined in §1.168(b)–1(a)(4)) of zero for purposes of section 1011. Therefore, no loss is realized upon the disposition of an asset from the

general asset account or upon the disposition of a portion of such asset as described in paragraph (e)(1)(ii) of this section. Similarly, where an asset or a portion of an asset, as applicable, is disposed of by transfer to a supplies, scrap, or similar account, the basis of the asset or the portion of the asset, as applicable, in the supplies, scrap, or similar account will be zero.

(ii) *Treatment of amount realized.* Any amount realized on a disposition is recognized as ordinary income, notwithstanding any other provision of subtitle A of the Internal Revenue Code (Code), to the extent the sum of the unadjusted depreciable basis of the general asset account and any expensed cost (as defined in paragraph (b)(5) of this section) for assets in the account exceeds any amounts previously recognized as ordinary income upon the disposition of other assets in the account or upon the disposition of portions of such assets as described in paragraph (e)(1)(ii) of this section. The recognition and character of any excess amount realized are determined under other applicable provisions of the Code other than sections 1245 and 1250 or provisions of the Code that treat gain on a disposition as subject to section 1245 or section 1250.

(iii) *Effect of disposition on a general asset account.* Except as provided in paragraph (e)(3) of this section, the unadjusted depreciable basis and the depreciation reserve of the general asset account are not affected as a result of a disposition of an asset from the general asset account or of a disposition of a portion of such asset as described in paragraph (e)(1)(ii) of this section.

(iv) *Coordination with nonrecognition provisions.* For purposes of determining the basis of an asset or a portion of an asset, as applicable, acquired in a transaction, other than a transaction described in paragraph (e)(3)(iv) (pertaining to transactions subject to section 168(i)(7)), paragraph (e)(3)(v) (pertaining to transactions subject to section 1031 or section 1033), and paragraph (e)(3)(vi) (pertaining to technical terminations of partnerships) of this section, to which a nonrecognition section of the Code applies, determined without regard to this section, the amount of ordinary income recognized under this paragraph (e)(2) is treated as the amount of gain recognized on the disposition.

(v) *Manner of disposition.* The manner of disposition (for example, normal retirement, abnormal retirement, ordinary retirement, or extraordinary retirement) is not taken into account in determining whether a disposition occurs or gain or loss is recognized.

(vi) *Disposition by transfer to a supplies account.* If a taxpayer made an election under §1.162–3(d) to treat the cost of any rotable spare part, temporary spare part, or standby emergency spare part (as defined in §1.162–3(c)) as a capital expenditure subject to the allowance for depreciation and also made an election under paragraph (l) of this section to include that rotable, temporary, or standby emergency spare part in a general asset account, the taxpayer can dispose of the rotable, temporary, or standby emergency spare part by transferring it to a supplies account only if the taxpayer has obtained the consent of the Commissioner to revoke the §1.162–3(d) election. If a taxpayer made an election under §1.162–3T(d) to treat the cost of any material and supply (as defined in §1.162–3T(c)(1)) as a capital expenditure subject to the allowance for depreciation and also made an election under paragraph (l) of this section to include that material and supply in a general asset account, the taxpayer can dispose of the material and supply by transferring it to a supplies account only if the taxpayer has obtained the consent of the Commissioner to revoke the §1.162–3T(d) election. See §1.162–3(d)(3) for the procedures for revoking a §1.162–3(d) or a §1.162–3T(d) election.

(vii) *Leasehold improvements.* The rules of paragraph (e) of this section also apply to—

(A) A lessor of leased property that made an improvement to that property for the lessee of the property, has a depreciable basis in the improvement, made an election under paragraph (l) of this section to include the improvement in a general asset account, and disposes of the improvement, or disposes of a portion of the improvement as described in paragraph (e)(1)(ii) of this section, before or upon the termination of the lease with the lessee. See section 168(i)(8)(B); and

(B) A lessee of leased property that made an improvement to that property, has a depreciable basis in the improvement, made an election under paragraph (l) of this section to include the improvement in a general asset account, and disposes of the improvement, or disposes of a portion of the improvement as described in paragraph (e)(1)(ii) of this section, before or upon the termination of the lease.

(viii) *Determination of asset disposed of*—(A) *General rules.* For purposes of applying paragraph (e) of this section to the disposition of an asset in a general asset account, instead of the disposition of the general asset account, the facts and circumstances of each disposition are considered in determining what is the appropriate asset disposed of. The asset for disposition purposes may not consist of items placed in service by the taxpayer on different dates, without taking into account the applicable convention. For purposes of determining what is the appropriate asset disposed of, the unit of property determination under §1.263(a)–3(e) or in published guidance in the Internal Revenue Bulletin under section 263(a) (see §601.601(d)(2) of this chapter) and the distinct asset determination under §1.1031(a)–3(a)(4) do not apply.

(B) *Special rules.* In addition to the general rules in paragraph (e)(2)(viii)(A) of this section, the following rules apply for purposes of applying paragraph (e) of this section to the disposition of an asset in a general asset account instead of the disposition of the general asset account:

(*1*) Each building, including its structural components, is the asset, except as provided in §1.1250–1(a)(2)(ii) or in paragraph (e)(2)(viii)(B)(*2*) or (*4*) of this section.

(*2*) If a building has two or more condominium or cooperative units, each condominium or cooperative unit, including its structural components, is the asset, except as provided in §1.1250–1(a)(2)(ii) or in paragraph (e)(2)(viii)(B)(*4*) of this section.

(*3*) If a taxpayer properly includes an item in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87–56 (1987–2 CB 674) (see §601.601(d)(2) of this chapter) or properly classifies an item in one of the categories under section 168(e)(3), except for a category that includes buildings or structural components (for example, retail motor fuels outlet, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property), each item is the asset, provided that paragraph (e)(2)(viii)(B)(*4*) of this section does not apply to the item. For example, each desk is the asset, each computer is the asset, and each qualified smart electric meter is the asset.

(*4*) If the taxpayer places in service an improvement or addition to an asset after the taxpayer placed the asset in service, the improvement or addition and, if applicable, its structural components are a separate asset.

(ix) *Examples.* The following examples illustrate the application of this paragraph (e)(2):

Example 1. A, a calendar-year partnership, maintains one general asset account for one office building that cost $10 million. A discovers a leak in the roof of the building and decides to replace the entire roof. The roof is a structural component of the building. In accordance with paragraph (e)(2)(viii)(B)(*1*) of this section, the office building, including its structural components, is the asset for disposition purposes. The retirement of the replaced roof is not a disposition of a portion of an asset as described in paragraph (e)(1)(ii) of this section. Thus, the retirement of the replaced roof is not a disposition under paragraph (e)(1) of this section. As a result, A continues to depreciate the $10 million cost of the general asset account. If A must capitalize the amount paid for the replacement roof pursuant to §1.263(a)–3, the replacement roof is a separate asset for disposition purposes pursuant to paragraph (e)(2)(viii)(B)(*4*) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 2. B, a calendar-year commercial airline company, maintains one general asset account for five aircraft that cost a total of $500 million. These aircraft are described in asset class 45.0 of Rev. Proc. 87–56. B replaces the existing engines on one of the aircraft with new engines. Assume each aircraft is a unit of property as determined under §1.263(a)–3(e)(3) and each engine of an aircraft is a major component or substantial structural part of the aircraft as determined under §1.263(a)–3(k)(6). Assume also that B treats each aircraft as the asset for disposition purposes in accordance with paragraph (e)(2)(viii) of this section. The retirement of the replaced engines is not a disposition of a portion of an asset as described in paragraph (e)(1)(ii) of this section. Thus, the retirement of the replaced engines is not a disposition under paragraph (e)(1) of this section. As a result, B continues to depreciate the $500 million cost of the general asset account. If B must capitalize the amount paid for the replacement engines pursuant to § 1.263(a)–3, the replacement engines are a separate asset for disposition purposes pursuant to paragraph (e)(2)(viii)(B)(*4*) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 3. (i) R, a calendar-year corporation, maintains one general asset account for ten machines. The machines cost a total of $10,000 and are placed in service in June 2014. Of the ten machines, one machine costs $8,200 and nine machines cost a total of $1,800. Assume R depreciates this general asset account using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and a half-year convention. R does not make a section 179 election for any of the machines, and all of the machines are not eligible for any additional first year depreciation deduction. As of January 1, 2015, the depreciation reserve of the account is $2,000 ($10,000 × 20%).

(ii) On February 8, 2015, R sells the machine that cost $8,200 to an unrelated party for $9,000. Under paragraph (e)(2)(i) of this section, this machine has an adjusted depreciable basis of zero.

(iii) On its 2015 tax return, R recognizes the amount realized of $9,000 as ordinary income because such amount does not exceed the unadjusted depreciable basis of the general asset account ($10,000), plus any expensed cost for assets in the account ($0), less amounts previously recognized as ordinary income ($0). Moreover, the unadjusted depreciable basis and depreciation reserve of the account are not affected by the disposition of the machine. Thus, the depreciation allowance for the account in 2015 is $3,200 ($10,000 × 32%).

Example 4. (i) The facts are the same as in *Example 3*. In addition, on June 4, 2016, R sells seven machines to an unrelated party for a total of $1,100. In accordance with paragraph (e)(2)(i) of this section, these machines have an adjusted depreciable basis of zero.

(ii) On its 2016 tax return, R recognizes $1,000 as ordinary income (the unadjusted depreciable basis of $10,000, plus the expensed cost of $0, less the amount of $9,000 previously recognized as ordinary income). The recognition and character of the excess amount realized of $100 ($1,100 − $1,000) are determined under applicable provisions of the Code other than section 1245 (such as section 1231). Moreover, the unadjusted depreciable basis and depreciation reserve of the account are not affected by the disposition of the machines. Thus, the depreciation allowance for the account in 2016 is $1,920 ($10,000 × 19.2%).

(3) *Special rules*—(i) *In general.* This paragraph (e)(3) provides the rules for terminating general asset account treatment upon certain dispositions. While the rules under paragraphs (e)(3)(ii) and (iii) of this section are optional rules, the rules under paragraphs (e)(3)(iv), (v), (vi), and (vii) of this section are mandatory rules. A taxpayer elects to apply paragraph (e)(3)(ii) or (iii) of this section by reporting the gain, loss, or other deduction on the taxpayer's timely filed original Federal tax return, including extensions, for the taxable year in which the disposition occurs. However, if the loss is on account of the demolition of a structure to which section 280B and § 1.280B–1 apply, a taxpayer elects to apply paragraph (e)(3)(ii) or (iii) of this section by ending depreciation for the structure at the time of the disposition of the structure, taking into account the convention applicable to the general asset account in which the demolished structure was included, and reporting the amount of depreciation for that structure for the taxable year in which the disposition occurs on the taxpayer's timely filed original Federal tax return, including extensions, for that taxable year. A taxpayer may revoke the election to apply paragraph (e)(3)(ii) or (iii) of this section only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer acted reasonably and in good faith, and the revocation will not prejudice the interests of the Government. See generally § 301.9100–3 of this chapter. The election to apply paragraph (e)(3)(ii) or (iii) of this section may not be made or revoked through the filing of an application for change in accounting method. For purposes of applying paragraphs (e)(3)(iii) through (vii) of this section, see paragraph (j) of this section for identifying an asset disposed of and its unadjusted depreciable basis. Solely for purposes of applying paragraphs (e)(3)(iii),

(e)(3)(iv)(C), (e)(3)(v)(B), and (e)(3)(vii) of this section, the term *asset* is:

(A) The asset as determined under paragraph (e)(2)(viii) of this section; or

(B) The portion of such asset that is disposed of in a disposition described in paragraph (e)(1)(ii) of this section.

(ii) *Disposition of all assets remaining in a general asset account*—(A) *Optional termination of a general asset account.* Upon the disposition of all of the assets, the last asset, or the remaining portion of the last asset in a general asset account, a taxpayer may apply this paragraph (e)(3)(ii) to recover the adjusted depreciable basis of the general asset account rather than having paragraph (e)(2) of this section apply. Under this paragraph (e)(3)(ii), the general asset account terminates and the amount of gain or loss for the general asset account is determined under section 1001(a) by taking into account the adjusted depreciable basis of the general asset account at the time of the disposition, as determined under the applicable convention for the general asset account. Whether and to what extent gain or loss is recognized is determined under other applicable provisions of the Code, including section 280B and §1.280B–1. The character of the gain or loss is determined under other applicable provisions of the Code, except that the amount of gain subject to section 1245 is limited to the excess of the depreciation allowed or allowable for the general asset account, including any expensed cost, over any amounts previously recognized as ordinary income under paragraph (e)(2) of this section, and the amount of gain subject to section 1250 is limited to the excess of the additional depreciation allowed or allowable for the general asset account, over any amounts previously recognized as ordinary income under paragraph (e)(2) of this section.

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

Example 1. (i) T, a calendar-year corporation, maintains a general asset account for 1,000 calculators. The calculators cost a total of $60,000 and are placed in service in 2014. Assume T depreciates this general asset account using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and a half-year convention. T does not make a section 179 election for any of the calculators, and all of the calculators are not eligible for any additional first year depreciation deduction. In 2015, T sells 200 of the calculators to an unrelated party for a total of $10,000 and recognizes the $10,000 as ordinary income in accordance with paragraph (e)(2) of this section.

(ii) On March 26, 2016, T sells the remaining calculators in the general asset account to an unrelated party for $35,000. T elects to apply paragraph (e)(3)(ii) of this section. As a result, the account terminates and gain or loss is determined for the account.

(iii) On the date of disposition, the adjusted depreciable basis of the account is $23,040 (unadjusted depreciable basis of $60,000 less the depreciation allowed or allowable of $36,960). Thus, in 2016, T recognizes gain of $11,960 (amount realized of $35,000 less the adjusted depreciable basis of $23,040). The gain of $11,960 is subject to section 1245 to the extent of the depreciation allowed or allowable for the account, plus the expensed cost for assets in the account, less the amounts previously recognized as ordinary income ($36,960 + $0 − $10,000 = $26,960). As a result, the entire gain of $11,960 is subject to section 1245.

Example 2. (i) J, a calendar-year corporation, maintains a general asset account for one item of equipment. This equipment costs $2,000 and is placed in service in 2014. Assume J depreciates this general asset account using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and a half-year convention. J does not make a section 179 election for the equipment, and it is not eligible for any additional first year depreciation deduction. In June 2016, J sells the equipment to an unrelated party for $1,000. J elects to apply paragraph (e)(3)(ii) of this section. As a result, the account terminates and gain or loss is determined for the account.

(ii) On the date of disposition, the adjusted depreciable basis of the account is $768 (unadjusted depreciable basis of $2,000 less the depreciation allowed or allowable of $1,232). Thus, in 2016, J recognizes gain of $232 (amount realized of $1,000 less the adjusted depreciable basis of $768). The gain of $232 is subject to section 1245 to the extent of the depreciation allowed or allowable for the account, plus the expensed cost for assets in the account, less the amounts previously recognized as ordinary income ($1,232 + $0 − $0 = $1,232).As a result, the entire gain of $232 is subject to section 1245.

(iii) *Disposition of an asset in a qualifying disposition*—(A) *Optional determination of the amount of gain, loss, or* *other deduction.* In the case of a qualifying disposition (described in paragraph (e)(3)(iii)(B) of this section) of an asset, a taxpayer may elect to apply this paragraph (e)(3)(iii) rather than having paragraph (e)(2) of this section apply. Under this paragraph (e)(3)(iii), general asset account treatment for the asset terminates as of the first day of the taxable year in which the qualifying disposition occurs, and the amount of gain, loss, or other deduction for the asset is determined under §1.168(i)–8 by taking into account the asset's adjusted depreciable basis at the time of the disposition. The adjusted depreciable basis of the asset at the time of the disposition, as determined under the applicable convention for the general asset account in which the asset was included, equals the unadjusted depreciable basis of the asset less the greater of the depreciation allowed or allowable for the asset. The allowable depreciation is computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included and by including the portion of the additional first year depreciation deduction claimed for the general asset account that is attributable to the asset disposed of. Whether and to what extent gain, loss, or other deduction is recognized is determined under other applicable provisions of the Code, including section 280B and §1.280B–1. The character of the gain, loss, or other deduction is determined under other applicable provisions of the Code, except that the amount of gain subject to section 1245 or section 1250 is limited to the lesser of—

(*1*) The depreciation allowed or allowable for the asset, including any expensed cost or, in the case of section 1250 property, the additional depreciation allowed or allowable for the asset; or

(*2*) The excess of—

(*i*) The original unadjusted depreciable basis of the general asset account plus, in the case of section 1245 property originally included in the general asset account, any expensed cost; over

(*ii*) The cumulative amounts of gain previously recognized as ordinary income under either paragraph (e)(2) of this section or section 1245 or section 1250.

(B) *Qualifying dispositions.* A *qualifying disposition* is a disposition that does not involve all the assets, the last asset, or the remaining portion of the last asset remaining in a general asset account and that is—

(*1*) A direct result of a fire, storm, shipwreck, or other casualty, or from theft;

(*2*) A charitable contribution for which a deduction is allowable under section 170;

(*3*) A direct result of a cessation, termination, or disposition of a business, manufacturing or other income producing process, operation, facility, plant, or other unit, other than by transfer to a supplies, scrap, or similar account; or

(*4*) A transaction, other than a transaction described in paragraph (e)(3)(iv) (pertaining to transactions subject to section 168(i)(7)), paragraph (e)(3)(v) (pertaining to transactions subject to section 1031 or section 1033), paragraph (e)(3)(vi) (pertaining to technical terminations of partnerships), or paragraph (e)(3)(vii) (anti-abuse rule) of this section, to which a nonrecognition section of the Internal Revenue Code applies (determined without regard to this section).

(C) *Effect of a qualifying disposition on a general asset account.* If the taxpayer elects to apply this paragraph (e)(3)(iii) to a qualifying disposition of an asset, then—

(*1*) The asset is removed from the general asset account as of the first day of the taxable year in which the qualifying disposition occurs. For that taxable year, the taxpayer accounts for the asset in a single asset account in accordance with the rules under §1.168(i)–7(b);

(*2*) The unadjusted depreciable basis of the general asset account is reduced by the unadjusted depreciable basis of the asset as of the first day of the taxable year in which the disposition occurs;

(*3*) The depreciation reserve of the general asset account is reduced by the greater of the depreciation allowed or allowable for the asset as of the end of the taxable year immediately preceding the year of disposition. The allowable depreciation is computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included and by including the portion of the additional first year depreciation deduction claimed for the general asset account that is attributable to the asset disposed of; and

(*4*) For purposes of determining the amount of gain realized on subsequent dispositions that is subject to ordinary income treatment under paragraph (e)(2)(ii) of this section, the amount of any expensed cost with respect to the asset is disregarded.

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

Example 1. (i) Z, a calendar-year corporation, maintains one general asset account for 12 machines. Each machine costs $15,000 and is placed in service in 2014. Of the 12 machines, nine machines that cost a total of $135,000 are used in Z's Kentucky plant, and three machines that cost a total of $45,000 are used in Z's Ohio plant. Assume Z depreciates this general asset account using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. Z does not make a section 179 election for any of the machines, and all of the machines are not eligible for any additional first year depreciation deduction. As of December 31, 2015, the depreciation reserve for the account is $93,600.

(ii) On May 27, 2016, Z sells its entire manufacturing plant in Ohio to an unrelated party. The sales proceeds allocated to each of the three machines at the Ohio plant is $5,000. This transaction is a qualifying disposition under paragraph (e)(3)(iii)(B)(*3*) of this section, and Z elects to apply paragraph (e)(3)(iii) of this section.

(iii) For Z's 2016 return, the depreciation allowance for the account is computed as follows. As of December 31, 2015, the depreciation allowed or allowable for the three machines at the Ohio plant is $23,400. Thus, as of January 1, 2016, the unadjusted depreciable basis of the account is reduced from $180,000 to $135,000 ($180,000 less the unadjusted depreciable basis of $45,000 for the three machines), and, as of December 31, 2015, the depreciation reserve of the account is decreased from $93,600 to $70,200 ($93,600 less the depreciation allowed or allowable of $23,400 for the three machines as of December 31, 2015). Consequently, the depreciation allowance for the account in 2016 is $25,920 ($135,000 × 19.2%).

(iv) For Z's 2016 return, gain or loss for each of the three machines at the Ohio plant is determined as follows. The depreciation allowed or allowable in 2016 for each machine is $1,440 (($15,000 × 19.2%)/2). Thus, the adjusted depreciable basis of each machine under section 1011 is $5,760 (the adjusted depreciable basis of $7,200 removed from the account less the depreciation allowed or allowable of $1,440 in 2016). As a result, the loss recognized in 2016 for each machine is $760 ($5,000 − $5,760), which is subject to section 1231.

Example 2. (i) A, a calendar-year partnership, maintains one general asset account for one office building that cost $20 million and was placed in service in July 2011. A depreciates this general asset account using the optional depreciation table that corresponds with the general depreciation system, the straight-line method, a 39-year recovery period, and the mid-month convention. As of January 1, 2014, the depreciation reserve for the account is $1,261,000.

(ii) In May 2014, a tornado occurs where the building is located and damages the roof of the building. A decides to replace the entire roof. The roof is replaced in June 2014. The roof is a structural component of the building. Because the roof was damaged as a result of a casualty event described in section 165, the partial disposition rule provided under paragraph (e)(1)(ii) of this section applies to the roof. Although the office building, including its structural components, is the asset for disposition purposes, the partial disposition rule provides that the retirement of the replaced roof is a disposition under paragraph (e)(1) of this section. This retirement is a qualifying disposition under paragraph (e)(3)(iii)(B)(*1*) of this section, and A elects to apply paragraph (e)(3)(iii) of this section for the retirement of the damaged roof.

(iii) Of the $20 million cost of the office building, assume $1 million is the cost of the retired roof.

(iv) For A's 2014 return, the depreciation allowance for the account is computed as follows. As of December 31, 2013, the depreciation allowed or allowable for the retired roof is $63,050. Thus, as of January 1, 2014, the unadjusted depreciable basis of the account is reduced from $20,000,000 to $19,000,000 ($20,000,000 less the unadjusted depreciable basis of $1,000,000 for the retired roof), and the depreciation reserve of the account is decreased from $1,261,000 to $1,197,950 ($1,261,000 less the depreciation allowed or allowable of $63,050 for the retired roof as of December 31, 2013). Consequently, the depreciation allowance for the account in 2014 is $487,160 ($19,000,000 × 2.564%).

(v) For A's 2014 return, gain or loss for the retired roof is determined as follows. The depreciation allowed or allowable in 2014 for the retired roof is $11,752 (($1,000,000 × 2.564%) × 5.5/12). Thus, the adjusted depreciable basis of the retired roof under section 1011 is $925,198 (the adjusted depreciable basis of $936,950 removed from the account less the depreciation allowed or allowable of $11,752 in 2014). As a result, the loss recognized in 2014 for the retired roof is $925,198, which is subject to section 1231.

(vi) If A must capitalize the amount paid for the replacement roof under §1.263(a)–3, the replacement roof is a separate asset for depreciation purposes pursuant to section 168(i)(6). If A includes the replacement roof in a general asset account, the replacement roof is a separate asset for disposition purposes pursuant to paragraph (e)(2)(viii)(B)(*4*) of this section. If A includes the replacement roof in a single asset account or a multiple asset account under §1.168(i)–7, the replacement roof is a separate asset for disposition purposes pursuant to §1.168(i)–8(c)(4)(ii)(D).

(iv) *Transactions subject to section 168(i)(7)*—(A) *In general.* If a taxpayer transfers one or more assets, or a portion of such asset, in a general asset account in a transaction described in section 168(i)(7)(B) (pertaining to treatment of transferees in certain nonrecognition transactions), the taxpayer (the transferor) and the transferee must apply this paragraph (e)(3)(iv) to the asset or the portion of such asset, instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section. The transferee is bound by the transferor's election under paragraph (l) of this section for the portion of the transferee's basis in the asset or the portion of such asset that does not exceed the transferor's adjusted depreciable basis of the general asset account or the asset or the portion of such asset, as applicable, as determined under paragraph (e)(3)(iv)(B)(*2*) or (C)(*2*) of this section, as applicable.

(B) *All assets remaining in general asset account are transferred.* If a taxpayer transfers all the assets, the last asset, or the remaining portion of the last asset in a general asset account in a transaction described in section 168(i)(7)(B)—

(*1*) The taxpayer (the transferor) must terminate the general asset account on the date of the transfer. The allowable depreciation deduction for the general asset account for the transferor's taxable year in which the section 168(i)(7)(B) transaction occurs is computed by using the depreciation method, recovery period, and convention applicable to the general asset account. This allowable depreciation deduction is allocated between the transferor and the transferee on a monthly basis. This allocation is made in accordance with the rules in §1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee;

(*2*) The transferee must establish a new general asset account for all the assets, the last asset, or the remaining portion of the last asset, in the taxable year in which the section 168(i)(7)(B) transaction occurs for the portion of its basis in the assets that does not exceed the transferor's adjusted depreciable basis of the general asset account in which all the assets, the last asset, or the remaining portion of the last asset, were included. The transferor's adjusted depreciable basis of this general asset account is equal to the adjusted depreciable basis of that account as of the beginning of the transferor's taxable year in which the transaction occurs, decreased by the amount of depreciation allocable to the transferor for the year of the transfer, as determined under paragraph (e)(3)(iv)(B)(*1*) of this section. The transferee is treated as the transferor for purposes of computing the allowable depreciation deduction for the new general asset account under section 168. The new general asset account must be established in accordance with the rules in paragraph (c) of this section, except that the unadjusted depreciable bases of all the assets, the last asset, or the remaining portion of the last asset, and the greater of the depreciation allowed or allowable for all the assets, the last asset, or the remaining portion of the last asset, including the amount of depreciation for the transferred assets that is allocable to the transferor for the year of the transfer, are included in the newly established general asset account. Consequently, this general asset account in the year of the transfer will have a beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the general asset account; and

(*3*) For purposes of section 168 and this section, the transferee treats the portion of its basis in the assets that exceeds the transferor's adjusted depreciable basis of the general asset account in which all the assets, the last asset, or the remaining portion of the last asset, were included, as determined under paragraph (e)(3)(iv)(B)(*2*) of this section, as a separate asset that the transferee placed in service on the date of the transfer. The transferee accounts for this asset under §1.168(i)–7 or may make an election under paragraph (l) of this section to include the asset in a general asset account.

(C) *Not all assets remaining in general asset account are transferred.* If a taxpayer transfers an asset in a general asset account in a transaction described in section 168(i)(7)(B) and if paragraph (e)(3)(iv)(B) of this section does not apply to this asset—

(*1*) The taxpayer (the transferor) must remove the transferred asset from the general asset account in which the asset is included, as of the first day of the taxable year in which the section 168(i)(7)(B) transaction occurs. In addition, the adjustments to the general asset account described in paragraphs (e)(3)(iii)(C)(*2*) through (*4*) of this section must be made. The allowable depreciation deduction for the asset for the transferor's taxable year in which the section 168(i)(7)(B) transaction occurs is computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included. This allowable depreciation deduction is allocated between the transferor and the transferee on a monthly basis. This allocation is made in accordance with the rules in §1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee;

(*2*) The transferee must establish a new general asset account for the asset in the taxable year in which the section 168(i)(7)(B) transaction occurs for the portion of its basis in the asset that does not exceed the transferor's adjusted depreciable basis of the asset. The transferor's adjusted depreciable basis of this asset is equal to the adjusted depreciable basis of the asset as of the beginning of the transferor's taxable year in which the transaction occurs, decreased by the amount of depreciation allocable to the transferor for the year of the transfer, as determined under paragraph (e)(3)(iv)(C)(*1*) of this section. The transferee is treated as the transferor for purposes of computing the allowable depreciation deduction for the new general asset account under section 168. The new general asset account must be established in accordance with the rules in paragraph (c) of this section, except that the unadjusted depreciable basis of the asset, and the greater of the depreciation allowed or allowable for the asset, including the amount of depreciation for the transferred asset that is allocable to the transferor for the year of the transfer, are included in the newly established general asset account. Consequently, this general asset account in the year of the transfer will have a beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the general asset account; and

(*3*) For purposes of section 168 and this section, the transferee treats the portion of its basis in the asset that exceeds the transferor's adjusted depreciable basis of the asset, as determined under paragraph (e)(3)(iv)(C)(*2*) of this section, as a separate asset that the transferee placed in service on the date of the transfer. The transferee accounts for this asset under §1.168(i)–7 or may make an election under paragraph (l) of this section to include the asset in a general asset account.

(v) *Transactions subject to section 1031 or section 1033*—(A) *Like-kind exchange or involuntary conversion of all assets remaining in a general asset account.* If all the assets, the last asset, or the remaining portion of the last asset in a general asset account are transferred by a taxpayer in a like-kind exchange (as defined under §1.168–6(b)(11)) or in an involuntary conversion (as defined under §1.168–6(b)(12)), the taxpayer must apply this paragraph (e)(3)(v)(A) instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section. Under this paragraph (e)(3)(v)(A), the general asset account terminates as of the first day of the year of disposition (as defined in §1.168(i)–6(b)(5)) and—

(*1*) The amount of gain or loss for the general asset account is determined under section 1001(a) by taking into account the adjusted depreciable basis of the general asset account at the time of disposition (as defined in §1.168(i)–6(b)(3)). The depreciation allowance for the general asset account in the year of disposition is determined in the same manner as the depreciation allowance for the relinquished MACRS property (as defined in §1.168(i)–6(b)(2)) in the year of disposition is determined under §1.168(i)–6. The recognition and character of gain or loss are determined in accordance with paragraph (e)(3)(ii)(A) of this section, notwithstanding that paragraph (e)(3)(ii) of this section is an optional rule; and

(*2*) The adjusted depreciable basis of the general asset account at the time of disposition is treated as the adjusted depreciable basis of the relinquished MACRS property.

(B) *Like-kind exchange or involuntary conversion of less than all assets remaining in a general asset account.* If an asset in a general asset account is transferred by a taxpayer in a like-kind exchange or in an involuntary conversion and if paragraph (e)(3)(v)(A) of this section does not apply to this asset, the taxpayer must apply this paragraph (e)(3)(v)(B) instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section. Under this paragraph (e)(3)(v)(B), general asset account treatment for the asset terminates as of the first day of the year of disposition (as defined in §1.168(i)–6(b)(5)), and—

(*1*) The amount of gain or loss for the asset is determined by taking into account the asset's adjusted depreciable basis at the time of disposition (as defined in §1.168(i)–6(b)(3)). The adjusted depreciable basis of the asset at the time of disposition equals the unadjusted depreciable basis of the asset less the greater of the depreciation allowed or allowable for the asset. The allowable depreciation is computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the asset was included and by including the portion of the additional first year depreciation deduction claimed for the general asset account that is attributable to the relinquished asset. The depreciation allowance for the asset in the year of disposition is determined in the same manner as the depreciation allowance for the relinquished MACRS property (as defined in §1.168(i)–6(b)(2)) in the year of disposition is determined under §1.168(i)–6. The recognition and character of the gain or loss are determined in accordance with paragraph (e)(3)(iii)(A) of this section, notwithstanding that paragraph (e)(3)(iii) of this section is an optional rule; and

(*2*) As of the first day of the year of disposition, the taxpayer must remove the relinquished asset from the general asset account and make the adjustments to the general asset account described in paragraphs (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(vi) *Technical termination of a partnership.* In the case of a technical termination of a partnership under section 708(b)(1)(B), the terminated partnership must apply this paragraph (e)(3)(vi) instead of applying paragraph (e)(2), (e)(3)(ii), or (e)(3)(iii) of this section. Under this paragraph (e)(3)(vi), all of the terminated partnership's general asset accounts terminate as of the date of its termination under section 708(b)(1)(B). The terminated partnership computes the allowable depreciation deduction for each of its general asset accounts for the taxable year in which the technical termination occurs by using the depreciation method, recovery period, and convention applicable to the general asset account. The new partnership is not bound by the terminated partnership's election under paragraph (l) of this section.

(vii) *Anti-abuse rule*—(A) *In general.* If an asset in a general asset account is disposed of by a taxpayer in a transaction described in paragraph (e)(3)(vii)(B) of this section, general asset account treatment for the asset terminates as of the first day of the taxable year in which the disposition occurs. Consequently, the taxpayer must determine the amount of gain, loss, or other deduction attributable to the disposition in the manner described in paragraph (e)(3)(iii)(A) of this section, notwithstanding that paragraph (e)(3)(iii)(A) of this section is an optional rule, and must make the adjustments to the general asset account described in paragraphs (e)(3)(iii)(C)(*1*) through (*4*) of this section.

(B) *Abusive transactions.* A transaction is described in this paragraph (e)(3)(vii)(B) if the transaction is not described in paragraph (e)(3)(iv), (e)(3)(v), or (e)(3)(vi) of this section, and if the transaction is entered into, or made, with a principal purpose of achieving a tax benefit or result that would not be available absent an election under this section. Examples of these types of transactions include—

(*1*) A transaction entered into with a principal purpose of shifting income or deductions among taxpayers in a manner that would not be possible absent an election under this section to take advantage of differing effective tax rates among the taxpayers; or

(*2*) An election made under this section with a principal purpose of disposing of an asset from a general asset account to utilize an expiring net operating loss or credit if the transaction is not a bona fide disposition. The fact that a taxpayer with a net operating loss carryover or a credit carryover transfers an asset to a related person or transfers an asset pursuant to an arrangement where the asset continues to be used or is available for use by the taxpayer pursuant to a lease or otherwise indicates, absent strong evidence to the contrary, that the transaction is described in this paragraph (e)(3)(vii)(B).

(f) *Assets generating foreign source income*—(1) *In general.* This paragraph (f) provides the rules for determining the source of any income, gain, or loss recognized, and the appropriate section 904(d) separate limitation category or categories for any foreign source income, gain, or loss recognized on a disposition (within the meaning of paragraph (e)(1) of this section) of an asset in a general asset account that consists of assets generating both United States and foreign source income. These rules apply only to a disposition to which paragraph (e)(2) (general disposition rules), paragraph (e)(3)(ii) (disposition of all assets remaining in a general asset account), paragraph (e)(3)(iii) (disposition of an asset in a qualifying disposition), paragraph (e)(3)(v) (transactions subject to section 1031 or section 1033), or paragraph (e)(3)(vii) (anti-abuse rule) of this section applies. Solely for purposes of applying this paragraph (f), the term *asset* is:

(i) The asset as determined under paragraph (e)(2)(viii) of this section; or

(ii) The portion of such asset that is disposed of in a disposition described in paragraph (e)(1)(ii) of this section.

(2) *Source of ordinary income, gain, or loss*—(i) *Source determined by allocation and apportionment of depreciation allowed.* The amount of any ordinary income, gain, or loss that is recognized on the disposition of an asset in a general asset account must be apportioned between United States and foreign sources based on the allocation and apportionment of the—

(A) Depreciation allowed for the general asset account as of the end of the taxable year in which the disposition occurs if paragraph (e)(2) of this section applies to the disposition;

(B) Depreciation allowed for the general asset account as of the time of disposition if the taxpayer applies paragraph (e)(3)(ii) of this section to the disposition of all assets, the last asset, or the remaining portion of the last asset, in the general asset account, or if all the assets, the last asset, or the remaining portion of the last asset, in the general asset account are disposed of in a transaction described in paragraph (e)(3)(v)(A) of this section; or

(C) Depreciation allowed for the asset disposed of for only the taxable year in which the disposition occurs if the taxpayer applies paragraph (e)(3)(iii) of this section to the disposition of the asset in a qualifying disposition, if the asset is disposed of in a transaction described in paragraph (e)(3)(v)(B) of this section (like-kind exchange or involuntary conversion), or if the asset is disposed of in a transaction described in paragraph (e)(3)(vii) of this section (anti-abuse rule).

(ii) *Formula for determining foreign source income, gain, or loss.* The amount of ordinary income, gain, or loss recognized on the disposition that shall be treated as foreign source income, gain, or loss must be determined under the formula in this paragraph (f)(2)(ii). For purposes of this formula, the allowed depreciation deductions are determined for the applicable time period provided in paragraph (f)(2)(i) of this section. The formula is:

Foreign Source Income, Gain, or Loss from The Disposition of an Asset.	=	Total Ordinary Income, Gain, or Loss from the Disposition of an Asset.	X	Allowed Depreciation Deductions Allocated and Apportioned to Foreign Source Income/Total Allowed Depreciation Deductions for the General Asset Account or for the Asset Disposed of (as applicable).

(3) *Section 904(d) separate categories.* If the assets in the general asset account generate foreign source income in more than one separate category under section 904(d)(1) or another section of the Code (for example, income treated as foreign source income under section 904(g)(10)), or under a United States income tax treaty that requires the foreign tax credit limitation to be determined separately for specified types of income, the amount of foreign source income, gain, or loss from the disposition of an asset, as determined under the formula in paragraph (f)(2)(ii) of this section, must be allocated and apportioned to the applicable separate category or categories under the formula in this paragraph (f)(3). For purposes of this formula, the allowed depreciation deductions are determined for the applicable time period provided in paragraph (f)(2)(i) of this section. The formula is:

Foreign Source Income, Gain, or Loss in a Separate Category.	=	Foreign Source Income, Gain, or Loss from The Disposition of an Asset.	X	Allowed Depreciation Deductions Allocated and Apportioned to a Separate Category/ Total Allowed Depreciation Deductions and Apportioned to Foreign Source Income.

(g) *Assets subject to recapture.* If the basis of an asset in a general asset account is increased as a result of the recapture of any allowable credit or deduction (for example, the basis adjustment for the recapture amount under section 30(e)(5), 50(c)(2), 168(l)(6), 168(n)(4), 179(d)(10), 179A(e)(4), or 1400N(d)(5)), general asset account treatment for the asset terminates as of the first day of the taxable year in which the recapture event occurs. Consequently, the taxpayer must remove the asset from the general asset account as of that day and must make the adjustments to the general asset account described in paragraphs (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(h) *Changes in use*—(1) *Conversion to any personal use.* An asset in a general asset account becomes ineligible for general asset account treatment if a taxpayer uses the asset in any personal activity during a taxable year. Upon a conversion to any personal use, the taxpayer must remove the asset from the general asset account as of the first day of the taxable year in which the change in use occurs (the year of change) and must make the adjustments to the general asset account described in paragraphs (e)(3)(iii)(C)(*2*) through (*4*) of this section.

(2) *Change in use results in a different recovery period and/or depreciation method*—(i) *No effect on general asset account election.* A change in the use described in §1.168(i)–4(d) (change in use results

in a different recovery period or depreciation method) of an asset in a general asset account shall not cause or permit the revocation of the election made under this section.

(ii) *Asset is removed from the general asset account.* Upon a change in the use described in §1.168(i)–4(d), the taxpayer must remove the asset from the general asset account as of the first day of the year of change (as defined in §1.168(i)–4(a)) and must make the adjustments to the general asset account described in paragraphs (e)(3)(iii)(C)(*2*) through (*4*) of this section. If, however, the result of the change in use is described in §1.168(i)–4(d)(3) (change in use results in a shorter recovery period or a more accelerated depreciation method) and the taxpayer elects to treat the asset as though the change in use had not occurred pursuant to §1.168(i)–4(d)(3)(ii), no adjustment is made to the general asset account upon the change in use.

(iii) *New general asset account is established*—(A) *Change in use results in a shorter recovery period or a more accelerated depreciation method.* If the result of the change in use is described in §1.168(i)–4(d)(3) (change in use results in a shorter recovery period or a more accelerated depreciation method) and adjustments to the general asset account are made pursuant to paragraph (h)(2)(ii) of this section, the taxpayer must establish a new general asset account for the asset in the year of change in accordance with the rules in paragraph (c) of this section, except that the adjusted depreciable basis of the asset as of the first day of the year of change is included in the general asset account. For purposes of paragraph (c)(2) of this section, the applicable depreciation method, recovery period, and convention are determined under §1.168(i)–4(d)(3)(i).

(B) *Change in use results in a longer recovery period or a slower depreciation method.* If the result of the change in use is described in §1.168(i)–4(d)(4) (change in use results in a longer recovery period or a slower depreciation method), the taxpayer must establish a separate general asset account for the asset in the year of change in accordance with the rules in paragraph (c) of this section, except that the unadjusted depreciable basis of the asset, and the greater of the depreciation of the asset allowed or allowable in accordance with section 1016(a)(2), as of the first day of the year of change are included in the newly established general asset account. Consequently, this general asset account as of the first day of the year of change will have a beginning balance for both the unadjusted depreciable basis and the depreciation reserve of the general asset account. For purposes of paragraph (c)(2) of this section, the applicable depreciation method, recovery period, and convention are determined under §1.168(i)–4(d)(4)(ii).

(i) *Redetermination of basis.* If, after the placed-in-service year, the unadjusted depreciable basis of an asset in a general asset account is redetermined due to a transaction other than that described in paragraph (g) of this section (for example, due to contingent purchase price or discharge of indebtedness), the taxpayer's election under paragraph (l) of this section for the asset also applies to the increase or decrease in basis resulting from the redetermination. For the taxable year in which the increase or decrease in basis occurs, the taxpayer must establish a new general asset account for the amount of the increase or decrease in basis in accordance with the rules in paragraph (c) of this section. For purposes of paragraph (c)(2) of this section, the applicable recovery period for the increase or decrease in basis is the recovery period of the asset remaining as of the beginning of the taxable year in which the increase or decrease in basis occurs, the applicable depreciation method and applicable convention for the increase or decrease in basis are the same depreciation method and convention applicable to the asset that applies for the taxable year in which the increase or decrease in basis occurs, and the increase or decrease in basis is deemed to be placed in service in the same taxable year as the asset.

(j) *Identification of disposed or converted asset*—(1) *In general.* The rules of this paragraph (j) apply when an asset in a general asset account is disposed of or converted in a transaction described in paragraph (e)(3)(iii) (disposition of an asset in a qualifying disposition), paragraph (e)(3)(iv)(B) (transactions subject to section 168(i)(7)), paragraph (e)(3)(v)(B) (transactions subject to section 1031 or section 1033), paragraph (e)(3)(vii) (anti-abuse rule), paragraph (g) (assets subject to recapture), or paragraph (h)(1) (conversion to any personal use) of this section.

(2) *Identifying which asset is disposed of or converted*—(i) *In general.* For purposes of identifying which asset in a general asset account is disposed of or converted, a taxpayer must identify the disposed of or converted asset by using—

(A) The specific identification method of accounting. Under this method of accounting, the taxpayer can determine the particular taxable year in which the disposed of or converted asset was placed in service by the taxpayer;

(B) A first-in, first-out method of accounting if the taxpayer can readily determine from its records the total dispositions of assets with the same recovery period during the taxable year but the taxpayer cannot readily determine from its records the unadjusted depreciable basis of the disposed of or converted asset. Under this method of accounting, the taxpayer identifies the general asset account with the earliest placed-in-service year that has the same recovery period as the disposed of or converted asset and that has assets at the beginning of the taxable year of the disposition or conversion, and the taxpayer treats the disposed of or converted asset as being from that general asset account. To determine which general asset account has assets at the beginning of the taxable year of the disposition or conversion, the taxpayer reduces the number of assets originally included in the account by the number of assets disposed of or converted in any prior taxable year in a transaction to which this paragraph (j) applies;

(C) A modified first-in, first-out method of accounting if the taxpayer can readily determine from its records the total dispositions of assets with the same recovery period during the taxable year and the unadjusted depreciable basis of the disposed of or converted asset. Under this method of accounting, the taxpayer identifies the general asset account with the earliest placed-in-service year that has the same recovery period as the disposed of or converted asset and that has assets at the beginning of the taxable year of the disposition or conversion with the same unadjusted depreciable basis as the disposed of or converted asset, and the taxpayer treats the disposed of or converted asset as being from that general asset account. To determine which general asset account has assets at the beginning of the taxable year of the disposition or conversion, the taxpayer reduces the number of assets originally included in the account by the number of assets disposed of or converted in any prior taxable year in a transaction to which this paragraph (j) applies;

(D) A mortality dispersion table if the asset is a mass asset accounted for in a separate general asset account in accordance with paragraph (c)(2)(ii)(H) of this section and if the taxpayer can readily determine from its records the total dispositions of assets with the same recovery period during the taxable year. The mortality dispersion table must be based upon an acceptable sampling of the taxpayer's actual disposition and conversion experience for mass assets or other acceptable statistical or engineering techniques. To use a mortality dispersion table, the taxpayer must adopt recordkeeping practices consistent with the taxpayer's prior practices and consonant with good accounting and engineering practices; or

(E) Any other method as the Secretary may designate by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) on or after September 19, 2013. See paragraph (j)(2)(iii) of this section regarding the last-in, first-out method of accounting.

(ii) *Disposition of a portion of an asset.* If a taxpayer disposes of a portion of an asset and paragraph (e)(1)(ii) of this section applies to that disposition, the taxpayer may identify the asset by using any applicable method provided in paragraph (j)(2)(i) of this section, after taking into account paragraph (j)(2)(iii) of this section.

(iii) *Last-in, first-out method of accounting.* For purposes of paragraph (j)(2) of this section, a last-in, first-out method of accounting may not be used. Examples of a last-in, first-out method of accounting include the taxpayer identifying the general asset account with the most recent placed-in-service year that has the same recovery period as the disposed of or converted asset and that has assets at the beginning of the taxable year of the disposition or conversion, and the taxpayer treating the disposed of or converted asset as being from that general asset account, or the taxpayer treating the disposed portion of an asset as being from the general asset account with the most recent placed-in-service year that has assets that are the same as the asset of which the disposed portion is a part.

(3) *Basis of disposed of or converted asset.* (i) Solely for purposes of this paragraph (j)(3), the term *asset* is the asset as determined under paragraph (e)(2)(viii) of this section or the portion of such asset that is disposed of in a disposition described in paragraph (e)(1)(ii) of this section. After identifying which asset in a general asset account is disposed of or converted, the taxpayer must determine the unadjusted depreciable basis of, and the depreciation allowed or allowable for, the disposed of or converted asset. If it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis of the disposed of or converted asset, the taxpayer may use any reasonable method that is consistently applied to all assets in the same general asset account for purposes of determining the unadjusted depreciable basis of the disposed of or converted asset in that general asset account. Examples of a reasonable method include, but are not limited to, the following:

(A) If the replacement asset is a restoration (as defined in §1.263(a)–3(k)), and is not a betterment (as defined in §1.263(a)–3(j)) or an adaptation to a new or different use (as defined in §1.263(a)–3(l)), discounting the cost of the replacement asset to its placed-in-service year cost using the Producer Price Index for Finished Goods or its successor, the Producer Price Index for Final Demand, or any other index designated by guidance in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) for purposes of this paragraph (j)(3);

(B) A pro rata allocation of the unadjusted depreciable basis of the general asset account based on the replacement cost of the disposed asset and the replacement cost of all of the assets in the general asset account; and

(C) A study allocating the cost of the asset to its individual components.

(ii) The depreciation allowable for the disposed of or converted asset is computed by using the depreciation method, recovery period, and convention applicable to the general asset account in which the disposed of or converted asset was included and by including the additional first year depreciation deduction claimed for the disposed of or converted asset.

(k) *Effect of adjustments on prior dispositions.* The adjustments to a general asset account under paragraph (e)(3)(iii), (e)(3)(iv), (e)(3)(v), (e)(3)(vii), (g), or (h) of this section have no effect on the recognition and character of prior dispositions subject to paragraph (e)(2) of this section.

(l) *Election*—(1) *Irrevocable election.* If a taxpayer makes an election under this paragraph (l), the taxpayer consents to, and agrees to apply, all of the provisions of this section to the assets included in a general asset account. Except as provided in paragraph (c)(1)(ii)(A), (e)(3), (g), or (h) of this section or except as otherwise expressly provided by other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), an election made under this section is irrevocable and will be binding on the taxpayer for computing taxable income for the taxable year for which the election is made and for all subsequent taxable years. An election under this paragraph (l) is made separately by each person owning an asset to which this section applies (for example, by each member of a consolidated group, at the partnership level and not by the partner separately, or at the S corporation level and not by the shareholder separately).

(l)(2) *Time for making election.* The election to apply this section shall be made on the taxpayer's timely filed (including extensions) income tax return for the taxable year in which the assets included in the general asset account are placed in service by the taxpayer.

(3) *Manner of making election.* In the year of election, a taxpayer makes the election under this section by typing or legibly printing at the top of the Form 4562, "GENERAL ASSET ACCOUNT ELECTION MADE UNDER SECTION 168(i)(4)," or in the manner provided for on Form 4562 and its instructions. The taxpayer shall maintain records (for example, "General Asset Account #1—all 1995 additions in asset class 00.11 for Salt Lake City, Utah facility") that identify the assets included in each general asset account, that establish the unadjusted depreciable basis and depreciation reserve of the general asset account, and that reflect the amount realized during the taxable year upon dispositions from each general asset account. (But see section 179(c) and §1.179–5 for the recordkeeping requirements for section 179 property.) The taxpayer's recordkeeping practices should be consistently applied to the general asset accounts. 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.

(m) *Effective/applicability dates*—(1) *In general.* Except as provided in paragraph (m)(5) of this section, this section applies to taxable years beginning on or after January 1, 2014. Except as provided in paragraphs (m)(2), (m)(3), and (m)(4) of this section, §1.168(i)–1 as contained in 26 CFR part 1 edition revised as of April 1, 2011, applies to taxable years beginning before January 1, 2014.

(2) *Early application of this section.* A taxpayer may choose to apply the provisions of this section to taxable years beginning on or after January 1, 2012.

(3) *Early application of regulation project REG–110732–13.* A taxpayer may rely on the provisions of this section in regulation project REG–110732–13 (2013–43 IRB 404) (see §601.601(d)(2) of this chapter) for taxable years beginning on or after January 1, 2012. However, a taxpayer may not rely on the provisions of this section in regulation project REG–110732–13 for taxable years beginning on or after January 1, 2014.

(4) *Optional application of TD 9564.* A taxpayer may choose to apply §1.168(i)–1T as contained in 26 CFR part 1 edition revised as of April 1, 2014, to taxable years beginning on or after January 1, 2012. However, a taxpayer may not apply §1.168(i)–1T as contained in 26 CFR part 1 edition revised as of April 1, 2014, to taxable years beginning on or after January 1, 2014.

(5) *Application of paragraph (e)(2)(viii)(A).* The language "and the distinct asset determination under §1.1031(a)–3(a)(4) do not apply." in the last sentence of paragraph (e)(2)(viii)(A) of this section applies on or after December 2, 2020. Paragraph (e)(2)(viii)(A) of this section as contained in 26 CFR part 1 edition revised as of April 1, 2020, applies before December 2, 2020.

(6) *Change in method of accounting.* A change to comply with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. A taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. This paragraph (m)(5) does not apply to a change to comply with paragraph (e)(3)(ii), (e)(3)(iii), or (l) of this section, except as otherwise expressly provided by other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

[T.D. 8566, 59 FR 51371, Oct. 11, 1994; 59 FR 64849, Dec. 16, 1994, as amended by T.D. 9115, 69 FR 9534, Mar. 1, 2004; T.D. 9132, 69 FR 33842, June 17, 2004; T.D. 9314, 72 FR 9249, Mar. 1, 2007; T.D. 9564, 76 FR 81086, Dec. 27, 2011; 77 FR 75016, Dec. 19, 2012; T.D. 9689, 79 FR 48667, Aug. 18, 2014; 79 FR 78697, Dec. 31, 2014; T.D. 9935, 85 FR 77378, Dec. 2, 2020]

§ 1.168(i)–2 Lease term.

(a) *In general.* For purposes of section 168, a lease term is determined under all the facts and circumstances. Paragraph (b) of this section and §1.168(j)–

1T, Q&A 17, describe certain circumstances that will result in a period of time not included in the stated duration of an original lease (additional period) nevertheless being included in the lease term. These rules do not prevent the inclusion of an additional period in the lease term in other circumstances.

(b) *Lessee retains financial obligation*—(1) *In general.* An additional period of time during which a lessee may not continue to be the lessee will nevertheless be included in the lease term if the lessee (or a related person)—

(i) Has agreed that one or both of them will or could be obligated to make a payment of rent or a payment in the nature of rent with respect to such period; or

(ii) Has assumed or retained any risk of loss with respect to the property for such period (including, for example, by holding a note secured by the property).

(2) *Payments in the nature of rent.* For purposes of paragraph (b)(1)(i) of this section, a payment in the nature of rent includes a payment intended to substitute for rent or to fund or supplement the rental payments of another. For example, a payment in the nature of rent includes a payment of any kind (whether denominated as supplemental rent, as liquidated damages, or otherwise) that is required to be made in the event that—

(i) The leased property is not leased for the additional period;

(ii) The leased property is leased for the additional period under terms that do not satisfy specified terms and conditions;

(iii) There is a failure to make a payment of rent with respect to such additional period; or

(iv) Circumstances similar to those described in paragraph (b)(2) (i), (ii), or (iii) of this section occur.

(3) *De minimis rule.* For the purposes of this paragraph (b), obligations to make de minimis payments will be disregarded.

(c) *Multiple leases or subleases.* If property is subject to more than one lease (including any sublease) entered into as part of a single transaction (or a series of related transactions), the lease term includes all periods described in one or more of such leases. For example, if one taxable corporation leases property to another taxable corporation for a 20-year term and, as part of the same transaction, the lessee subleases the property to a tax-exempt entity for a 10-year term, then the lease term of the property for purposes of section 168 is 20 years. During the period of tax-exempt use, the property must be depreciated under the alternative depreciation system using the straight line method over the greater of its class life or 25 years (125 percent of the 20-year lease term).

(d) *Related person.* For purposes of paragraph (b) of this section, a person is related to the lessee if such person is described in section 168(h)(4).

(e) *Changes in status.* Section 168(i)(5) (changes in status) applies if an additional period is included in a lease term under this section and the leased property ceases to be tax-exempt use property for such additional period.

(f) *Example.* The following example illustrates the principles of this section. The example does not address common law doctrines or other authorities that may apply to cause an additional period to be included in the lease term or to recharacterize a lease as a conditional sale or otherwise for federal income tax purposes. Unless otherwise indicated, parties to the transactions are not related to one another.

Example. Financial obligation with respect to an additional period. (i) *Facts.* X, a taxable corporation, and Y, a foreign airline whose income is not subject to United States taxation, enter into a lease agreement under which X agrees to lease an aircraft to Y for a period of 10 years. The lease agreement provides that, at the end of the lease period, Y is obligated to find a subsequent lessee (replacement lessee) to enter into a subsequent lease (replacement lease) of the aircraft from X for an additional 10-year period. The provisions of the lease agreement require that any replacement lessee be unrelated to Y and that it not be a tax-exempt entity as defined in section 168(h)(2). The provisions of the lease agreement also set forth the basic terms and conditions of the replacement lease, including its duration and the required rental payments. In the event Y fails to secure a replacement lease, the lease agreement requires Y to make a payment to X in an amount determined under the lease agreement.

(ii) *Application of this section.* The lease agreement between X and Y obligates Y to make a payment in the event the aircraft is not leased for the period commencing after the initial 10-year lease period and ending on the date the replacement lease is scheduled to end. Accordingly, pursuant to paragraph (b) of this section, the term of the lease between X and Y includes such additional period, and the lease term is 20 years for purposes of section 168.

(iii) *Facts modified.* Assume the same facts as in paragraph (i) of this *Example,* except that Y is required to guarantee the payment of rentals under the 10-year replacement lease and to make a payment to X equal to the present value of any excess of the replacement lease rental payments specified in the lease agreement between X and Y, over the rental payments actually agreed to be paid by the replacement lessee. Pursuant to paragraph (b) of this section, the term of the lease between X and Y includes the additional period, and the lease term is 20 years for purposes of section 168.

(iv) *Changes in status.* If, upon the conclusion of the stated duration of the lease between X and Y, the aircraft either is returned to X or leased to a replacement lessee that is not a tax-exempt entity as defined in section 168(h)(2), the subsequent method of depreciation will be determined pursuant to section 168(i)(5).

(g) *Effective date*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, this section applies to leases entered into on or after April 20, 1995.

(2) *Special rules.* Paragraphs (b)(1)(ii) and (c) of this section apply to leases entered into after April 26, 1996.

[T.D. 8667, 61 FR 18677, Apr. 29, 1996]

§ 1.168(i)–3 Treatment of excess deferred income tax reserve upon disposition of deregulated public utility property.

(a) *Scope*—(1) *In general.* This section provides rules for the application of section 203(e) of the Tax Reform Act of 1986, Public Law 99–514 (100 Stat. 2146) to a taxpayer with respect to public utility property (within the meaning of section 168(i)(10)) that ceases, whether by disposition, deregulation, or otherwise, to be public utility property with respect to the taxpayer and that is not described in paragraph (a)(2) of this section (deregulated public utility property).

(2) *Exceptions.* This section does not apply to the following property:

(i) Property that ceases to be public utility property with respect to the taxpayer on account of an ordinary retirement within the meaning of §1.167(a)–11(d)(3)(ii).

(ii) Property transferred by the taxpayer if after the transfer the property is public utility property of the transferee and the taxpayer's excess tax reserve with respect to the property (within the meaning of section 203(e) of the Tax Reform Act of 1986) is treated as an excess tax reserve of the transferee with respect to the property.

(b) *Amount of reduction.* If public utility property of a taxpayer becomes deregulated public utility property to which this section applies, the reduction in the taxpayer's excess tax reserve permitted under section 203(e) of the Tax Reform Act of 1986 is equal to the amount by which the reserve could be reduced under that provision if all such property had remained public utility property of the taxpayer and the taxpayer had continued use of its normalization method of accounting with respect to such property.

(c) *Cross reference.* See §1.46–6(k) for rules relating to the treatment of accumulated deferred investment tax credits when utilities dispose of regulated public utility property.

(d) *Effective/applicability dates*—(1) *In general.* Except as provided in paragraph (d)(2) of this section, this section applies to public utility property that becomes deregulated public utility property after December 21, 2005.

(2) *Property that becomes public utility property of the transferee.* This section does not apply to property that becomes deregulated public utility property with respect to a taxpayer on account of a transfer on or before March 20, 2008 if after the transfer the property is public utility property of the transferee.

(3) *Application of regulation project (REG–104385–01).* A reduction in the taxpayer's excess deferred income tax reserve will be treated as ratable if it is consistent with the proposed rules in regulation project (REG–104385–01) (68 FR 10190) March 4, 2003, and occurs during the period beginning on March 5, 2003, and ending on the earlier of—

(i) The last date on which the utility's rates are determined under the rate order in effect on December 21, 2005; or

(ii) December 21, 2007.

[T.D. 9387, 73 FR 14937, Mar. 20, 2008]

§ 1.168(i)–4 Changes in use.

(a) *Scope.* This section provides the rules for determining the depreciation allowance for MACRS property (as defined in § 1.168(b)–1T(a)(2)) for which the use changes in the hands of the same taxpayer (change in the use). The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a) for the year of change and any subsequent taxable year. For purposes of this section, the year of change is the taxable year in which a change in the use occurs.

(b) *Conversion to business or income-producing use*—(1) *Depreciation deduction allowable.* This paragraph (b) applies to property that is converted from personal use to use in a taxpayer's trade or business, or for the production of income, during a taxable year. This conversion includes property that was previously used by the taxpayer for personal purposes, including real property (other than land) that is acquired before 1987 and converted from personal use to business or income-producing use after 1986, and depreciable property that was previously used by a tax-exempt entity before the entity changed to a taxable entity. Except as otherwise provided by the Internal Revenue Code or regulations under the Internal Revenue Code, upon a conversion to business or income-producing use, the depreciation allowance for the year of change and any subsequent taxable year is determined as though the property is placed in service by the taxpayer on the date on which the conversion occurs. Thus, except as otherwise provided by the Internal Revenue Code or regulations under the Internal Revenue Code, the taxpayer must use any applicable depreciation method, recovery period, and convention prescribed under section 168 for the property in the year of change, consistent with any election made under section 168 by the taxpayer for that year (see, for example, section 168(b)(5)). See §§ 1.168(k)–1(f)(6)(iii) or 1.168(k)–2(g)(6)(iii), as applicable, and 1.1400L(b)–1(f)(6) for the additional first year depreciation deduction rules applicable to a conversion to business or income-producing use. The depreciable basis of the property for the year of change is the lesser of its fair market value or its adjusted depreciable basis (as defined in § 1.168(b)–1T(a)(4)), as applicable, at the time of the conversion to business or income-producing use.

(2) *Example.* The application of this paragraph (b) is illustrated by the following example:

Example. A, a calendar-year taxpayer, purchases a house in 1985 that she occupies as her principal residence. In February 2004, *A* ceases to occupy the house and converts it to residential rental property. At the time of the conversion to residential rental property, the house's fair market value (excluding land) is $130,000 and adjusted depreciable basis attributable to the house (excluding land) is $150,000. Pursuant to this paragraph (b), *A* is considered to have placed in service residential rental property in February 2004 with a depreciable basis of $130,000. *A* depreciates the residential rental property under the general depreciation system by using the straight-line method, a 27.5-year recovery period, and the mid-month convention. Pursuant to §§ 1.168(k)–1T(f)(6)(iii)(B) or 1.1400L(b)–1T(f)(6), this property is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). Thus, the depreciation allowance for the house for 2004 is $4,137, after taking into account the mid-month convention (($130,000 adjusted depreciable basis multiplied by the applicable depreciation rate of 3.636% (1/27.5)) multiplied by the mid-month convention fraction of 10.5/12). The amount of depreciation computed under section 168, however, may be limited under other provisions of the Internal Revenue Code, such as, section 280A.

(c) *Conversion to personal use.* The conversion of MACRS property from business or income-producing use to personal use during a taxable year is treated as a disposition of the property in that taxable year. The depreciation allowance for MACRS property for the year of change in which the property is treated as being disposed of is determined by first multiplying the adjusted depreciable basis of the property as of the first day of the year of change by the applicable depreciation rate for that taxable year (for further guidance, for example, see section 6 of Rev. Proc. 87–57 (1987–2 C. B. 687, 692) (see § 601.601(d)(2)(ii)(*b*) of this chapter)). This amount is then multiplied by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service during the year of change (taking into account the applicable convention) and the denominator of which is 12. No depreciation deduction is allowable for MACRS property placed in service and disposed of in the same taxable year. See §§1.168(k)–1(f)(6)(ii)or 1.168(k)–2(g)(6)(ii), as applicable, and 1.1400L(b)–1(f)(6) for the additional first year depreciation deduction rules applicable to property placed in service and converted to personal use in the same taxable year. Upon the conversion to personal use, no gain, loss, or depreciation recapture under section 1245 or section 1250 is recognized. However, the provisions of section 1245 or section 1250 apply to any disposition of the converted property by the taxpayer at a later date. For listed property (as defined in section 280F(d)(4)), see section 280F(b)(2) for the recapture of excess depreciation upon the conversion to personal use.

(d) *Change in the use results in a different recovery period and/or depreciation method*—(1) *In general.* This paragraph (d) applies to a change in the use of MACRS property during a taxable year subsequent to the placed-in-service year, if the property continues to be MACRS property owned by the same taxpayer and, as a result of the change in the use, has a different recovery period, a different depreciation method, or both. For example, this paragraph (d) applies to MACRS property that—

(i) Begins or ceases to be used predominantly outside the United States;

(ii) Results in a reclassification of the property under section 168(e) due to a change in the use of the property; or

(iii) Begins or ceases to be tax-exempt use property (as defined in section 168(h)).

(2) *Determination of change in the use*—(i) *In general.* Except as provided in paragraph (d)(2)(ii) of this section, a change in the use of MACRS property occurs when the primary use of the MACRS property in the taxable year is different from its primary use in the immediately preceding taxable year. The primary use of MACRS property may be determined in any reasonable manner that is consistently applied to the taxpayer's MACRS property.

(ii) *Alternative depreciation system property*—(A) *Property used within or outside the United States.* A change in the use of MACRS property occurs when a taxpayer begins or ceases to use MACRS property predominantly outside the United States during the taxable year. The determination of whether MACRS property is used predominantly outside the United States is made in accordance with the test in §1.48–1(g)(1)(i) for determining predominant use.

(B) *Tax-exempt bond financed property.* A change in the use of MACRS property occurs when the property changes to tax-exempt bond financed property, as described in section 168(g)(1)(C) and (g)(5), during the taxable year. For purposes of this paragraph (d), MACRS property changes to tax-exempt bond financed property when a tax-exempt bond is first issued after the MACRS property is placed in service. MACRS property continues to be tax-exempt bond financed property in the hands of the taxpayer even if the tax-exempt bond (including any refunding issue) is no longer outstanding or is redeemed.

(C) *Other mandatory alternative depreciation system property.* A change in the use of MACRS property occurs when the property changes to, or changes from, property described in section 168(g)(1)(B) (tax-exempt use property) or (D) (imported property covered by an Executive order) during the taxable year.

(iii) *Change in the use deemed to occur on first day of the year of change.* If a change in the use of MACRS property occurs under this paragraph (d)(2), the depreciation allowance for that MACRS property for the year of change is determined as though the use of the MACRS property changed on the first day of the year of change.

(3) *Change in the use results in a shorter recovery period and/or a more accelerated depreciation method*—(i) *Treated as placed in service in the year of change*—(A) *In general.* If a change in the use results in the MACRS property changing to a shorter recovery period and/or a depreciation method that is more accelerated than the method used for the MACRS property before the change in the use, the depreciation allowances

beginning in the year of change are determined as though the MACRS property is placed in service by the taxpayer in the year of change.

(B) *Computation of depreciation allowance.* The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of each taxable year by the applicable depreciation rate for each taxable year. In determining the applicable depreciation rate for the year of change and subsequent taxable years, the taxpayer must use any applicable depreciation method and recovery period prescribed under section 168 for the MACRS property in the year of change, consistent with any election made under section 168 by the taxpayer for that year (see, for example, section 168(b)(5)). If there is a change in the use of MACRS property, the applicable convention that applies to the MACRS property is the same as the convention that applied before the change in the use of the MACRS property. However, the depreciation allowance for the year of change for the MACRS property is determined without applying the applicable convention, unless the MACRS property is disposed of during the year of change. See paragraph (d)(5) of this section for the rules relating to the computation of the depreciation allowance under the optional depreciation tables. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(3)(i) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15 (1989–1 C.B. 816) (see §601.601(d)(2)(ii)(*b*) of this chapter)).

(C) *Special rules.* MACRS property affected by this paragraph (d)(3)(i) is not eligible in the year of change for the election provided under section 168(f)(1), 179, or 1400L(f), or for the additional first year depreciation deduction provided in section 168(k) or 1400L(b). See §§1.168(k)–1(f)(6)(iv) or 1.168(k)–2(g)(6)(iv), as applicable, and 1.1400L(b)–1(f)(6) for other additional first year depreciation deduction rules applicable to a change in the use of MACRS property subsequent to its placed-in-service year. For purposes of determining whether the mid-quarter convention applies to other MACRS property placed in service during the year of change, the unadjusted depreciable basis (as defined in §1.168(b)–1T(a)(3)) or the adjusted depreciable basis of MACRS property affected by this paragraph (d)(3)(i) is not taken into account.

(ii) *Option to disregard the change in the use.* In lieu of applying paragraph (d)(3)(i) of this section, the taxpayer may elect to determine the depreciation allowance as though the change in the use had not occurred. The taxpayer elects this option by claiming on the taxpayer's timely filed (including extensions) Federal income tax return for the year of change the depreciation allowance for the property as though the change in the use had not occurred. See paragraph (g)(2) of this section for the manner for revoking this election.

(4) *Change in the use results in a longer recovery period and/or a slower depreciation method*—(i) *Treated as originally placed in service with longer recovery period and/or slower depreciation method.* If a change in the use results in a longer recovery period and/or a depreciation method for the MACRS property that is less accelerated than the method used for the MACRS property before the change in the use, the depreciation allowances beginning with the year of change are determined as though the MACRS property had been originally placed in service by the taxpayer with the longer recovery period and/or the slower depreciation method. MACRS property affected by this paragraph (d)(4) is not eligible in the year of change for the election provided under section 168(f)(1), 179, or 1400L(f), or for the additional first year depreciation deduction provided in section 168(k) or 1400L(b). See §§1.168(k)–1(f)(6)(iv) or 1.168(k)–2(g)(6)(iv), as applicable, and 1.1400L(b)–1(f)(6) for other additional first year depreciation deduction rules applicable to a change in the use of MACRS property subsequent to its placed-in-service year.

(ii) *Computation of the depreciation allowance.* The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of each taxable year by the applicable depreciation rate for each taxable year. If there is a change in the use of MACRS property, the applicable convention that applies to the MACRS property is the same as the convention that applied before the change in the use of the MACRS property. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(4)(ii) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15 (1989–1 C.B. 816) (see §601.601(d)(2)(ii)(*b*) of this chapter)). See paragraph (d)(5) of this section for the rules relating to the computation of the depreciation allowance under the optional depreciation tables. In determining the applicable depreciation rate for the year of change and any subsequent taxable year—

(A) The applicable depreciation method is the depreciation method that would apply in the year of change and any subsequent taxable year for the MACRS property had the taxpayer used the longer recovery period and/or the slower depreciation method in the placed-in-service year of the property. If the 200-or 150-percent declining balance method would have applied in the placed-in-service year but the method would have switched to the straight line method in the year of change or any prior taxable year, the applicable depreciation method beginning with the year of change is the straight line method; and

(B) The applicable recovery period is either—

(*1*) The longer recovery period resulting from the change in the use if the applicable depreciation method is the 200-or 150-percent declining balance method (as determined under paragraph (d)(4)(ii)(A) of this section) unless the recovery period did not change as a result of the change in the use, in which case the applicable recovery period is the same recovery period that applied before the change in the use; or

(*2*) The number of years remaining as of the beginning of each taxable year (taking into account the applicable convention) had the taxpayer used the longer recovery period in the placed-in-service year of the property if the applicable depreciation method is the straight line method (as determined under paragraph (d)(4)(ii)(A) of this section) unless the recovery period did not change as a result of the change in the use, in which case the applicable recovery period is the number of years remaining as of the beginning of each taxable year (taking into account the applicable convention) based on the recovery period that applied before the change in the use.

(5) *Using optional depreciation tables*—(i) *Taxpayer not bound by prior use of table.* If a taxpayer used an optional depreciation table for the MACRS property before a change in the use, the taxpayer is not bound to use the appropriate new table for that MACRS property beginning in the year of change (for further guidance, for example, see section 8 of Rev. Proc. 87–57 (1987–2 C.B. 687, 693) (see §601.601(d)(2)(ii)(*b*) of this chapter)). If a taxpayer did not use an optional depreciation table for MACRS property before a change in the use and the change in the use results in a shorter recovery period and/or a more accelerated depreciation method (as described in paragraph (d)(3)(i) of this section), the taxpayer may use the appropriate new table for that MACRS property beginning in the year of change. If a taxpayer chooses not to use the optional depreciation table, the depreciation allowances for the MACRS property beginning in the year of change are determined under paragraph (d)(3)(i) or (4) of this section, as applicable.

(ii) *Taxpayer chooses to use optional depreciation table after a change in the use.* If a taxpayer chooses to use an optional depreciation table for the MACRS property after a change in the use, the depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined as follows:

(A) *Change in the use results in a shorter recovery period and/or a more accelerated depreciation method.* If a change in the use results in a shorter recovery period and/or a more accelerated depreciation method (as described in paragraph (d)(3)(i) of this section), the depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by multiplying the adjusted depreciable basis of the MACRS property as of the first day of the year of change by the annual depreciation rate for each recovery year (expressed as a decimal equivalent) specified in the appropriate optional depreciation table. The appropriate optional depreciation table for the MACRS property is based on the depreciation system, depreciation method, recovery period, and convention applicable to the MACRS property in the year of change as determined under paragraph (d)(3)(i) of this section. The depreciation allowance for the year of change for the MACRS property is determined by taking into account the applicable convention (which is already factored into the optional depreciation tables). If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(5)(ii)(A) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15 (1989–1 C.B. 816) (see §601.601(d)(2)(ii)(*b*) of this chapter)).

(B) *Change in the use results in a longer recovery period and/or a slower depreciation method*—(*1*) *Determination of the appropriate optional depreciation table*. If a change in the use results in a longer recovery period and/or a slower depreciation method (as described in paragraph (d)(4)(i) of this section), the depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are determined by choosing the optional depreciation table that corresponds to the depreciation system, depreciation method, recovery period, and convention that would have applied to the MACRS property in the placed-in-service year had that property been originally placed in service by the taxpayer with the longer recovery period and/or the slower depreciation method. If there is a change in the use of MACRS property, the applicable convention that applies to the MACRS property is the same as the convention that applied before the change in the use of the MACRS property. If the year of change or any subsequent taxable year is less than 12 months, the depreciation allowance determined under this paragraph (d)(5)(ii)(B) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15 (1989–1 C.B. 816) (see §601.601(d)(2)(ii)(*b*) of this chapter)).

(*2*) *Computation of the depreciation allowance*. The depreciation allowances for the MACRS property for any 12-month taxable year beginning with the year of change are computed by first determining the appropriate recovery year in the table identified under paragraph (d)(5)(ii)(B)(*1*) of this section. The appropriate recovery year for the year of change is the year that corresponds to the year of change. For example, if the recovery year for the year of change would have been Year 4 in the table that applied before the change in the use of the MACRS property, then the recovery year for the year of change is Year 4 in the table identified under paragraph (d)(5)(ii)(B)(*1*) of this section. Next, the annual depreciation rate (expressed as a decimal equivalent) for each recovery year is multiplied by a transaction coefficient. The transaction coefficient is the formula $(1 / (1-x))$ where x equals the sum of the annual depreciation rates from the table identified under paragraph (d)(5)(ii)(B)(*1*) of this section (expressed as a decimal equivalent) for the taxable years beginning with the placed-in-service year of the MACRS property through the taxable year immediately prior to the year of change. The product of the annual depreciation rate and the transaction coefficient is multiplied by the adjusted depreciable basis of the MACRS property as of the beginning of the year of change.

(6) *Examples*. The application of this paragraph (d) is illustrated by the following examples:

Example 1. Change in the use results in a shorter recovery period and/or a more accelerated depreciation method and optional depreciation table is not used. (i) *X*, a calendar-year corporation, places in service in 1999 equipment at a cost of $100,000 and uses this equipment from 1999 through 2003 primarily in its *A* business. *X* depreciates the equipment for 1999 through 2003 under the general depreciation system as 7-year property by using the

200-percent declining balance method (which switched to the straight-line method in 2003), a 7-year recovery period, and a half-year convention. Beginning in 2004, *X* primarily uses the equipment in its *B* business. As a result, the classification of the equipment under section 168(e) changes from 7-year property to 5-year property and the recovery period of the equipment under the general depreciation system changes from 7 years to 5 years. The depreciation method does not change. On January 1, 2004, the adjusted depreciable basis of the equipment is $22,311. *X* depreciates its 5-year recovery property placed in service in 2004 under the general depreciation system by using the 200-percent declining balance method and a 5-year recovery period. *X* does not use the optional depreciation tables.

(ii) Under paragraph (d)(3)(i) of this section, *X*'s allowable depreciation deduction for the equipment for 2004 and subsequent taxable years is determined as though *X* placed the equipment in service in 2004 for use primarily in its *B* business. The depreciable basis of the equipment as of January 1, 2004, is $22,311 (the adjusted depreciable basis at January 1, 2004). Because *X* does not use the optional depreciation tables, the depreciation allowance for 2004 (the deemed placed-in-service year) for this equipment only is computed without taking into account the half-year convention. Pursuant to paragraph (d)(3)(i)(C) of this section, this equipment is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). Thus, *X*'s allowable depreciation deduction for the equipment for 2004 is $8,924 ($22,311 adjusted depreciable basis at January 1, 2004, multiplied by the applicable depreciation rate of 40% (200/5)). *X*'s allowable depreciation deduction for the equipment for 2005 is $5,355 ($13,387 adjusted depreciable basis at January 1, 2005, multiplied by the applicable depreciation rate of 40% (200/5)).

(iii) Alternatively, under paragraph (d)(3)(ii) of this section, *X* may elect to disregard the change in the use and, as a result, may continue to treat the equipment as though it is used primarily in its *A* business. If the election is made, *X*'s allowable depreciation deduction for the equipment for 2004 is $8,924 ($22,311 adjusted depreciable basis at January 1, 2004, multiplied by the applicable depreciation rate of 40% (1/2.5 years remaining at January 1, 2004)). *X*'s allowable depreciation deduction for the equipment for 2005 is $8,925 ($13,387 adjusted depreciable basis at January 1, 2005, multiplied by the applicable depreciation rate of 66.67% (1/1.5 years remaining at January 1, 2005)).

Example 2. Change in the use results in a shorter recovery period and/or a more accelerated depreciation method and optional depreciation table is used. (i) Same facts as in *Example 1*, except that *X* used the optional depreciation tables for computing depreciation for 1999 through 2003. Pursuant to paragraph (d)(5) of this section, *X* chooses to continue to use the optional depreciation table for the equipment. *X* does not make the election provided in paragraph (d)(3)(ii) of this section to disregard the change in use.

(ii) In accordance with paragraph (d)(5)(ii)(A) of this section, *X* must first identify the appropriate optional depreciation table for the equipment. This table is table 1 in Rev. Proc. 87–57 because the equipment will be depreciated in the year of change (2004) under the general depreciation system using the 200-percent declining balance method, a 5-year recovery period, and the half-year convention (which is the convention that applied to the equipment in 1999). Pursuant to paragraph (d)(3)(i)(C) of this section, this equipment is not eligible for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). For 2004, *X* multiplies its adjusted depreciable basis in the equipment as of January 1, 2004, of $22,311, by the annual depreciation rate in table 1 for recovery year 1 for a 5-year recovery period (.20), to determine the depreciation allowance of $4,462. For 2005, *X* multiplies its adjusted depreciable basis in the equipment as of January 1, 2004, of $22,311, by the annual depreciation rate in table 1 for recovery year 2 for a 5-year recovery period (.32), to determine the depreciation allowance of $7,140.

Example 3. Change in the use results in a longer recovery period and/or a slower depreciation method. (i) *Y*, a calendar-year corporation, places in service in January 2002, equipment at a cost of $100,000 and uses this equipment in 2002 and 2003 only within the United States. *Y* elects not to deduct the additional first year depreciation under section 168(k). *Y* depreciates the equipment for 2002 and 2003 under the general depreciation system by using the 200-percent declining balance method, a 5-year recovery period, and a half-year convention. Beginning in 2004, *Y* uses the equipment predominantly outside the United States. As a result of this change in the use, the equipment is subject to the alternative depreciation system beginning in 2004. Under the alternative depreciation system, the equipment is depreciated by using the straight line method and a 9-year recovery period. The adjusted depreciable basis of the equipment at January 1, 2004, is $48,000.

(ii) Pursuant to paragraph (d)(4) of this section, *Y*'s allowable depreciation deduction for 2004 and subsequent taxable years is determined as though the equipment had been placed in service in January 2002, as property used predominantly outside the United States. Further, pursuant to paragraph (d)(4)(i) of this section, the equipment is not eligible in 2004 for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b). In determining the applicable depreciation rate for 2004, the applicable depreciation method is the straight line method and the applicable recovery period is 7.5 years, which is the number of years remaining at January 1, 2004, for property placed in service in 2002 with a 9-year recovery period (taking into account the half-year convention). Thus, the depreciation allowance for 2004 is $6,398 ($48,000 adjusted depreciable basis at January 1, 2004, multiplied by the applicable depreciation rate of 13.33% (1/7.5 years)). The depreciation allowance for 2005 is $6,398 ($41,602 adjusted depreciable basis at January 1, 2005, multiplied by the applicable depreciation rate of 15.38% (1/6.5 years remaining at January 1, 2005)).

Example 4. Change in the use results in a longer recovery period and/or a slower depreciation method and optional depreciation table is used. (i) Same facts as in *Example 3*, except that *Y* used the optional depreciation tables for computing depreciation in 2002 and 2003. Pursuant to paragraph (d)(5) of this section, *Y* chooses to continue to use the optional depreciation table for the equipment. Further, pursuant to paragraph (d)(4)(i) of this section, the equipment is not eligible in 2004 for the additional first year depreciation deduction provided by section 168(k) or section 1400L(b).

(ii) In accordance with paragraph (d)(5)(ii)(B) of this section, *Y* must first determine the appropriate optional depreciation table for the equipment pursuant to paragraph (d)(5)(ii)(B)(*1*) of this section. This table is table 8 in Rev. Proc. 87–57, which corresponds to the alternative depreciation system, the straight line method, a 9-year recovery period, and the half-year convention (because *Y* depreciated 5-year property in 2002 using a half-year convention). Next, *Y* must determine the appropriate recovery year in table 8. Because the year of change is 2004, the depreciation allowance for the equipment for 2004 is determined using recovery year 3 of table 8. For 2004, *Y* multiplies its adjusted depreciable basis in the equipment as of January 1, 2004, of $48,000, by the product of the annual depreciation rate in table 8 for recovery year 3 for a 9-year recovery period (.1111) and the transaction coefficient of 1.200 [1/(1 − (.0556 (table 8 for recovery year 1 for a 9-year recovery period) + .1111 (table 8 for recovery year 2 for a 9-year recovery period)))], to determine the depreciation allowance of $6,399. For 2005, *Y* multiplies its adjusted depreciable basis in the equipment as of January 1, 2004, of $48,000, by the product of the annual depreciation rate in table 8 for recovery year 4 for a 9-year recovery period (.1111) and the transaction coefficient (1.200), to determine the depreciation allowance of $6,399.

(e) *Change in the use of MACRS property during the placed-in-service year*—(1) *In general.* Except as provided in paragraph (e)(2) of this section, if a change in the use of MACRS property occurs during the placed-in-service year and the property continues to be MACRS property owned by the same taxpayer, the depreciation allowance for that property for the placed-in-service year is determined by its primary use during that year. The primary use of MACRS property may be determined in any reasonable manner that is consistently applied to the taxpayer's MACRS property. For purposes of this paragraph (e), the determination of whether the mid-quarter convention applies to any MACRS property placed in service during the year of change is made in accordance with § 1.168(d)–1.

(2) *Alternative depreciation system property*—(i) *Property used within and outside the United States.* The depreciation allowance for the placed-in-service year for MACRS property that is used within and outside the United States is determined by its predominant use during that year. The determination of whether MACRS property is used predominantly outside the United States during the placed-in-service year shall be made in accordance with the test in § 1.48–1(g)(1)(i) for determining predominant use.

(ii) *Tax-exempt bond financed property.* The depreciation allowance for the placed-in-service year for MACRS property that changes to tax-exempt bond financed property, as described in section 168(g)(1)(C) and (g)(5), during that taxable year is determined under the alternative depreciation system. For purposes of this paragraph (e), MACRS property changes to tax-exempt bond financed property when a tax-exempt bond is first issued after the MACRS property is placed in service. MACRS property continues to be tax-exempt bond financed property in the hands of the taxpayer even if the tax-exempt bond (including any refunding issue) is not outstanding at, or is redeemed by, the end of the placed-in-service year.

(iii) *Other mandatory alternative depreciation system property.* The depreciation allowance for the placed-in-service year for MACRS property that changes to, or changes from, property described in section 168(g)(1)(B) (tax-exempt use property) or (D) (imported property covered by an Executive order) during that taxable year is determined under—

(A) The alternative depreciation system if the MACRS property is described in section 168(g)(1)(B) or (D) at the end of the placed-in-service year; or

(B) The general depreciation system if the MACRS property is not described in section 168(g)(1)(B) or (D) at the end of the placed-in-service year, unless other provisions of the Internal Revenue Code or regulations under the Internal Revenue Code require the depreciation allowance for that MACRS property to be determined under the alternative depreciation system (for example, section 168(g)(7)).

(3) *Examples.* The application of this paragraph (e) is illustrated by the following examples:

Example 1. (i) *Z,* a utility and calendar-year corporation, acquires and places in service on January 1, 2004, equipment at a cost of $100,000. *Z* uses this equipment in its combustion turbine production plant for 4 months and then uses the equipment in its steam production plant for the remainder of 2004. *Z*'s combustion turbine production plant assets are classified as 15-year property and are depreciated by *Z* under the general depreciation system using a 15-year recovery period and the 150-percent declining balance method of depreciation. *Z*'s steam production plant assets are classified as 20-year property and are depreciated by *Z* under the general depreciation system using a 20-year recovery period and the 150-percent declining balance method of depreciation. *Z* uses the optional depreciation tables. The equipment is 50-percent bonus depreciation property for purposes of section 168(k).

(ii) Pursuant to this paragraph (e), *Z* must determine depreciation based on the primary use of the equipment during the placed-in-service year. *Z* has consistently determined the primary use of all of its MACRS properties by comparing the number of full months in the taxable year during which a MACRS property is used in one manner with the number of full months in that taxable year during which that MACRS property is used in another manner. Applying this approach, *Z* determines the depreciation allowance for the equipment for 2004 is based on the equipment being classified as 20-year property because the equipment was used by *Z* in its steam production plant for 8 months in 2004. If the half-year convention applies in 2004, the appropriate optional depreciation table is table 1 in Rev. Proc. 87–57, which is the table for MACRS property subject to the general depreciation system, the 150-percent declining balance method, a 20-year recovery period, and the half-year convention. Thus, the depreciation allowance for the equipment for 2004 is $51,875, which is the total of $50,000 for the 50-percent additional first year depreciation deduction allowable (the unadjusted depreciable basis of $100,000 multiplied by .50), plus $1,875 for the 2004 depreciation allowance on the remaining adjusted depreciable basis of $50,000 [(the unadjusted depreciable basis of $100,000 less the additional first year depreciation deduction of $50,000) multiplied by the annual depreciation rate of .0375 in table 1 for recovery year 1 for a 20-year recovery period].

Example 2. T , a calendar year corporation, places in service on January 1, 2004, several computers at a total cost of $100,000. *T* uses these computers within the United States for 3 months in 2004 and then moves and uses the computers outside the United States for the remainder of 2004. Pursuant to §1.48–1(g)(1)(i), the computers are considered as used predominantly outside the United States in 2004. As a result, for 2004, the computers are required to be depreciated under the alternative depreciation system of section 168(g) with a recovery period of 5 years pursuant to section 168(g)(3)(C). *T* uses the optional depreciation tables. If the half-year convention applies in 2004, the appropriate optional depreciation table is table 8 in Rev. Proc. 87–57, which is the table for MACRS property subject to the alternative depreciation system, the straight line method, a 5-year recovery period, and the half-year convention. Thus, the depreciation allowance for the computers for 2004 is $10,000, which is equal to the unadjusted depreciable basis of $100,000 multiplied by the annual depreciation rate of .10 in table 8 for recovery year 1 for a 5-year recovery period. Because the computers are required to be depreciated under the alternative depreciation system in their placed-in-service year, pursuant to section 168(k)(2)(C)(i) and §1.168(k)–1T(b)(2)(ii), the computers are not eligible for the additional first year depreciation deduction provided by section 168(k).

(f) *No change in accounting method.* A change in computing the depreciation allowance in the year of change for property subject to this section is not a change in method of accounting under section 446(e). *See* §1.446–1(e)(2)(ii)(*d*)(*3*)(*ii*).

(g) *Effective dates*—(1) *In general.* Except as provided in paragraph (g)(2) of this section, this section applies to any change in the use of MACRS property in a taxable year ending on or after June 17, 2004. For any change in the use of MACRS property after December 31, 1986, in a taxable year ending before

June 17, 2004, the Internal Revenue Service will allow any reasonable method of depreciating the property under section 168 in the year of change and the subsequent taxable years that is consistently applied to any property for which the use changes in the hands of the same taxpayer or the taxpayer may choose, on a property-by-property basis, to apply the provisions of this section.

(2) *Qualified property under section 168(k) acquired and placed in service after September 27, 2017*—(i) *In general.* The language "or §1.168(k)–2(g)(6)(iii), as applicable" in paragraph (b)(1) of this section, the language "or §1.168(k)–2(g)(6)(ii), as applicable" in paragraph (c) of this section, and the language "or §1.168(k)–2(g)(6)(iv), as applicable" in paragraphs (d)(3)(i)(C) and (d)(4)(i) of this section applies to any change in use of MACRS property, which is qualified property under section 168(k)(2), by a taxpayer during or after the taxpayer's taxable year that includes September 24, 2019.

(ii) *Early application.* A taxpayer may choose to apply the language "or §1.168(k)–2(g)(6)(iii), as applicable" in paragraph (b)(1) of this section, the language "or §1.168(k)–2(g)(6)(ii), as applicable" in paragraph (c) of this section, and the language "or §1.168(k)–2(g)(6)(iv), as applicable" in paragraphs (d)(3)(i)(C) and (d)(4)(i) of this section for any change in use of MACRS property, which is qualified property under section 168(k)(2) and acquired and placed in service after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017.

(iii) *Early application of regulation project REG–104397–18.* A taxpayer may rely on the language "or §1.168(k)–2(f)(6)(iii), as applicable" in paragraph (b)(1) of this section, the language "or §1.168(k)–2(f)(6)(ii), as applicable" in paragraph (c) of this section, and the language "or §1.168(k)–2(f)(6)(iv), as applicable" in paragraphs (d)(3)(i)(C) and (d)(4)(i) of this section in regulation project REG–104397–18 (2018–41 I.R.B. 558) (see §601.601(d)(2)(ii)(b) of this chapter) for any change in use of MACRS property, which is qualified property under section 168(k)(2) and acquired and placed in service after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017, and ending before the taxpayer's taxable year that includes September 24, 2019.

(3) *Change in method of accounting*—(i) *In general.* If a taxpayer adopted a method of accounting for depreciation due to a change in the use of MACRS property in a taxable year ending on or after December 30, 2003, and the method adopted is not in accordance with the method of accounting for depreciation provided in this section, a change to the method of accounting for depreciation provided in this section is a change in the method of accounting to which the provisions of sections 446(e) and 481 and the regulations under sections 446(e) and 481 apply. Also, a revocation of the election provided in paragraph (d)(3)(ii) of this section to disregard a change in the use is a change in method of accounting to which the provisions of sections 446(e) and 481 and the regulations under sections 446(e) and 481 apply. However, if a taxpayer adopted a method of accounting for depreciation due to a change in the use of MACRS property after December 31, 1986, in a taxable year ending before December 30, 2003, and the method adopted is not in accordance with the method of accounting for depreciation provided in this section, the taxpayer may treat the change to the method of accounting for depreciation provided in this section as a change in method of accounting to which the provisions of sections 446(e) and 481 and the regulations under sections 446(e) and 481 apply.

(ii) *Automatic consent to change method of accounting.* A taxpayer changing its method of accounting in accordance with this paragraph (g)(2) must follow 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, for example, *see* Rev. Proc. 2002–9 (2002–1 C.B. 327), (*see* §601.601(d)(2)(ii)(*b*) of this chapter)). Any change in method of accounting made under this paragraph (g)(2) must be made using an adjustment under section 481(a). For purposes of Form 3115, *Application for Change in Accounting Method,* the designated number for the automatic accounting method change authorized by this paragraph (g)(2) is ''88.'' If Form 3115 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form.

[T.D. 9132, 69 FR 33843, June 17, 2004, as amended by T.D. 9307, 71 FR 78068, Dec. 28, 2006; T.D. 9874, 84 FR 50127, Sept. 24, 2019]

§ 1.168(i)–5 Table of contents.

This section lists the major paragraphs contained in § 1.168(i)–6.

§ 1.168(i)–6 Like-kind exchanges and involuntary conversions.

(1) In general.

(2) Application to pre-effective date like-kind exchanges and involuntary conversions.

(3) Like-kind exchanges and involuntary conversions where the taxpayer made the election under section 168(f)(1) for the relinquished property.

[T.D. 9314, 72 FR 9250, Mar. 1, 2007]

§ 1.168(i)–6 Like-kind exchanges and involuntary conversions.

(a) *Scope.* This section provides the rules for determining the depreciation allowance for MACRS property acquired in a like-kind exchange or an involuntary conversion, including a like-kind exchange or an involuntary conversion of MACRS property that is exchanged or replaced with other MACRS property in a transaction between members of the same affiliated group. The allowance for depreciation under this section constitutes the amount of depreciation allowable under section 167(a) for the year of replacement and any subsequent taxable year for the replacement MACRS property and for the year of disposition of the relinquished MACRS property. The provisions of this section apply only to MACRS property to which §1.168(h)–1 (like-kind exchanges of tax-exempt use property) does not apply. Additionally, paragraphs (c) through (f) of this section apply only to MACRS property for which an election under paragraph (i) of this section has not been made.

(b) *Definitions.* For purposes of this section, the following definitions apply:

(1) *Replacement MACRS property* is MACRS property (as defined in §1.168(b)–1(a)(2)) in the hands of the acquiring taxpayer that is acquired for other MACRS property in a like-kind exchange or an involuntary conversion.

(2) *Relinquished MACRS property* is MACRS property that is transferred by the taxpayer in a like-kind exchange, or in an involuntary conversion.

(3) *Time of disposition* is when the disposition of the relinquished MACRS property takes place under the convention, as determined under §1.168(d)–1, that applies to the relinquished MACRS property.

(4) *Time of replacement* is the later of—

(i) When the replacement MACRS property is placed in service under the convention, as determined under this section, that applies to the replacement MACRS property; or

(ii) The time of disposition of the exchanged or involuntarily converted property.

(5) *Year of disposition* is the taxable year that includes the time of disposition.

(6) *Year of replacement* is the taxable year that includes the time of replacement.

(7) *Exchanged basis* is determined after the depreciation deductions for the year of disposition are determined under paragraph (c)(5)(i) of this section and is the lesser of—

(i) The basis in the replacement MACRS property, as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b); or

(ii) The adjusted depreciable basis (as defined in §1.168(b)–1(a)(4)) of the relinquished MACRS property.

(8) *Excess basis* is any excess of the basis in the replacement MACRS property, as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b), over the exchanged basis as determined under paragraph (b)(7) of this section.

(9) *Depreciable exchanged basis* is the exchanged basis as determined under paragraph (b)(7) of this section reduced by—

(i) The percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); and

(ii) Any adjustments to basis provided by other provisions of the Internal Revenue Code (Code) and the regulations under the Code (including section 1016(a)(2) and (3), for example, depreciation deductions in the year of replacement allowable under section 168(k) or 1400L(b)).

(10) *Depreciable excess basis* is the excess basis as determined under paragraph (b)(8) of this section reduced by—

(i) The percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income);

(ii) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179; and

(iii) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (including section 1016(a)(2) and (3), for example, depreciation deductions in the year of replacement allowable under section 168(k) or 1400L(b)).

(11) *Like-kind exchange* is an exchange of property in a transaction to which section 1031(a)(1), (b), or (c) applies.

(12) *Involuntary conversion* is a transaction described in section 1033(a)(1) or (2) that resulted in the nonrecognition of any part of the gain realized as the result of the conversion.

(c) *Determination of depreciation allowance*—(1) *Computation of the depreciation allowance for depreciable exchanged basis beginning in the year of replacement*—(i) *In general.* This paragraph (c) provides rules for determining the applicable recovery period, the applicable depreciation method, and the applicable convention used to determine the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement. See paragraph (c)(5) of this section for rules relating to the computation of the depreciation allowance for the year of disposition and for the year of replacement. See paragraph (d)(1) of this section for rules relating to the computation of the depreciation allowance for depreciable excess basis. See paragraph (d)(4) of this section if the replacement MACRS property is acquired before disposition of the relinquished MACRS property in a transaction to which section 1033 applies. See paragraph (e) of this section for rules relating to the computation of the depreciation allowance using the optional depreciation tables.

(ii) *Applicable recovery period, depreciation method, and convention.* The recovery period, depreciation method, and convention determined under this paragraph (c) are the only permissible methods of accounting for MACRS property within the scope of this section unless the taxpayer makes the election under paragraph (i) of this section not to apply this section.

(2) *Effect of depreciation treatment of the replacement MACRS property by previous owners of the acquired property.* If replacement MACRS property is acquired by a taxpayer in a like-kind exchange or an involuntary conversion, the depreciation treatment of the replacement MACRS property by previous owners has no effect on the determination of depreciation allowances for the replacement MACRS property in the hands of the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property for property that was depreciated under section 168 of the Internal Revenue Code of 1954 (ACRS) by the previous owner must use this section because the replacement property will become MACRS property in the hands of the acquiring taxpayer. In addition, elections made by previous owners in determining depreciation allowances for the replacement MACRS property have no effect on the acquiring taxpayer. For example, a taxpayer exchanging, in a like-kind exchange, MACRS property that the taxpayer depreciates under the general depreciation system of section 168(a) for other MACRS property that the previous owner elected to depreciate under the alternative depreciation system pursuant to section 168(g)(7) does not have to continue using the alternative depreciation system for the replacement MACRS property.

(3) *Recovery period and/or depreciation method of the properties are the same, or both are not the same*—(i) *In general.* For purposes of paragraphs (c)(3) and (c)(4) of this section in determining whether the recovery period and the depreciation method prescribed under section 168 for the replacement MACRS property are the same as the recovery period and the depreciation method prescribed under section 168 for the relinquished MACRS property, the recovery period and the depreciation method for the replacement MACRS property are considered to be the recovery period and the depreciation method that would have applied under section 168, taking into account any elections made by the acquiring taxpayer under section 168(b)(5) or 168(g)(7), had the replacement MACRS property been

placed in service by the acquiring taxpayer at the same time as the relinquished MACRS property.

(ii) *Both the recovery period and the depreciation method are the same.* If both the recovery period and the depreciation method prescribed under section 168 for the replacement MACRS property are the same as the recovery period and the depreciation method prescribed under section 168 for the relinquished MACRS property, the depreciation allowances for the replacement MACRS property beginning in the year of replacement are determined by using the same recovery period and depreciation method that were used for the relinquished MACRS property. Thus, the replacement MACRS property is depreciated over the remaining recovery period (taking into account the applicable convention), and by using the depreciation method, of the relinquished MACRS property. Except as provided in paragraph (c)(5) of this section, the depreciation allowances for the depreciable exchanged basis for any 12-month taxable year beginning with the year of replacement are determined by multiplying the depreciable exchanged basis by the applicable depreciation rate for each taxable year (for further guidance, for example, see section 6 of Rev. Proc. 87–57 (1987–2 CB 687, 692) and §601.601(d)(2)(ii)(*b*) of this chapter).

(iii) *Either the recovery period or the depreciation method is the same, or both are not the same.* If either the recovery period or the depreciation method prescribed under section 168 for the replacement MACRS property is the same as the recovery period or the depreciation method prescribed under section 168 for the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined using the recovery period or the depreciation method that is the same as the relinquished MACRS property. See paragraph (c)(4) of this section to determine the depreciation allowances when the recovery period or the depreciation method of the replacement MACRS property is not the same as that of the relinquished MACRS property.

(4) *Recovery period or depreciation method of the properties is not the same.* If the recovery period prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is not the same as the recovery period prescribed under section 168 for the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined under this paragraph (c)(4). Similarly, if the depreciation method prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is not the same as the depreciation method prescribed under section 168 for the relinquished MACRS property, the depreciation method used to determine the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement is determined under this paragraph (c)(4).

(i) *Longer recovery period.* If the recovery period prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is longer than that prescribed for the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined as though the replacement MACRS property had originally been placed in service by the acquiring taxpayer in the same taxable year the relinquished MACRS property was placed in service by the acquiring taxpayer, but using the longer recovery period of the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) and the convention determined under paragraph (c)(4)(v) of this section. Thus, the depreciable exchanged basis is depreciated over the remaining recovery period (taking into account the applicable convention) of the replacement MACRS property.

(ii) *Shorter recovery period.* If the recovery period prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is shorter than that of the relinquished MACRS property, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined using the same recovery period as that of the relinquished MACRS property. Thus, the depreciable exchanged basis is depreciated over the remaining recovery period (taking into account the applicable convention) of the relinquished MACRS property.

(iii) *Less accelerated depreciation method*—(A) If the depreciation method prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is less accelerated than that of the relinquished MACRS property at the time of disposition, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined as though the replacement MACRS property had originally been placed in service by the acquiring taxpayer at the same time the relinquished MACRS property was placed in service by the acquiring taxpayer, but using the less accelerated depreciation method. Thus, the depreciable exchanged basis is depreciated using the less accelerated depreciation method.

(B) Except as provided in paragraph (c)(5) of this section, the depreciation allowances for the depreciable exchanged basis for any 12-month taxable year beginning in the year of replacement are determined by multiplying the adjusted depreciable basis by the applicable depreciation rate for each taxable year. If, for example, the depreciation method of the replacement MACRS property in the year of replacement is the 150-percent declining balance method and the depreciation method of the relinquished MACRS property in the year of replacement is the 200-percent declining balance method, and neither method had been switched to the straight line method in the year of replacement or any prior taxable year, the applicable depreciation rate for the year of replacement and subsequent taxable years is determined by using the depreciation rate of the replacement MACRS property as if the replacement MACRS property was placed in service by the acquiring taxpayer at the same time the relinquished MACRS property was placed in service by the acquiring taxpayer, until the 150-percent declining balance method has been switched to the straight line method. If, for example, the depreciation method of the replacement MACRS property is the straight line method, the applicable depreciation rate for the year of replacement is determined by using the remaining recovery period at the beginning of the year of disposition (as determined under this paragraph (c)(4) and taking into account the applicable convention).

(iv) *More accelerated depreciation method*—(A) If the depreciation method prescribed under section 168 for the replacement MACRS property (as determined under paragraph (c)(3)(i) of this section) is more accelerated than that of the relinquished MACRS property at the time of disposition, the depreciation allowances for the replacement MACRS property beginning in the year of replacement are determined using the same depreciation method as the relinquished MACRS property.

(B) Except as provided in paragraph (c)(5) of this section, the depreciation allowances for the depreciable exchanged basis for any 12-month taxable year beginning in the year of replacement are determined by multiplying the adjusted depreciable basis by the applicable depreciation rate for each taxable year. If, for example, the depreciation method of the relinquished MACRS property in the year of replacement is the 150-percent declining balance method and the depreciation method of the replacement MACRS property in the year of replacement is the 200-percent declining balance method, and neither method had been switched to the straight line method in the year of replacement or any prior taxable year, the applicable depreciation rate for the year of replacement and subsequent taxable years is the same depreciation rate that applied to the relinquished MACRS property in the year of replacement, until the 150-percent declining balance method has been switched to the straight line method. If, for example, the depreciation method is the straight line method, the applicable depreciation rate for the year of replacement is determined by using the remaining recovery period at the beginning of the year of disposition (as determined under this paragraph (c)(4) and taking into account the applicable convention).

(v) *Convention.* The applicable convention for the exchanged basis is determined under this paragraph (c)(4)(v).

(A) *Either the relinquished MACRS property or the replacement MACRS property is mid-month property.* If either the relinquished MACRS property or the replacement MACRS property is property for which the applicable convention (as determined under section 168(d)) is the mid-month convention, the exchanged basis must be depreciated using the mid-month convention.

(B) *Neither the relinquished MACRS property nor the replacement MACRS property is mid-month property.* If neither the relinquished MACRS property nor the replacement MACRS property is property for which the applicable convention (as determined under section 168(d)) is the mid-month convention, the applicable convention for the exchanged basis is the same convention that applied to the relinquished MACRS property. If the relinquished MACRS property is placed in service in the year of disposition, and the time of replacement is also in the year of disposition, the convention that applies to the relinquished MACRS property is determined under paragraph (f)(1)(i) of this section. If, however, relinquished MACRS property was placed in service in the year of disposition and the time of replacement is in a taxable year subsequent to the year of disposition, the convention that applies to the exchanged basis is the convention that applies in that subsequent taxable year (see paragraph (f)(1)(ii) of this section).

(5) *Year of disposition and year of replacement.* No depreciation deduction is allowable for MACRS property disposed of by a taxpayer in a like-kind exchange or involuntary conversion in the same taxable year that such property was placed in service by the taxpayer. If replacement MACRS property is disposed of by a taxpayer during the same taxable year that the relinquished MACRS property is placed in service by the taxpayer, no depreciation deduction is allowable for either MACRS property. Otherwise, the depreciation allowances for the year of disposition and for the year of replacement are determined as follows:

(i) *Relinquished MACRS property*—(A) *General rule.* Except as provided in paragraphs (c)(5)(i)(B), (c)(5)(iii), (e), and (i) of this section, the depreciation allowance in the year of disposition for the relinquished MACRS property is computed by multiplying the allowable depreciation deduction for the property for that year by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service during the year of disposition (taking into account the applicable convention of the relinquished MACRS property), and the denominator of which is 12. In the case of termination under §1.168(i)–1(e)(3)(v) of general asset account treatment of an asset, or of all the assets remaining, in a general asset account, the allowable depreciation deduction in the year of disposition for the asset or assets for which general asset account treatment is terminated is determined using the depreciation method, recovery period, and convention of the general asset account. This allowable depreciation deduction is adjusted to account for the period the asset or assets is deemed to be in service in accordance with this paragraph (c)(5)(i).

(B) *Special rule.* If, at the beginning of the year of disposition, the remaining recovery period of the relinquished MACRS property, taking into account the applicable convention of such property, is less than the period between the beginning of the year of disposition and the time of disposition, the depreciation deduction for the relinquished MACRS property for the year of disposition is equal to the adjusted depreciable basis of the relinquished MACRS property at the beginning of the year of disposition. If this paragraph applies, the exchanged basis is zero and no depreciation is allowable for the exchanged basis in the replacement MACRS property.

(ii) *Replacement MACRS property*—(A) *Remaining recovery period of the replacement MACRS property.* The replacement MACRS property is treated as placed in service at the time of replacement under the convention that applies to the replacement MACRS property as determined under this paragraph (c)(5)(ii). The remaining recovery period of the replacement MACRS property at the time of replacement is the excess of the recovery period for the replacement MACRS property, as determined under paragraph (c) of this section, over the period of time that the replacement MACRS property would have been in service if it had been placed in service when the relinquished MACRS property was placed in service and removed from service at the time of disposition of the relinquished MACRS property. This period is determined by using the convention that applied to the relinquished MACRS property to determine the date that the relinquished MACRS property is deemed to have been placed in service and the date that it is deemed to have been disposed of. The length of time the replacement MACRS property would have been in service is determined by using these dates and the convention that applies to the replacement MACRS property.

(B) *Year of replacement is 12 months.* Except as provided in paragraphs (c)(5)(iii), (e), and (i) of this section, the depreciation allowance in the year of replacement for the depreciable exchanged basis is determined by—

(*1*) Calculating the applicable depreciation rate for the replacement MACRS property as of the beginning of the year of replacement taking into account the depreciation method prescribed for the replacement MACRS property under paragraph (c)(3) of this section and the remaining recovery period of the replacement MACRS property as of the beginning of the year of disposition as determined under this paragraph (c)(5)(ii);

(*2*) Calculating the depreciable exchanged basis of the replacement MACRS property, and adding to that amount the amount determined under paragraph (c)(5)(i) of this section for the year of disposition; and

(*3*) Multiplying the product of the amounts determined under paragraphs (c)(5)(ii)(B)(*1*) and (B)(*2*) of this section by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be in service during the year of replacement (in the year of replacement the replacement MACRS property is deemed to be placed in service by the acquiring taxpayer at the time of replacement under the convention determined under paragraph (c)(4)(v) of this section), and the denominator of which is 12.

(iii) *Year of disposition or year of replacement is less than 12 months.* If the year of disposition or the year of replacement is less than 12 months, the depreciation allowance determined under paragraph (c)(5)(ii)(A) of this section must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15 (1989–1 CB 816) and § 601.601(d)(2)(ii)(*b*) of this chapter).

(iv) *Deferred transactions*—(A) *In general.* If the replacement MACRS property is not acquired until after the disposition of the relinquished MACRS property, taking into account the applicable convention of the relinquished MACRS property and replacement MACRS property, depreciation is not allowable during the period between the disposition of the relinquished MACRS property and the acquisition of the replacement MACRS property. The recovery period for the replacement MACRS property is suspended during this period. For purposes of paragraph (c)(5)(ii) of this section, only the depreciable exchanged basis of the replacement MACRS property is taken into account for calculating the amount in paragraph (c)(5)(ii)(B)(*2*) of this section if the year of replacement is a taxable year subsequent to the year of disposition.

(B) *Allowable depreciation for a qualified intermediary.* [Reserved]

(v) *Remaining recovery period.* The remaining recovery period of the replacement MACRS property is determined as of the beginning of the year of disposition of the relinquished MACRS property. For purposes of determining the remaining recovery period of the replacement MACRS property, the replacement MACRS property is deemed to have been originally placed in service under the convention determined under paragraph (c)(4)(v) of this section, but at the time the relinquished MACRS property was deemed to be placed in service under the convention that applied to it when it was placed in service.

(6) *Examples.* The application of this paragraph (c) is illustrated by the following examples:

Example 1. A1, a calendar-year taxpayer, exchanges Building M, an office building, for Building N, a warehouse in a like-kind exchange. Building M is relinquished in July 2004 and Building N is acquired and placed in service in October 2004. A1 did not make any elections under section 168 for either Building M or Building N. The unadjusted depreciable basis of Building M was $4,680,000 when placed in service in July 1997. Since the recovery period and depreciation method prescribed under section 168 for Building N (39 years, straight line method) are the same as the recovery period and depreciation method prescribed under section 168 for Building M (39 years, straight line method), Building N is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, Building M. Applying the applicable convention, Building M is deemed disposed of on July 15, 2004, and Building N is placed in service on October 15, 2004. Thus, Building N will be depreciated using the straight line method over a remaining recovery period of 32 years beginning in October 2004 (the remaining recovery period of 32 years and 6.5 months at the beginning of 2004, less the 6.5 months of depreciation taken prior to the disposition of the exchanged MACRS property (Building M) in 2004). For 2004, the year in which the transaction takes place, the depreciation allowance for Building M is ($120,000)(6.5/12) which equals $65,000. The depreciation allowance for Building N for 2004 is ($120,000)(2.5/12) which equals $25,000. For 2005 and subsequent years, Building N is depreciated over the remaining recovery period of, and using the same depreciation method and convention as that of, Building M. Thus, the depreciation allowance for Building N is the same as Building M, namely $10,000 per month.

Example 2. B, a calendar-year taxpayer, placed in service Bridge P in January 1998. Bridge P is depreciated using the half-year convention. In January 2004, B exchanges Bridge P for Building Q, an apartment building, in a like-kind exchange. Pursuant to paragraph (k)(2)(i) of this section, B decided to apply §1.168(i)-6 to the exchange of Bridge P for Building Q, the replacement MACRS property. B did not make any elections under section 168 for either Bridge P or Building Q. Since the recovery period prescribed under section 168 for Building Q (27.5 years) is longer than that of Bridge P (15 years), Building Q is depreciated as if it had originally been placed in service in July 1998 and disposed of in July 2004 using a 27.5 year recovery period. Additionally, since the depreciation method prescribed under section 168 for Building Q (straight line method) is less accelerated than that of Bridge P (150-percent declining balance method), then the depreciation allowance for Building Q is computed using the straight line method. Thus, when Building Q is acquired and placed in service in 2004, its basis is depreciated over the remaining 21.5 year recovery period using the straight line method of depreciation and the mid-month convention beginning in July 2004.

Example 3. C, a calendar-year taxpayer, placed in service Building R, a restaurant, in January 1996. In January 2004, C exchanges Building R for Tower S, a radio transmitting tower, in a like-kind exchange. Pursuant to paragraph (k)(2)(i) of this section, C decided to apply §1.168(i)-6 to the exchange of Building R for Tower S, the replacement MACRS property. C did not make any elections under section 168 for either Building R or Tower S. Since the recovery period prescribed under section 168 for Tower S (15 years) is shorter than that of Building R (39 years), Tower S is depreciated over the remaining recovery period of Building R. Additionally, since the depreciation method prescribed under section 168 for Tower S (150% declining balance method) is more accelerated than that of Building R (straight line method), then the depreciation allowance for Tower S is also computed using the same depreciation method as Building R. Thus, Tower S is depreciated over the remaining 31 year recovery period of Building R using the straight line method of depreciation and the mid-month convention. Alternatively, C may elect under paragraph (i) of this section to treat Tower S as though it is placed in service in January 2004. In such case, C uses the applicable recovery period, depreciation method, and convention prescribed under section 168 for Tower S.

Example 4. (i) In February 2002, D, a calendar-year taxpayer and manufacturer of rubber products, acquired for $60,000 and placed in service Asset T (a special tool) and depreciated Asset T using the straight line method election under section 168(b)(5) and the mid-quarter convention over its 3-year recovery period. D elected not to deduct the additional first year depreciation for 3-year property placed in service in 2002. In June 2004, D exchanges Asset T for Asset U (not a special tool) in a like-kind exchange. D elected not to deduct the additional first year depreciation for 7-year property placed in service in 2004. Since the recovery period prescribed under section 168 for Asset U (7 years) is longer than that of Asset T (3 years), Asset U is depreciated as if it had originally been placed in service in February

2002 using a 7-year recovery period. Additionally, since the depreciation method prescribed under section 168 for Asset U (200-percent declining balance method) is more accelerated than that of Asset T (straight line method) at the time of disposition, the depreciation allowance for Asset U is computed using the straight line method. Asset U is depreciated over its remaining recovery period of 4.75 years using the straight line method of depreciation and the mid-quarter convention.

(ii) The 2004 depreciation allowance for Asset T is $7,500 ($20,000 allowable depreciation deduction for 2004) × 4.5 months ÷ 12).

(iii) The depreciation rate in 2004 for Asset U is 0.1951 (1 ÷ 5.125 years (the length of the applicable recovery period remaining as of the beginning of 2004)). Therefore, the depreciation allowance for Asset U in 2004 is $2,744 (0.1951 × $22,500 (the sum of the $15,000 depreciable exchanged basis of Asset U ($22,500 adjusted depreciable basis at the beginning of 2004 for Asset T, less the $7,500 depreciation allowable for Asset T for 2004) and the $7,500 depreciation allowable for Asset T for 2004) × 7.5 months ÷ 12).

Example 5. The facts are the same as in *Example 4* except that D exchanges Asset T for Asset U in June 2005, in a like-kind exchange. Under these facts, the remaining recovery period of Asset T at the beginning of 2005 is 1.5 months and, as a result, is less than the 5-month period between the beginning of 2005 (year of disposition) and June 2005 (time of disposition). Accordingly, pursuant to paragraph (c)(5)(i)(B) of this section, the 2005 depreciation allowance for Asset T is $2,500 ($2,500 adjusted depreciable basis at the beginning of 2005 ($60,000 original basis minus $17,500 depreciation deduction for 2002 minus $20,000 depreciation deduction for 2003 minus $20,000 depreciation deduction for 2004)). Because the exchanged basis of asset U is $0.00, no depreciation is allowable for asset U.

Example 6. On January 1, 2004, E, a calendar-year taxpayer, acquired and placed in service Canopy V, a gas station canopy. The purchase price of Canopy V was $60,000. On August 1, 2004, Canopy V was destroyed in a hurricane and was therefore no longer usable in E's business. On October 1, 2004, as part of the involuntary conversion, E acquired and placed in service new Canopy W with the insurance proceeds E received due to the loss of Canopy V. E elected not to deduct the additional first year depreciation for 5-year property placed in service in 2004. E depreciates both canopies under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. No depreciation deduction is allowable for Canopy V. The depreciation deduction allowable for Canopy W for 2004 is $12,000 ($60,000 × the annual depreciation rate of .40 × ½ year). For 2005, the depreciation deduction for Canopy W is $19,200 ($48,000 adjusted basis × the annual depreciation rate of .40).

Example 7. The facts are the same as in *Example 6*, except that E did not make the election out of the additional first year depreciation for 5-year property placed in service in 2004. E depreciates both canopies under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. No depreciation deduction is allowable for Canopy V. For 2004, E is allowed a 50-percent additional first year depreciation deduction of $30,000 for Canopy W (the unadjusted depreciable basis of $60,000 multiplied by .50), and a regular MACRS depreciation deduction of $6,000 for Canopy W (the depreciable exchanged basis of $30,000 multiplied by the annual depreciation rate of .40 × ½ year). For 2005, E is allowed a regular MACRS depreciation deduction of $9,600 for Canopy W (the depreciable exchanged basis of $24,000 ($30,000 minus regular 2003 depreciation of $6,000) multiplied by the annual depreciation rate of .40).

Example 8. In January 2001, F, a calendar-year taxpayer, places in service a paved parking lot, Lot W, and begins depreciating Lot W over its 15-year recovery period. F's unadjusted depreciable basis in Lot W is $1,000x. On April 1, 2004, F disposes of Lot W in a like-kind exchange for Building X, which is nonresidential real property. Lot W is depreciated using the 150 percent declining balance method and the half-year convention. Building X is depreciated using the straight-line method with a 39-year recovery period and using the mid-month convention. Both Lot W and Building X were in service at the time of the exchange. Because Lot W was depreciated using the half-year convention, it is deemed to have been placed in service on July 1, 2001, the first day of the second half of 2001, and to have been disposed of on July 1, 2004, the first day of the second half of 2004. To determine the remaining recovery period of Building X at the time of replacement, Building X is deemed to have been placed in service on July 1, 2001, and removed from service on July 1, 2004. Thus, Building X is deemed to have been in service, at the time of replacement, for 3 years (36 months = 5.5 months in 2001 + 12 months in 2002 + 12 months in 2003 + 6.5 months in 2004) and its remaining recovery period is 36 years (39 − 3). Because Building X is deemed to be placed in service at the time of replacement, July 1, 2004, the first day of the second half of 2004, Building X is depreciated for 5.5 months in 2004. However, at the beginning of the year of replacement the remaining recovery period for Building X is 36 years and 6.5 months (39 years − 2 years and 5.5 months (5.5 months in 2001 + 12 months in 2002 + 12 months in 2003)). The depreciation rate for building X for 2004 is 0.02737 (= 1/(39–2–5.5/12)). For 2005, the depreciation rate for Building X is 0.02814 (= 1/(39–3–5.5/12)).

Example 9. The facts are the same as in *Example 8.* F did not make the election under paragraph (i) of this section for Building Y in the initial exchange. In January 2006, F exchanges Building Y for Building Z, an office building, in a like-kind exchange. F did not make any elections under section 168 for either Building Y or Building Z. Since the recovery period prescribed for Building Y as a result of the initial exchange (39 years) is longer than that of Building Z (27.5 years), Building Z is depreciated over the remaining 33 years of the recovery period of Building Y. The depreciation methods are the same for both Building Y and Building Z so F's exchanged basis in Building Z is depreciated over 33 years, using the straight-line method and the mid-month convention, beginning in January 2006. Alternatively, F could have made the election under paragraph (i) of this section. If F makes such election, Building Z is treated as placed in service by F when acquired in January 2006 and F would recover its exchanged basis in Building Z over 27.5 years, using the straight line method and the mid-month convention, beginning in January 2006.

(d) *Special rules for determining depreciation allowances*—(1) *Excess basis*—(i) *In general.* Any excess basis in the replacement MACRS property is treated as property that is placed in service by the acquiring taxpayer in the year of replacement. Thus, the depreciation allowances for the depreciable excess basis are determined by using the applicable recovery period, depreciation method, and convention prescribed under section 168 for the property at the time of replacement. However, if replacement MACRS property is disposed of during the same taxable year the relinquished MACRS property is placed in service by the acquiring taxpayer, no depreciation deduction is allowable for either MACRS property. See paragraph (g) of this section regarding the application of section 179. See paragraph (h) of this section regarding the application of section 168(k) or 1400L(b).

(ii) *Example.* The application of this paragraph (d)(1) is illustrated by the following example:

Example. In 1989, G placed in service a hospital. On January 16, 2004, G exchanges this hospital plus $2,000,000 cash for an office building in a like-kind exchange. On January 16, 2004, the hospital has an adjusted depreciable basis of $1,500,000. After the exchange, the basis of the office building is $3,500,000. Pursuant to paragraph (k)(2)(i) of this section, G decided to apply §1.168(i)–6 to the exchange of the hospital for the office building, the replacement MACRS property. The depreciable exchanged basis of the office building is depreciated in accordance with paragraph (c) of this section. The depreciable excess basis of $2,000,000 is treated as being placed in service by G in 2004 and, as a result, is depreciated using the applicable depreciation method, recovery period, and convention prescribed for the office building under section 168 at the time of replacement.

(2) *Depreciable and nondepreciable property*—(i) If land or other nondepreciable property is acquired in a like-kind exchange for, or as a result of an involuntary conversion of, depreciable property, the land or other nondepreciable property is not depreciated. If both MACRS and nondepreciable property are acquired in a like-kind exchange for, or as part of an involuntary conversion of, MACRS property, the basis allocated to the nondepreciable property (as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b)) is not depreciated and the basis allocated to the replacement MACRS property (as determined under section 1031(d) and the regulations under section 1031(d) or section 1033(b) and the regulations under section 1033(b)) is depreciated in accordance with this section.

(ii) If MACRS property is acquired, or if both MACRS and nondepreciable property are acquired, in a like-kind exchange for, or as part of an involuntary conversion of, land or other nondepreciable property, the basis in the replacement MACRS property that is attributable to the relinquished nondepreciable property is treated as though the replacement MACRS property is placed in service by the acquiring taxpayer in the year of replacement. Thus, the depreciation allowances for the replacement MACRS property are determined by using the applicable recovery period, depreciation method, and convention prescribed under section 168 for the replacement MACRS property at the time of replacement. See paragraph (g) of this section regarding the application of section 179. See paragraph (h) of this section regarding the application of section 168(k) or 1400L(b).

(3) *Depreciation limitations for automobiles*—(i) *In general.* Depreciation allowances under section 179 and section 167 (including allowances under sections 168 and 1400L(b)) for a passenger automobile, as defined in section 280F(d)(5), are subject to the limitations of section 280F(a). The depreciation allowances for a passenger automobile that is replacement MACRS property (replacement MACRS passenger automobile) generally are limited in any taxable year to the replacement automobile section 280F limit for the taxable year. The taxpayer's basis in the replacement MACRS passenger automobile is treated as being comprised of two separate components. The first component is the exchanged basis and the second component is the excess basis, if any. The depreciation allowances for a passenger automobile that is relinquished MACRS property (relinquished MACRS passenger automobile) for the taxable year generally are limited to the relinquished automobile section 280F limit for that taxable year. In the year of disposition the sum of the depreciation deductions for the relinquished MACRS passenger automobile and the replacement MACRS passenger automobile may not exceed the replacement automobile section 280F limit unless the taxpayer makes the election under §1.168(i)–6(i). For purposes of this paragraph (d)(3), the following definitions apply:

(A) *Replacement automobile section 280F limit* is the limit on depreciation deductions under section 280F(a) for the taxable year based on the time of replacement of the replacement MACRS passenger automobile (including the effect of any elections under section 168(k) or section 1400L(b), as applicable).

(B) *Relinquished automobile section 280F limit* is the limit on depreciation deductions under section 280F(a) for the taxable year based on when the relinquished MACRS passenger automobile was placed in service by the taxpayer.

(ii) *Order in which limitations on depreciation under section 280F(a) are applied.* Generally, depreciation deductions allowable under section 280F(a) reduce the basis in the relinquished MACRS passenger automobile and the exchanged basis of the replacement MACRS passenger automobile, before the excess basis of the replacement MACRS passenger automobile is reduced. The depreciation deductions for the relinquished MACRS passenger automobile in the year of disposition and the replacement MACRS passenger automobile in the year of replacement and each subsequent taxable year are allowable in the following order:

(A) The depreciation deduction allowable for the relinquished MACRS passenger automobile as determined under paragraph (c)(5)(i) of this section for the year of disposition to the extent of the smaller of the replacement automobile section 280F limit and the relinquished automobile section 280F limit, if the year of disposition is the year of replacement. If the year of replacement is a taxable year subsequent to the year of disposition, the depreciation deduction allowable for the relinquished MACRS passenger automobile for the year of disposition is limited to the relinquished automobile section 280F limit.

(B) The additional first year depreciation allowable on the remaining exchanged basis (remaining carryover basis as determined under §1.168(k)–1(f)(5), §1.168(k)–2(g)(5), or §1.1400L(b)–1(f)(5), as applicable) of the replacement MACRS passenger automobile, as determined under §1.168(k)–1(f)(5), §1.168(k)–2(g)(5), or §1.1400L(b)–1(f)(5), as applicable, to the extent of the excess of the replacement automobile section 280F limit over the amount allowable under paragraph (d)(3)(ii)(A) of this section.

(C) The depreciation deduction allowable for the taxable year on the depreciable exchanged basis of the replacement MACRS passenger automobile determined under paragraph (c) of this section to the extent of any excess over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A) and (B) of this section of the smaller of the replacement automobile section 280F limit and the relinquished automobile section 280F limit.

(D) Any section 179 deduction allowable in the year of replacement on the excess basis of the replacement

MACRS passenger automobile to the extent of the excess of the replacement automobile section 280F limit over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A), (B), and (C) of this section.

(E) The additional first year depreciation allowable on the remaining excess basis of the replacement MACRS passenger automobile, as determined under §1.168(k)–1(f)(5), §1.168(k)–2(g)(5), or §1.1400L(b)–1(f)(5), as applicable, to the extent of the excess of the replacement automobile section 280F limit over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A), (B), (C), and (D) of this section.

(F) The depreciation deduction allowable under paragraph (d) of this section for the depreciable excess basis of the replacement MACRS passenger automobile to the extent of the excess of the replacement automobile section 280F limit over the sum of the amounts allowable under paragraphs (d)(3)(ii)(A), (B), (C), (D), and (E) of this section.

(iii) *Examples.* The application of this paragraph (d)(3) is illustrated by the following examples:

Example 1. H, a calendar-year taxpayer, acquired and placed in service Automobile X in January 2000 for $30,000 to be used solely for H's business. In December 2003, H exchanges, in a like-kind exchange, Automobile X plus $15,000 cash for new Automobile Y that will also be used solely in H's business. Automobile Y is 50-percent bonus depreciation property for purposes of section 168(k)(4). Both automobiles are depreciated using the double declining balance method, the half-year convention, and a 5-year recovery period. Pursuant to §1.168(k)–1(g)(3)(ii) and paragraph (k)(2)(i) of this section, H decided to apply §1.168(i)–6 to the exchange of Automobile X for Automobile Y, the replacement MACRS property. The relinquished automobile section 280F limit for 2003 for Automobile X is $1,775. The replacement automobile section 280F limit for Automobile Y is $10,710. The exchanged basis for Automobile Y is $17,315 ($30,000 less total depreciation allowable of $12,685 (($3,060 for 2000, $4,900 for 2001, $2,950 for 2002, and $1,775 for 2003)). Without taking section 280F into account, the additional first year depreciation deduction for the remaining exchanged basis is $8,658 ($17,315 × 0.5). Because this amount is less than $8,935 ($10,710 (the replacement automobile section 280F limit for 2003 for Automobile Y) − $1,775 (the depreciation allowable for Automobile X for 2003)), the additional first year depreciation deduction for the exchanged basis is $8,658. No depreciation deduction is allowable in 2003 for the depreciable exchanged basis because the depreciation deductions taken for Automobile X and the remaining exchanged basis exceed the exchanged automobile section 280F limit. An additional first year depreciation deduction of $277 is allowable for the excess basis of $15,000 in Automobile Y. Thus, at the end of 2003 the adjusted depreciable basis in Automobile Y is $23,379 comprised of adjusted depreciable exchanged basis of $8,657 ($17,315 (exchanged basis) − $8,658 (additional first year depreciation for exchanged basis)) and of an adjusted depreciable excess basis of $14,723 ($15,000 (excess basis) − $277 (additional first year depreciation for 2003)).

Example 2. The facts are the same as in *Example 1*, except that H used Automobile X only 75 percent for business use. As such, the total allowable depreciation for Automobile X is reduced to reflect that the automobile is only used 75 percent for business. The total allowable depreciation of Automobile X is $9,513.75 ($2,295 for 2000 ($3,060 limit × .75), $3,675 for 2001 ($4,900 limit × .75), $2,212.50 for 2002 ($2,950 limit × .75), and $1,331.25 for 2003 ($1,775 limit × .75). However, under §1.280F–2T(g)(2)(ii)(A), the exchanged basis is reduced by the excess (if any) of the depreciation that would have been allowable if the exchanged automobile had been used solely for business over the depreciation that was allowable in those years. Thus, the exchanged basis, for purposes of computing depreciation, for Automobile Y is $17,315.

Example 3. The facts are the same as in *Example 1*, except that H placed in service Automobile X in January 2002, and H elected not to claim the additional first year depreciation deduction for 5-year property placed in service in 2002 and 2003. The relinquished automobile section 280F limit for Automobile X for 2003 is $4,900. Because the replacement automobile section 280F limit for 2003 for Automobile Y ($3,060) is less than the relinquished automobile section 280F limit for Automobile X for 2003 and is less than $5,388 (($30,000 (cost) − $3,060 (depreciation allowable for 2002)) × 0.4 × 6/12), the depreciation that would be allowable for Automobile X (determined without regard to section 280F) in the year of disposition, the depreciation for Automobile X in the year of disposition is limited to $3,060. For 2003 no depreciation is allowable for the excess basis and the exchanged basis in Automobile Y.

Example 4. AB, a calendar-year taxpayer, purchased and placed in service Automobile X1 in February 2000 for $10,000. X1 is a passenger automobile subject to section 280F(a) and is used solely for AB's business. AB depreciated X1 using a 5-year recovery period, the double declining balance method, and the half-year convention. As of January 1, 2003, the adjusted depreciable basis of X1 was

$2,880 ($10,000 original cost minus $2,000 depreciation deduction for 2000, minus $3,200 depreciation deduction for 2001, and $1,920 depreciation deduction for 2002). In November 2003, AB exchanges, in a like-kind exchange, Automobile X1 plus $14,000 cash for new Automobile Y1 that will be used solely in AB's business. Automobile Y1 is 50-percent bonus depreciation property for purposes of section 168(k)(4) and qualifies for the expensing election under section 179. Pursuant to paragraph §1.168(k)–1(g)(3)(ii) and paragraph (k)(2)(i) of this section, AB decided to apply §1.168(i)–6 to the exchange of Automobile X1 for Automobile Y1, the replacement MACRS property. AB also makes the election under section 179 for the excess basis of Automobile Y1. AB depreciates Y1 using a five-year recovery period, the double declining balance method and the half-year convention. For 2003, the relinquished automobile section 280F limit for Automobile X1 is $1,775 and the replacement automobile section 280F limit for 2003 for Automobile Y1 is $10,710.

(i) The 2003 depreciation deduction for Automobile X1 is $576. The depreciation deduction calculated for X1 is $576 (the adjusted depreciable basis of Automobile X1 at the beginning of 2003 of $2,880 × 40% × ½ year), which is less than the relinquished automobile section 280F limit and the replacement automobile section 280F limit.

(ii) The additional first year depreciation deduction for the exchanged basis is $1,152. The additional first year depreciation deduction of $1,152 (remaining exchanged basis of $2,304 ($2,880 adjusted basis of Automobile X1 at the beginning of 2003 minus $576) − 0.5)) is less than the replacement automobile section 280F limit minus $576.

(iii) AB's MACRS depreciation deduction allowable in 2003 for the remaining exchanged basis of $1,152 is $47 (the relinquished automobile section 280F limit of $1,775 less the depreciation deduction of $576 taken for Automobile X1 less the additional first year depreciation deduction of $1,152 taken for the exchanged basis) which is less than the depreciation deduction calculated for the depreciable exchanged basis.

(iv) For 2003, AB takes a $1,400 section 179 deduction for the excess basis of Automobile Y1. AB must reduce the excess basis of $14,000 by the section 179 deduction of $1,400 to determine the remaining excess basis of $12,600.

(v) For 2003, AB is allowed a 50-percent additional first year depreciation deduction of $6,300 (the remaining excess basis of $12,600 multiplied by .50).

(vi) For 2003, AB's depreciation deduction for the depreciable excess basis is limited to $1,235. The depreciation deduction computed without regard to the replacement automobile section 280F limit is $1,260 ($6,300 depreciable excess basis × 0.4 × 6/12). However the depreciation deduction for the depreciable excess basis is limited to $1,235 ($10,710 (replacement automobile section 280F limit) − $576 (depreciation deduction for Automobile X1) − $1,152 (additional first year depreciation deduction for the exchanged basis) − $47 (depreciation deduction for exchanged basis) − 1,400 (section 179 deduction) − $6,300 (additional first year depreciation deduction for remaining excess basis)).

(4) *Involuntary conversion for which the replacement MACRS property is acquired and placed in service before disposition of relinquished MACRS property*. If, in an involuntary conversion, a taxpayer acquires and places in service the replacement MACRS property before the date of disposition of the relinquished MACRS property, the taxpayer depreciates the unadjusted depreciable basis of the replacement MACRS property under section 168 beginning in the taxable year when the replacement MACRS property is placed in service by the taxpayer and by using the applicable depreciation method, recovery period, and convention prescribed under section 168 for the replacement MACRS property at the placed-in-service date. However, at the time of disposition of the relinquished MACRS property, the taxpayer determines the exchanged basis and the excess basis of the replacement MACRS property and begins to depreciate the depreciable exchanged basis of the replacement MACRS property in accordance with paragraph (c) of this section. The depreciable excess basis of the replacement MACRS property continues to be depreciated by the taxpayer in accordance with the first sentence of this paragraph (d)(4). Further, in the year of disposition of the relinquished MACRS property, the taxpayer must include in taxable income the excess of the depreciation deductions allowable on the unadjusted depreciable basis of the replacement MACRS property over the depreciation deductions that would have been allowable to the taxpayer on the depreciable excess basis of the replacement MACRS property from the date the replacement MACRS property was placed in service by the taxpayer (taking into account the applicable convention) to the time of disposition of the relinquished MACRS property. However, see §1.168(k)–1(f)(5)(v) for replacement MACRS property that is qualified property or 50-percent bonus

depreciation property and §1.1400L(b)–1(f)(5) for replacement MACRS property that is qualified New York Liberty Zone property. Further, see §1.168(k)–2(g)(5)(iv) for replacement MACRS property that is qualified property under section 168(k), as amended by the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054 (December 22, 2017)).

(e) *Use of optional depreciation tables*—(1) *Taxpayer not bound by prior use of table*. If a taxpayer used an optional depreciation table for the relinquished MACRS property, the taxpayer is not required to use an optional table for the depreciable exchanged basis of the replacement MACRS property. Conversely, if a taxpayer did not use an optional depreciation table for the relinquished MACRS property, the taxpayer may use the appropriate table for the depreciable exchanged basis of the replacement MACRS property. If a taxpayer decides not to use the table for the depreciable exchanged basis of the replacement MACRS property, the depreciation allowance for this property for the year of replacement and subsequent taxable years is determined under paragraph (c) of this section. If a taxpayer decides to use the optional depreciation tables, no depreciation deduction is allowable for MACRS property placed in service by the acquiring taxpayer and subsequently exchanged or involuntarily converted by such taxpayer in the same taxable year, and, if, during the same taxable year, MACRS property is placed in service by the acquiring taxpayer, exchanged or involuntarily converted by such taxpayer, and the replacement MACRS property is disposed of by such taxpayer, no depreciation deduction is allowable for either MACRS property.

(2) *Determination of the depreciation deduction*—(i) *Relinquished MACRS property*. In the year of disposition, the depreciation allowance for the relinquished MACRS property is computed by multiplying the unadjusted depreciable basis (less the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k) or section 1400L(b), as applicable) of the relinquished MACRS property by the annual depreciation rate (expressed as a decimal equivalent) specified in the appropriate table for the recovery year corresponding to the year of disposition. This product is then multiplied by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service during the year of the exchange or involuntary conversion (taking into account the applicable convention) and the denominator of which is 12. However, if the year of disposition is less than 12 months, the depreciation allowance determined under this paragraph (e)(2)(i) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15 (1989–1 CB 816) and §601.601(d)(2)(ii)(*b*) of this chapter).

(ii) *Replacement MACRS property*—(A) *Determination of the appropriate optional depreciation table*. If a taxpayer chooses to use the appropriate optional depreciation table for the depreciable exchanged basis, the depreciation allowances for the depreciable exchanged basis beginning in the year of replacement are determined by choosing the optional depreciation table that corresponds to the recovery period, depreciation method, and convention of the replacement MACRS property determined under paragraph (c) of this section.

(B) *Calculating the depreciation deduction for the replacement MACRS property*. (*1*) The depreciation deduction for the taxable year is computed by first determining the appropriate recovery year in the table identified under paragraph (e)(2)(ii)(A) of this section. The appropriate recovery year for the year of replacement is the same as the recovery year for the year of disposition, regardless of the taxable year in which the replacement property is acquired. For example, if the recovery year for the year of disposition would have been year 4 in the table that applied before the disposition of the relinquished MACRS property, then the recovery year for the year of replacement is Year 4 in the table identified under paragraph (e)(2)(ii)(A) of this section.

(*2*) Next, the annual depreciation rate (expressed as a decimal equivalent) for each recovery year is multiplied by a transaction coefficient. The transaction coefficient is the formula (1 / (1

− x)) where x equals the sum of the annual depreciation rates from the table identified under paragraph (e)(2)(ii)(A) of this section (expressed as a decimal equivalent) corresponding to the replacement MACRS property (as determined under paragraph (e)(2)(ii)(A) of this section) for the taxable years beginning with the placed-in-service year of the relinquished MACRS property through the taxable year immediately prior to the year of disposition. The product of the annual depreciation rate and the transaction coefficient is multiplied by the depreciable exchanged basis (taking into account paragraph (e)(2)(i) of this section). In the year of replacement, this product is then multiplied by a fraction, the numerator of which is the number of months (including fractions of months) the property is deemed to be placed in service by the acquiring taxpayer during the year of replacement (taking into account the applicable convention) and the denominator of which is 12. However, if the year of replacement is the year the relinquished MACRS property is placed in service by the acquiring taxpayer, the preceding sentence does not apply. In addition, if the year of replacement is less than 12 months, the depreciation allowance determined under paragraph (e)(2)(ii) of this section must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15 (1989–1 CB 816) and §601.601(d)(2)(ii)(*b*) of this chapter).

(iii) *Unrecovered basis*. If the replacement MACRS property would have unrecovered depreciable basis after the final recovery year (for example, due to a deferred exchange), the unrecovered basis is an allowable depreciation deduction in the taxable year that corresponds to the final recovery year unless the unrecovered basis is subject to a depreciation limitation such as section 280F.

(3) *Excess basis*. As provided in paragraph (d)(1) of this section, any excess basis in the replacement MACRS property is treated as property that is placed in service by the acquiring taxpayer at the time of replacement. Thus, if the taxpayer chooses to use the appropriate optional depreciation table for the depreciable excess basis in the replacement MACRS property, the depreciation allowances for the depreciable excess basis are determined by multiplying the depreciable excess basis by the annual depreciation rate (expressed as a decimal equivalent) specified in the appropriate table for each taxable year. The appropriate table for the depreciable excess basis is based on the depreciation method, recovery period, and convention applicable to the depreciable excess basis under section 168 at the time of replacement. However, If the year of replacement is less than 12 months, the depreciation allowance determined under this paragraph (e)(3) must be adjusted for a short taxable year (for further guidance, for example, see Rev. Proc. 89–15 (1989–1 CB 816) and §601.601(d)(2)(ii)(*b*) of this chapter).

(4) *Examples*. The application of this paragraph (e) is illustrated by the following examples:

Example 1. J, a calendar-year taxpayer, acquired 5-year property for $10,000 and placed it in service in January 2001. J uses the optional tables to depreciate the property. J uses the half-year convention and did not make any elections for the property. In December 2003, J exchanges the 5-year property for used 7-year property in a like-kind exchange. Pursuant to paragraph (k)(2)(i) of this section, J decided to apply §1.168(i)–6 to the exchange of the 5-year property for the 7-year property, the replacement MACRS property. The depreciable exchanged basis of the 7-year property equals the adjusted depreciable basis of the 5-year property at the time of disposition of the relinquished MACRS property, namely $3,840 ($10,000 less $2,000 depreciation in 2001, $3,200 depreciation in 2002, and $960 depreciation in 2003). J must first determine the appropriate optional depreciation table pursuant to paragraph (c) of this section. Since the replacement MACRS property has a longer recovery period and the same depreciation method as the relinquished MACRS property, J uses the optional depreciation table corresponding to a 7-year recovery period, the 200% declining balance method, and the half-year convention (because the 5-year property was depreciated using a half-year convention). Had the replacement MACRS property been placed in service in the same taxable year as the placed-in-service year of the relinquished MACRS property, the depreciation allowance for the replacement MACRS property for the year of replacement would be determined using recovery year 3 of the optional table. The depreciation allowance equals the depreciable exchanged basis ($3,840) multiplied by the annual depreciation rate for the current taxable year (.1749 for recovery year 3) as modified by the transaction coefficient [1 / (1 − (.1429 + .2449))] which equals 1.6335. Thus, J multiplies $3,840, its depreciable exchanged basis in the replacement MACRS property, by the product of .1749 and 1.6335, and then by one-half, to determine the depreciation allowance for 2003, $549. For 2004, J multiples its depreciable exchanged basis in the replacement MACRS property determined at the time of replacement of $3,840 by the product of the modified annual depreciation rate for the current taxable year (.1249 for recovery year 4) and the transaction coefficient (1.6335) to determine its depreciation allowance of $783.

Example 2. K, a calendar-year taxpayer, acquired used Asset V for $100,000 and placed it in service in January 1999. K depreciated Asset V under the general depreciation system of section 168(a) by using a 5-year recovery period, the 200-percent declining balance method of depreciation, and the half-year convention. In December 2003, as part of the involuntary conversion, Asset V is involuntarily converted due to an earthquake. In October 2005, K purchases used Asset W with the insurance proceeds from the destruction of Asset V and places Asset W in service to replace Asset V. Pursuant to paragraph (k)(2)(i) of this section, K decided to apply §1.168(i)–6 to the involuntary conversion of Asset V with the replacement of Asset W, the replacement MACRS property. If Asset W had been placed in service when Asset V was placed in service, it would have been depreciated using a 7-year recovery period, the 200-percent declining balance method, and the half-year convention. K uses the optional depreciation tables to depreciate Asset V and Asset W. For 2003 (recovery year 5 on the optional table), the depreciation deduction for Asset V is $5,760 ((0.1152)($100,000)(1/2)). Thus, the adjusted depreciable basis of Asset V at the time of replacement is $11,520 ($100,000 less $20,000 depreciation in 1999, $32,000 depreciation in 2000, $19,200 depreciation in 2001, $11,520 depreciation in 2002, and $5,760 depreciation in 2003). Under the table that applied to Asset V, the year of disposition was recovery year 5 and the depreciation deduction was determined under the straight line method. The table that applies for Asset W is the table that applies the straight line depreciation method, the half-year convention, and a 7-year recovery period. The appropriate recovery year under this table is recovery year 5. The depreciation deduction for Asset W for 2005 is $1,646 (($11,520)(0.1429)(1/(1−0.5))(1/2)). Thus, the depreciation deduction for Asset W in 2006 (recovery year 6) is $3,290 ($11,520)(0.1428)(1/(1−0.5)). The depreciation deduction for 2007 (recovery year 7) is $3,292 (($11,520)(.1429)(1/(1−.5))). The depreciation deduction for 2008 (recovery year 8) is $3292 ($11,520 less allowable depreciation for Asset W for 2005 through 2007 ($1,646 + $3,290 + $3,292)).

Example 3. L, a calendar-year taxpayer, placed in service used Computer X in January 2002 for $5,000. L depreciated Computer X under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. Computer X is destroyed in a fire in March 2004. For 2004, the depreciation deduction allowable for Computer X equals $480 ([($5,000)(.1920)] × (1/2)). Thus, the adjusted depreciable basis of Computer X was $1,920 when it was destroyed ($5,000 unadjusted depreciable basis less $1,000 depreciation for 2002, $1,600 depreciation for 2003, and $480 depreciation for 2004). In April 2004, as part of the involuntary conversion, L acquired and placed in service used Computer Y with insurance proceeds received due to the loss of Computer X. Computer Y will be depreciated using the same depreciation method, recovery period, and convention as Computer X. L elected to use the optional depreciation tables to compute the depreciation allowance for Computer X and Computer Y. The depreciation deduction allowable for 2004 for Computer Y equals $384 ([$1,920 × (.1920)(1/(1−.52))] × (1/2)).

(f) *Mid-quarter convention.* For purposes of applying the 40-percent test under section 168(d) and the regulations under section 168(d), the following rules apply:

(1) *Exchanged basis.* If, in a taxable year, MACRS property is placed in service by the acquiring taxpayer (but not as a result of a like-kind exchange or involuntary conversion) and—

(i) In the same taxable year, is disposed of by the acquiring taxpayer in a like-kind exchange or an involuntary conversion and replaced by the acquiring taxpayer with replacement MACRS property, the exchanged basis (determined without any adjustments for depreciation deductions during the taxable year) of the replacement MACRS property is taken into account in the year of replacement in the quarter the relinquished MACRS property was placed in service by the acquiring taxpayer; or

(ii) In the same taxable year, is disposed of by the acquiring taxpayer in a like-kind exchange or an involuntary conversion, and in a subsequent taxable year is replaced by the acquiring taxpayer with replacement MACRS property, the exchanged basis (determined without any adjustments for depreciation deductions during the taxable year) of the replacement MACRS property is taken into account in the year of replacement in the quarter the replacement MACRS property was placed in service by the acquiring taxpayer; or

(iii) In a subsequent taxable year, disposed of by the acquiring taxpayer in a like-kind exchange or involuntary conversion, the exchanged basis of the replacement MACRS property is not taken into account in the year of replacement.

(2) *Excess basis.* Any excess basis is taken into account in the quarter the replacement MACRS property is placed in service by the acquiring taxpayer.

(3) *Depreciable property acquired for nondepreciable property.* Both the exchanged basis and excess basis of the replacement MACRS property described in paragraph (d)(2)(ii) of this section (depreciable property acquired for nondepreciable property), are taken into account for determining whether the mid-quarter convention applies in the year of replacement.

(g) *Section 179 election.* In applying the section 179 election, only the excess basis, if any, in the replacement MACRS property is taken into account. If the replacement MACRS property is described in paragraph (d)(2)(ii) of this section (depreciable property acquired for nondepreciable property), only the excess basis in the replacement MACRS property is taken into account.

(h) *Additional first year depreciation deduction.* See §1.168(k)–1(f)(5) (for qualified property or 50-percent bonus depreciation property) and §1.1400L(b)–1(f)(5) (for qualified New York Liberty Zone property). Further, see §1.168(k)–2(g)(5) for qualified property under section 168(k), as amended by the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054 (December 22, 2017)).

(i) *Elections*—(1) *Election not to apply this section.* A taxpayer may elect not to apply this section for any MACRS property involved in a like-kind exchange or involuntary conversion. An election under this paragraph (i)(1) applies only to the taxpayer making the election and the election applies to both the relinquished MACRS property and the replacement MACRS property. If an election is made under this paragraph (i)(1), the depreciation allowances for the replacement MACRS property beginning in the year of replacement and for the relinquished MACRS property in the year of disposition are not determined under this section (except as otherwise provided in this paragraph). Instead, for depreciation purposes only, the sum of the exchanged basis and excess basis, if any, in the replacement MACRS property is treated as property placed in service by the taxpayer at the time of replacement and the adjusted depreciable basis of the relinquished MACRS property is treated as being disposed of by the taxpayer at the time of disposition. While the relinquished MACRS property is treated as being disposed of at the time of disposition for depreciation purposes, the election not to apply this section does not affect the application of sections 1031 and 1033 (for example, if a taxpayer does not make the election under this paragraph (i)(1) and does not recognize gain or loss under section 1031, this result would not change if the taxpayer chose to make the election under this paragraph (i)(1)). In addition, the election not to apply this section does not affect the application of sections 1245 and 1250 to the relinquished MACRS property. Paragraphs (c)(5)(i) (determination of depreciation for relinquished MACRS property in the year of disposition), (c)(5)(iii) (rules for deferred transactions), (g) (section 179 election), and (h) (additional first year depreciation deduction) of this section apply to property to which this paragraph (i)(1) applies. See paragraph (j) of this section for the time and manner of making the election under this paragraph (i)(1).

(2) *Election to treat certain replacement property as MACRS property.* If the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion (the replacement property) replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS (the relinquished property), the taxpayer may elect to treat, for depreciation purposes only, the sum

of the exchanged basis and excess basis, if any, of the replacement property as MACRS property that is placed in service by the taxpayer at the time of replacement. An election under this paragraph (i)(2) applies only to the taxpayer making the election and the election applies to both the relinquished property and the replacement property. If an election is made under this paragraph (i)(2), the adjusted depreciable basis of the relinquished property is treated as being disposed of by the taxpayer at the time of disposition. Rules similar to those provided in §§1.168(i)–6(b)(3) and (4) apply for purposes of determining the time of disposition and time of replacement under this paragraph (i)(2). While the relinquished property is treated as being disposed of at the time of disposition for depreciation purposes, the election under this paragraph (i)(2) does not affect the application of sections 1031 and 1033, and the application of sections 1245 and 1250 to the relinquished property. If an election is made under this paragraph (i)(2), rules similar to those provided in paragraphs (c)(5)(iii) (rules for deferred transactions), (g) (section 179 election), and (h) (additional first year depreciation deduction) of this section apply to property. Except as provided in paragraph (k)(3)(ii) of this section, a taxpayer makes the election under this paragraph (i)(2) by claiming the depreciation allowance as determined under MACRS for the replacement property on the taxpayer's timely filed (including extensions) original Federal tax return for the placed-in-service year of the replacement property as determined under this paragraph (i)(2).

(j) *Time and manner of making election under paragraph (i)(1) of this section*—(1) *In general*. The election provided in paragraph (i)(1) of this section is made separately by each person acquiring replacement MACRS property. The election is made for each member of a consolidated group by the common parent of the group, by the partnership (and not by the partners separately) in the case of a partnership, or by the S corporation (and not by the shareholders separately) in the case of an S corporation. A separate election under paragraph (i)(1) of this section is required for each like-kind exchange or involuntary conversion. The election provided in paragraph (i)(1) of this section must be made within the time and manner provided in paragraph (j)(2) and (3) of this section and may 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), except as provided in paragraph (k)(2) of this section.

(2) *Time for making election*. The election provided in paragraph (i)(1) of this section must be made by the due date (including extensions) of the taxpayer's Federal tax return for the year of replacement.

(3) *Manner of making election*. The election provided in paragraph (i)(1) of this section is made in the manner provided for on Form 4562, Depreciation and Amortization, and its instructions. If Form 4562 is revised or renumbered, any reference in this section to that form is treated as a reference to the revised or renumbered form.

(4) *Revocation*. The election provided in paragraph (i)(1) of this section, once made, may be revoked only with the consent of the Commissioner of Internal Revenue. Such consent will be granted only in extraordinary circumstances. Requests for consent are requests for a letter ruling and must be filed with the Commissioner of Internal Revenue, Washington, DC 20224. Requests for consent may not be made in any other manner (for example, through a request under section 446(e) to change the taxpayer's method of accounting).

(k) *Effective date*—(1) *In general*. Except as provided in paragraphs (k)(3) and (4) of this section, this section applies to a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition and the time of replacement both occur after February 27, 2004.

(2) *Application to pre-effective date like-kind exchanges and involuntary conversions*. For a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may—

(i) Apply the provisions of this section. If a taxpayer's applicable Federal tax return has been filed on or before February 27, 2004, and the taxpayer has treated the replacement MACRS property as acquired, and the relinquished MACRS property as disposed of, in a like-kind exchange or an involuntary conversion, the taxpayer changes its method of accounting for depreciation of the replacement MACRS property and relinquished MACRS property in accordance with this paragraph (k)(2)(i) 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 CB 327) and §601.601(d)(2)(ii)(*b*) of this chapter); or

(ii) Rely on prior guidance issued by the Internal Revenue Service for determining the depreciation deductions of replacement MACRS property and relinquished MACRS property (for further guidance, for example, see Notice 2000–4 (2001–1 CB 313) and §601.601(d)(2)(ii)(*b*) of this chapter). In relying on such guidance, a taxpayer may use any reasonable, consistent method of determining depreciation in the year of disposition and the year of replacement. If a taxpayer's applicable Federal tax return has been filed on or before February 27, 2004, and the taxpayer has treated the replacement MACRS property as acquired, and the relinquished MACRS property as disposed of, in a like-kind exchange or an involuntary conversion, the taxpayer changes its method of accounting for depreciation of the replacement MACRS property and relinquished MACRS property in accordance with this paragraph (k)(2)(ii) 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 CB 327) and §601.601(d)(2)(ii)(*b*) of this chapter).

(3) *Like-kind exchanges and involuntary conversions where the taxpayer made the election under section 168(f)(1) for the relinquished property*—(i) *In general.* If the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion (the replacement property) replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS (the relinquished property), paragraph (i)(2) of this section applies to such relinquished property and replacement property for which the time of disposition and the time of replacement (both as determined under paragraph (i)(2) of this section) both occur after February 26, 2007.

(ii) *Application of paragraph (i)(2) of this section to pre-February 26, 2007 like-kind exchanges and involuntary conversions.* If the tangible depreciable property acquired by a taxpayer in a like-kind exchange or involuntary conversion (the replacement property) replaces tangible depreciable property for which the taxpayer made a valid election under section 168(f)(1) to exclude it from the application of MACRS (the relinquished property), the taxpayer may apply paragraph (i)(2) of this section to the relinquished property and the replacement property for which the time of disposition, the time of replacement (both as determined under paragraph (i)(2) of this section), or both occur on or before February 26, 2007. If the taxpayer wants to apply paragraph (i)(2) of this section and the taxpayer's applicable Federal tax return has been filed on or before February 26, 2007, the taxpayer must change its method of accounting for depreciation of the replacement property and relinquished property in accordance with this paragraph (k)(3)(ii) 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 CB 327) and §601.601(d)(2)(ii)(b) of this chapter).

(4) *Qualified property under section 168(k) acquired and placed in service after September 27, 2017*—(i) *In general.* The language "1.168(k)–2(g)(5)," in paragraphs (d)(3)(ii)(B) and (E) of this section and the final sentence in paragraphs (d)(4) and (h) of this section

apply to a like-kind exchange or an involuntary conversion of MACRS property, which is qualified property under section 168(k)(2), for which the time of replacement occurs on or after September 24, 2019.

(ii) *Early application.* A taxpayer may choose to apply the language ''1.168(k)–2(g)(5),'' in paragraphs (d)(3)(ii)(B) and (E) of this section and the final sentence in paragraphs (d)(4) and (h) of this section to a like-kind exchange or an involuntary conversion of MACRS property, which is qualified property under section 168(k)(2), for which the time of replacement occurs on or after September 28, 2017.

(iii) *Early application of regulation project REG–104397–18.* A taxpayer may rely on the language ''1.168(k)–2(f)(5),'' in paragraphs (d)(3)(ii)(B) and (E) of this section and the final sentence in paragraphs (d)(4) and (h) of this section in regulation project REG–104397–18 (2018–41 I.R.B. 558) (see §601.601(d)(2)(ii)(*b*) of this chapter) for a like-kind exchange or an involuntary conversion of MACRS property, which is qualified property under section 168(k)(2), for which the time of replacement occurs on or after September 28, 2017, and occurs before September 24, 2019.

[T.D. 9314, 72 FR 9251, Mar. 1, 2007, as amended by T.D. 9874, 84 FR 50127, Sept. 24, 2019]

§ 1.168(i)–7 Accounting for MACRS property.

(a) *In general.* A taxpayer may account for MACRS property (as defined in §1.168(b)–1(a)(2)) by treating each individual asset as an account (a ''single asset account'' or an ''item account'') or by combining two or more assets in a single account (a ''multiple asset account'' or a ''pool''). A taxpayer may establish as many accounts for MACRS property as the taxpayer wants. This section does not apply to assets included in general asset accounts. For rules applicable to general asset accounts, see §1.168(i)–1.

(b) *Required use of single asset accounts.* A taxpayer must account for an asset in a single asset account if the taxpayer uses the asset both in a trade or business or for the production of income and in a personal activity, or if the taxpayer places in service and disposes of the asset during the same taxable year. Also, if general asset account treatment for an asset terminates under §1.168(i)–1(c)(1)(ii)(A), (e)(3)(iii), (e)(3)(v), (e)(3)(vii), (g), or (h)(1), as applicable, the taxpayer must account for the asset in a single asset account beginning in the taxable year in which the general asset account treatment for the asset terminates. If a taxpayer accounts for an asset in a multiple asset account or a pool and the taxpayer disposes of the asset, the taxpayer must account for the asset in a single asset account beginning in the taxable year in which the disposition occurs. See §1.168(i)–8(h)(2)(i). If a taxpayer disposes of a portion of an asset and §1.168(i)–8(d)(1) applies to that disposition, the taxpayer must account for the disposed portion in a single asset account beginning in the taxable year in which the disposition occurs. See §1.168(i)–8(h)(3)(i).

(c) *Establishment of multiple asset accounts or pools*—(1) *Assets eligible for multiple asset accounts or pools.* Except as provided in paragraph (b) of this section, assets that are subject to either the general depreciation system of section 168(a) or the alternative depreciation system of section 168(g) may be accounted for in one or more multiple asset accounts or pools.

(2) *Grouping assets in multiple asset accounts or pools*—(i) *General rules.* Assets that are eligible to be grouped into a single multiple asset account or pool may be divided into more than one multiple asset account or pool. Each multiple asset account or pool must include only assets that—

(A) Have the same applicable depreciation method;

(B) Have the same applicable recovery period;

(C) Have the same applicable convention; and

(D) Are placed in service by the taxpayer in the same taxable year.

(ii) *Special rules.* In addition to the general rules in paragraph (c)(2)(i) of this section, the following rules apply when establishing multiple asset accounts or pools—

(A) Assets subject to the mid-quarter convention may only be grouped into a multiple asset account or pool with assets that are placed in service in the same quarter of the taxable year;

(B) Assets subject to the mid-month convention may only be grouped into a multiple asset account or pool with assets that are placed in service in the same month of the taxable year;

(C) Passenger automobiles for which the depreciation allowance is limited under section 280F(a) must be grouped into a separate multiple asset account or pool;

(D) Assets not eligible for any additional first year depreciation deduction (including assets for which the taxpayer elected not to deduct the additional first year depreciation) provided by, for example, section 168(k) through (n), 1400L(b), or 1400N(d), must be grouped into a separate multiple asset account or pool;

(E) Assets eligible for the additional first year depreciation deduction may only be grouped into a multiple asset account or pool with assets for which the taxpayer claimed the same percentage of the additional first year depreciation (for example, 30 percent, 50 percent, or 100 percent);

(F) Except for passenger automobiles described in paragraph (c)(2)(ii)(C) of this section, listed property (as defined in section 280F(d)(4)) must be grouped into a separate multiple asset account or pool;

(G) Assets for which the depreciation allowance for the placed-in-service year is not determined by using an optional depreciation table (for further guidance, see section 8 of Rev. Proc. 87–57, 1987–2 CB 687, 693 (see §601.601(d)(2) of this chapter)) must be grouped into a separate multiple asset account or pool; and

(H) Mass assets (as defined in §1.168(i)–8(b)(3)) that are or will be subject to §1.168(i)–8(g)(2)(iii) (disposed of or converted mass asset is identified by a mortality dispersion table) must be grouped into a separate multiple asset account or pool.

(d) *Cross references.* See §1.167(a)–7(c) for the records to be maintained by a taxpayer for each account. In addition, see §1.168(i)–1(l)(3) for the records to be maintained by a taxpayer for each general asset account.

(e) *Effective/applicability dates*—(1) *In general.* This section applies to taxable years beginning on or after January 1, 2014.

(2) *Early application of this section.* A taxpayer may choose to apply the provisions of this section to taxable years beginning on or after January 1, 2012.

(3) *Early application of regulation project REG–110732–13.* A taxpayer may rely on the provisions of this section in regulation project REG–110732–13 (2013–43 IRB 404) (see §601.601(d)(2) of this chapter) for taxable years beginning on or after January 1, 2012. However, a taxpayer may not rely on the provisions of this section in regulation project REG–110732–13 for taxable years beginning on or after January 1, 2014.

(4) *Optional application of TD 9564.* A taxpayer may choose to apply §1.168(i)–7T as contained in 26 CFR part 1 edition revised as of April 1, 2013, to taxable years beginning on or after January 1, 2012. However, a taxpayer may not apply §1.168(i)–7T as contained in 26 CFR part 1 edition revised as of April 1, 2013, to taxable years beginning on or after January 1, 2014.

(5) *Change in method of accounting.* A change to comply with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. A taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply.

[T.D. 9636, 78 FR 57707, Sept. 19, 2013, as amended by T.D. 9689, 79 FR 48678, Aug. 18, 2014; 79 FR 78697, Dec. 31, 2014]

§ 1.168(i)–8 Dispositions of MACRS property.

(a) *Scope.* This section provides rules applicable to dispositions of MACRS property (as defined in §1.168(b)–1(a)(2)) or to depreciable property (as defined in §1.168(b)–1(a)(1)) that would be MACRS property but for an election made by the taxpayer either to expense all or some of the property's cost under section 179, section 179A, section 179B, section 179C, section 179D, or section 1400I(a)(1), or any similar provision, or to amortize all or some of the property's cost under section 1400I(a)(2) or any similar provision. This section also applies to dispositions described in paragraph (d)(1) of this section of a portion of such property. Except as provided in §1.168(i)–1(e)(3), this section does not apply to dispositions of assets included in a general asset account. For rules applicable to dispositions of assets included in a general asset account, see §1.168(i)–1(e).

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

(1) *Building* has the same meaning as that term is defined in §1.48–1(e)(1).

(2) *Disposition* occurs when ownership of the asset is transferred or when the asset is permanently withdrawn from use either in the taxpayer's trade or business or in the production of income. A disposition includes the sale, exchange, retirement, physical abandonment, or destruction of an asset. A disposition also occurs when an asset is transferred to a supplies, scrap, or similar account, or when a portion of an asset is disposed of as described in paragraph (d)(1) of this section. If a structural component, or a portion thereof, of a building is disposed of in a disposition described in paragraph (d)(1) of this section, a disposition also includes the disposition of such structural component or such portion thereof.

(3) *Mass assets* is a mass or group of individual items of depreciable assets—

(i) That are not necessarily homogenous;

(ii) Each of which is minor in value relative to the total value of the mass or group;

(iii) Numerous in quantity;

(iv) Usually accounted for only on a total dollar or quantity basis;

(v) With respect to which separate identification is impracticable; and

(vi) Placed in service in the same taxable year.

(4) *Portion of an asset* is any part of an asset that is less than the entire asset as determined under paragraph (c)(4) of this section.

(5) *Structural component* has the same meaning as that term is defined in §1.48–1(e)(2).

(6) *Unadjusted depreciable basis of the multiple asset account or pool* is the sum of the unadjusted depreciable bases (as defined in §1.168(b)–1(a)(3)) of all assets included in the multiple asset account or pool.

(c) *Special rules*—(1) *Manner of disposition.* The manner of disposition (for example, normal retirement, abnormal retirement, ordinary retirement, or extraordinary retirement) is not taken into account in determining whether a disposition occurs or gain or loss is recognized.

(2) *Disposition by transfer to a supplies account.* If a taxpayer made an election under §1.162–3(d) to treat the cost of any rotable spare part, temporary spare part, or standby emergency spare part (as defined in §1.162–3(c)) as a capital expenditure subject to the allowance for depreciation, the taxpayer can dispose of the rotable, temporary, or standby emergency spare part by transferring it to a supplies account only if the taxpayer has obtained the consent of the Commissioner to revoke the §1.162–3(d) election. If a taxpayer made an election under §1.162–3T(d) to treat the cost of any material and supply (as defined in §1.162–3T(c)(1)) as a capital expenditure subject to the allowance for depreciation, the taxpayer can dispose of the material and supply by transferring it to a supplies account only if the taxpayer has obtained the consent of the Commissioner to revoke the §1.162–3T(d) election. See §1.162–3(d)(3) for the procedures for revoking a §1.162–3(d) or a §1.162–3T(d) election.

(3) *Leasehold improvements.* This section also applies to—

(i) A lessor of leased property that made an improvement to that property for the lessee of the property, has a depreciable basis in the improvement, and disposes of the improvement, or disposes of a portion of the improvement under paragraph (d)(1) of this section, before or upon the termination of the lease with the lessee. See section 168(i)(8)(B); and

(ii) A lessee of leased property that made an improvement to that property, has a depreciable basis in the improvement, and disposes of the improvement, or disposes of a portion of the improvement under paragraph (d)(1) of this section, before or upon the termination of the lease.

(4) *Determination of asset disposed of*—(i) *General rules.* For purposes of applying this section, the facts and circumstances of each disposition are considered in determining what is the appropriate asset disposed of. The asset for disposition purposes may not consist of items placed in service by the taxpayer on different dates, without taking into account the applicable convention. For purposes of determining what is the appropriate asset disposed of, the unit of property determination under § 1.263(a)–3(e) or in published guidance in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) under section 263(a) and the distinct asset determination under § 1.1031(a)–3(a)(4) do not apply.

(ii) *Special rules.* In addition to the general rules in paragraph (c)(4)(i) of this section, the following rules apply for purposes of applying this section:

(A) Each building, including its structural components, is the asset, except as provided in § 1.1250–1(a)(2)(ii) or in paragraph (c)(4)(ii)(B) or (D) of this section.

(B) If a building has two or more condominium or cooperative units, each condominium or cooperative unit, including its structural components, is the asset, except as provided in § 1.1250–1(a)(2)(ii) or in paragraph (c)(4)(ii)(D) of this section.

(C) If a taxpayer properly includes an item in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87–56 (1987–2 CB 674) (see § 601.601(d)(2) of this chapter) or properly classifies an item in one of the categories under section 168(e)(3), except for a category that includes buildings or structural components (for example, retail motor fuels outlet, qualified leasehold improvement property, qualified restaurant property, and qualified retail improvement property), each item is the asset provided paragraph (c)(4)(ii)(D) of this section does not apply to the item. For example, each desk is the asset, each computer is the asset, and each qualified smart electric meter is the asset.

(D) If the taxpayer places in service an improvement or addition to an asset after the taxpayer placed the asset in service, the improvement or addition and, if applicable, its structural components are a separate asset.

(d) *Disposition of a portion of an asset*—(1) *In general.* For purposes of applying this section, a disposition includes a disposition of a portion of an asset as a result of a casualty event described in section 165, a disposition of a portion of an asset for which gain, determined without regard to section 1245 or section 1250, is not recognized in whole or in part under section 1031 or section 1033, a transfer of a portion of an asset in a transaction described in section 168(i)(7)(B), or a sale of a portion of an asset, even if the taxpayer does not make the election under paragraph (d)(2)(i) of this section for that disposed portion. For other transactions, a disposition includes a disposition of a portion of an asset only if the taxpayer makes the election under paragraph (d)(2)(i) of this section for that disposed portion.

(2) *Partial disposition election*—(i) *In general.* A taxpayer may make an election under this paragraph (d)(2) to apply this section to a disposition of a portion of an asset. If the asset is properly included in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87–56, a taxpayer may make an election under this paragraph (d)(2) to apply this section to a disposition of a portion of such asset only if the taxpayer classifies the replacement portion of the asset under the same asset class as the disposed portion of the asset.

(ii) *Time and manner for making election*—(A) *Time for making election.* Except as provided in paragraph (d)(2)(iii) or (iv) of this section, a taxpayer must make the election specified in paragraph (d)(2)(i) of this section by the due date, including extensions, of the original Federal tax return for the taxable year in which the portion of an asset is disposed of by the taxpayer.

(B) *Manner of making election.* Except as provided in paragraph (d)(2)(iii) or (iv) of this section, a taxpayer must make the election specified in paragraph (d)(2)(i) of this section by applying the provisions of this section for the taxable year in which the portion of an asset is disposed of by the taxpayer, by reporting the gain, loss, or other deduction on the taxpayer's timely filed, including extensions, original Federal tax return for that taxable year, and, if the asset is properly included in one of the asset classes 00.11 through 00.4 of Rev. Proc. 87–56, by classifying the replacement portion of such asset under the same asset class as the disposed portion of the asset in the taxable year in which the replacement portion is placed in service by the taxpayer. Except as provided in paragraph (d)(2)(iii) or (iv)(B) of this section or except as otherwise expressly provided by other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter), the election specified in paragraph (d)(2)(i) of this section may not be made through the filing of an application for change in accounting method.

(iii) *Special rule for subsequent Internal Revenue Service adjustment.* This paragraph (d)(2)(iii) applies when a taxpayer deducted the amount paid or incurred for the replacement of a portion of an asset as a repair under §1.162–4, the taxpayer did not make the election specified in paragraph (d)(2)(i) of this section for the disposed portion of that asset within the time and in the manner under paragraph (d)(2)(ii) or (iv) of this section, and as a result of an examination of the taxpayer's Federal tax return, the Internal Revenue Service disallows the taxpayer's repair deduction for the amount paid or incurred for the replacement of the portion of that asset and instead capitalizes such amount under §1.263(a)–2 or §1.263(a)–3. If this paragraph (d)(2)(iii) applies, the taxpayer may make the election specified in paragraph (d)(2)(i) of this section for the disposition of the portion of the asset to which the Internal Revenue Service's adjustment pertains by filing an application for change in accounting method, provided the asset of which the disposed portion was a part is owned by the taxpayer at the beginning of the year of change (as defined for purposes of section 446(e)).

(iv) *Special rules for 2012 or 2013 returns.* If, under paragraph (j)(2) of this section, a taxpayer chooses to apply the provisions of this section to a taxable year beginning on or after January 1, 2012, and ending on or before September 19, 2013 (applicable taxable year), and the taxpayer did not make the election specified in paragraph (d)(2)(i) of this section on its timely filed original Federal tax return for the applicable taxable year, including extensions, the taxpayer must make the election specified in paragraph (d)(2)(i) of this section for the applicable taxable year by filing either—

(A) An amended Federal tax return for the applicable taxable year on or before 180 days from the due date including extensions of the taxpayer's Federal tax return for the applicable taxable year, notwithstanding that the taxpayer may not have extended the due date; or

(B) An application for change in accounting method with the taxpayer's timely filed original Federal tax return for the first or second taxable year succeeding the applicable taxable year.

(v) *Revocation.* A taxpayer may revoke the election specified in paragraph (d)(2)(i) of this section only by filing a request for a private letter ruling and obtaining the Commissioner's consent to revoke the election. The Commissioner may grant a request to revoke this election if the taxpayer acted reasonably and in good faith, and the revocation will not prejudice the interests of the Government. See generally §301.9100–3 of this chapter. The election specified in paragraph (d)(2)(i) of this section may not be revoked through the filing of an application for change in accounting method.

(e) *Gain or loss on dispositions.* Solely for purposes of this paragraph (e), the term *asset* is an asset within the scope of this section or the portion of such asset that is disposed of in a disposition described in paragraph (d)(1) of this section. Except as provided by section 280B and §1.280B–1, the following rules apply when an asset is disposed of during a taxable year:

(1) If an asset is disposed of by sale, exchange, or involuntary conversion, gain or loss must be recognized under

the applicable provisions of the Internal Revenue Code.

(2) If an asset is disposed of by physical abandonment, loss must be recognized in the amount of the adjusted depreciable basis (as defined in § 1.168(b)–1(a)(4)) of the asset at the time of the abandonment, taking into account the applicable convention. However, if the abandoned asset is subject to nonrecourse indebtedness, paragraph (e)(1) of this section applies to the asset instead of this paragraph (e)(2). For a loss from physical abandonment to qualify for recognition under this paragraph (e)(2), the taxpayer must intend to discard the asset irrevocably so that the taxpayer will neither use the asset again nor retrieve it for sale, exchange, or other disposition.

(3) If an asset is disposed of other than by sale, exchange, involuntary conversion, physical abandonment, or conversion to personal use (as, for example, when the asset is transferred to a supplies or scrap account), gain is not recognized. Loss must be recognized in the amount of the excess of the adjusted depreciable basis of the asset at the time of the disposition, taking into account the applicable convention, over the asset's fair market value at the time of the disposition, taking into account the applicable convention.

(f) *Basis of asset disposed of*—(1) *In general*. The adjusted basis of an asset disposed of for computing gain or loss is its adjusted depreciable basis at the time of the asset's disposition, as determined under the applicable convention for the asset.

(2) *Assets disposed of are in multiple asset accounts*. (i) If the taxpayer accounts for the asset disposed of in a multiple asset account or pool and it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis (as defined in § 1.168(b)–1(a)(3)) of the asset disposed of, the taxpayer may use any reasonable method that is consistently applied to all assets in the same multiple asset account or pool for purposes of determining the unadjusted depreciable basis of assets disposed of. Examples of a reasonable method include, but are not limited to, the following:

(A) If the replacement asset is a restoration (as defined in § 1.263(a)–3(k)), and is not a betterment (as defined in § 1.263(a)–3(j)) or an adaptation to a new or different use (as defined in § 1.263(a)–3(l)), discounting the cost of the replacement asset to its placed-in-service year cost using the Producer Price Index for Finished Goods or its successor, the Producer Price Index for Final Demand, or any other index designated by guidance in the Internal Revenue Bulletin (see § 601.601(d)(2) of this chapter) for purposes of this paragraph (f)(2);

(B) A pro rata allocation of the unadjusted depreciable basis of the multiple asset account or pool based on the replacement cost of the disposed asset and the replacement cost of all of the assets in the multiple asset account or pool; and

(C) A study allocating the cost of the asset to its individual components.

(ii) To determine the adjusted depreciable basis of an asset disposed of in a multiple asset account or pool, the depreciation allowable for the asset disposed of is computed by using the depreciation method, recovery period, and convention applicable to the multiple asset account or pool in which the asset disposed of was included and by including the additional first year depreciation deduction claimed for the asset disposed of.

(3) *Disposition of a portion of an asset*. (i) This paragraph (f)(3) applies only when a taxpayer disposes of a portion of an asset and paragraph (d)(1) of this section applies to that disposition. For computing gain or loss, the adjusted basis of the disposed portion of the asset is the adjusted depreciable basis of that disposed portion at the time of its disposition, as determined under the applicable convention for the asset. If it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis (as defined in § 1.168(b)–1(a)(3)) of the disposed portion of the asset, the taxpayer may use any reasonable method for purposes of determining the unadjusted depreciable basis (as defined in § 1.168(b)–1(a)(3)) of the disposed portion of the asset. If a taxpayer disposes of more than one portion of the same asset and it is impracticable from the taxpayer's records to determine the

unadjusted depreciable basis (as defined in §1.168(b)–1(a)(3)) of the first disposed portion of the asset, the reasonable method used by the taxpayer must be consistently applied to all portions of the same asset for purposes of determining the unadjusted depreciable basis of each disposed portion of the asset. If the asset, a portion of which is disposed of, is in a multiple asset account or pool and it is impracticable from the taxpayer's records to determine the unadjusted depreciable basis (as defined in §1.168(b)–1(a)(3)) of the disposed portion of the asset, the reasonable method used by the taxpayer must be consistently applied to all assets in the same multiple asset account or pool for purposes of determining the unadjusted depreciable basis of assets disposed of or any disposed portion of the assets. Examples of a reasonable method include, but are not limited to, the following:

(A) If the replacement portion is a restoration (as defined in §1.263(a)–3(k)), and is not a betterment (as defined in §1.263(a)–3(j)) or an adaptation to a new or different use (as defined in §1.263(a)–3(l)), discounting the cost of the replacement portion of the asset to its placed-in-service year cost using the Producer Price Index for Finished Goods or its successor, the Producer Price Index for Final Demand, or any other index designated by guidance in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) for purposes of this paragraph (f)(3);

(B) A pro rata allocation of the unadjusted depreciable basis of the asset based on the replacement cost of the disposed portion of the asset and the replacement cost of the asset; and

(C) A study allocating the cost of the asset to its individual components.

(ii) To determine the adjusted depreciable basis of the disposed portion of the asset, the depreciation allowable for the disposed portion is computed by using the depreciation method, recovery period, and convention applicable to the asset in which the disposed portion was included and by including the portion of the additional first year depreciation deduction claimed for the asset that is attributable to the disposed portion.

(g) *Identification of asset disposed of*—(1) *In general.* Except as provided in paragraph (g)(2) or (3) of this section, a taxpayer must use the specific identification method of accounting to identify which asset is disposed of by the taxpayer. Under this method of accounting, the taxpayer can determine the particular taxable year in which the asset disposed of was placed in service by the taxpayer.

(2) *Asset disposed of is in a multiple asset account.* If a taxpayer accounts for the asset disposed of in a multiple asset account or pool and the total dispositions of assets with the same recovery period during the taxable year are readily determined from the taxpayer's records, but it is impracticable from the taxpayer's records to determine the particular taxable year in which the asset disposed of was placed in service by the taxpayer, the taxpayer must identify the asset disposed of by using—

(i) A first-in, first-out method of accounting if the unadjusted depreciable basis of the asset disposed of cannot be readily determined from the taxpayer's records. Under this method of accounting, the taxpayer identifies the multiple asset account or pool with the earliest placed-in-service year that has the same recovery period as the asset disposed of and that has assets at the beginning of the taxable year of the disposition, and the taxpayer treats the asset disposed of as being from that multiple asset account or pool;

(ii) A modified first-in, first-out method of accounting if the unadjusted depreciable basis of the asset disposed of can be readily determined from the taxpayer's records. Under this method of accounting, the taxpayer identifies the multiple asset account or pool with the earliest placed-in-service year that has the same recovery period as the asset disposed of and that has assets at the beginning of the taxable year of the disposition with the same unadjusted depreciable basis as the asset disposed of, and the taxpayer treats the asset disposed of as being from that multiple asset account or pool;

(iii) A mortality dispersion table if the asset disposed of is a mass asset. The mortality dispersion table must be based upon an acceptable sampling of the taxpayer's actual disposition experience for mass assets or other acceptable statistical or engineering techniques. To use a mortality dispersion table, the taxpayer must adopt recordkeeping practices consistent with the taxpayer's prior practices and consonant with good accounting and engineering practices; or

(iv) Any other method as the Secretary may designate by publication in the FEDERAL REGISTER or in the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter) on or after September 19, 2013. See paragraph (g)(4) of this section regarding the last-in, first-out method of accounting.

(3) *Disposition of a portion of an asset.* If a taxpayer disposes of a portion of an asset and paragraph (d)(1) of this section applies to that disposition, but it is impracticable from the taxpayer's records to determine the particular taxable year in which the asset was placed in service, the taxpayer must identify the asset by using any applicable method provided in paragraph (g)(2) of this section, after taking into account paragraph (g)(4) of this section.

(4) *Last-in, first-out method of accounting.* For purposes of this paragraph (g), a last-in, first-out method of accounting may not be used. Examples of a last-in, first-out method of accounting include the taxpayer identifying the multiple asset account or pool with the most recent placed-in-service year that has the same recovery period as the asset disposed of and that has assets at the beginning of the taxable year of the disposition, and the taxpayer treating the asset disposed of as being from that multiple asset account or pool, or the taxpayer treating the disposed portion of an asset as being from an asset with the most recent placed-in-service year that is the same as the asset of which the disposed portion is a part.

(h) *Accounting for asset disposed of*—(1) *Depreciation ends.* Depreciation ends for an asset at the time of the asset's disposition, as determined under the applicable convention for the asset. See §1.167(a)–10(b). If the asset disposed of is in a single asset account initially or as a result of §1.168(i)–8(h)(2)(i), §1.168(i)–8(h)(3)(i), or general asset account treatment for the asset terminated under §1.168(i)–1(c)(1)(ii)(A), (e)(3)(iii), (e)(3)(v), (e)(3)(vii), (g), or (h)(1), as applicable, the single asset account terminates at the time of the asset's disposition, as determined under the applicable convention for the asset. If a taxpayer disposes of a portion of an asset and paragraph (d)(1) of this section applies to that disposition, depreciation ends for that disposed portion of the asset at the time of the disposition of the disposed portion, as determined under the applicable convention for the asset.

(2) *Asset disposed of in a multiple asset account or pool.* If the taxpayer accounts for the asset disposed of in a multiple asset account or pool, then—

(i) As of the first day of the taxable year in which the disposition occurs, the asset disposed of is removed from the multiple asset account or pool and is placed into a single asset account. See §1.168(i)–7(b);

(ii) The unadjusted depreciable basis of the multiple asset account or pool must be reduced by the unadjusted depreciable basis of the asset disposed of as of the first day of the taxable year in which the disposition occurs. See paragraph (f)(2)(i) of this section for determining the unadjusted depreciable basis of the asset disposed of;

(iii) The depreciation reserve of the multiple asset account or pool must be reduced by the greater of the depreciation allowed or allowable for the asset disposed of as of the end of the taxable year immediately preceding the year of disposition. The allowable depreciation is computed by using the depreciation method, recovery period, and convention applicable to the multiple asset account or pool in which the asset disposed of was included and by including the additional first year depreciation deduction claimed for the asset disposed of; and

(iv) In determining the adjusted depreciable basis of the asset disposed of at the time of disposition, taking into account the applicable convention, the depreciation allowable for the asset disposed of is computed by using the depreciation method, recovery period, and convention applicable to the multiple asset account or pool in which the asset disposed of was included and by including the additional first year depreciation deduction claimed for the asset disposed of.

(3) *Disposition of a portion of an asset.* This paragraph (h)(3) applies only when a taxpayer disposes of a portion of an asset and paragraph (d)(1) of this section applies to that disposition. In this case—

(i) As of the first day of the taxable year in which the disposition occurs, the disposed portion is placed into a single asset account. See §1.168(i)–7(b);

(ii) The unadjusted depreciable basis of the asset must be reduced by the unadjusted depreciable basis of the disposed portion as of the first day of the taxable year in which the disposition occurs. See paragraph (f)(3)(i) of this section for determining the unadjusted depreciable basis of the disposed portion;

(iii) The depreciation reserve of the asset must be reduced by the greater of the depreciation allowed or allowable for the disposed portion as of the end of the taxable year immediately preceding the year of disposition. The allowable depreciation is computed by using the depreciation method, recovery period, and convention applicable to the asset in which the disposed portion was included and by including the portion of the additional first year depreciation deduction claimed for the asset that is attributable to the disposed portion; and

(iv) In determining the adjusted depreciable basis of the disposed portion at the time of disposition, taking into account the applicable convention, the depreciation allowable for the disposed portion is computed by using the depreciation method, recovery period, and convention applicable to the asset in which the disposed portion was included and by including the portion of the additional first year depreciation deduction claimed for the asset that is attributable to the disposed portion.

(i) *Examples.* The application of this section is illustrated by the following examples:

Example 1. A owns an office building with four elevators. A replaces one of the elevators. The elevator is a structural component of the office building. In accordance with paragraph (c)(4)(ii)(A) of this section, the office building, including its structural components, is the asset for disposition purposes. A does not make the partial disposition election provided under paragraph (d)(2) of this section for the elevator. Thus, the retirement of the replaced elevator is not a disposition. As a result, depreciation continues for the cost of the building, including the cost of the retired elevator and the building's other structural components, and A does not recognize a loss for this retired elevator. If A must capitalize the amount paid for the replacement elevator pursuant to §1.263(a)–3, the replacement elevator is a separate asset for disposition purposes pursuant to paragraph (c)(4)(ii)(D) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 2. The facts are the same as in *Example 1,* except A accounts for each structural component of the office building as a separate asset in its fixed asset system. Although A treats each structural component as a separate asset in its records, the office building, including its structural components, is the asset for disposition purposes in accordance with paragraph (c)(4)(ii)(A) of this section. Accordingly, the result is the same as in *Example 1.*

Example 3. The facts are the same as in *Example 1,* except A makes the partial disposition election provided under paragraph (d)(2) of this section for the elevator. Although the office building, including its structural components, is the asset for disposition purposes, the result of A making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. Thus, depreciation for the retired elevator ceases at the time of its retirement, taking into account the applicable convention, and A recognizes a loss upon this retirement. Further, A must capitalize the amount paid for the replacement elevator pursuant to §1.263(a)–3(k)(1)(i), and the replacement elevator is a separate asset for disposition purposes pursuant to paragraph (c)(4)(ii)(D) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 4. B, a calendar-year commercial airline company, owns several aircraft that are used in the commercial carrying of passengers and described in asset class 45.0 of Rev. Proc. 87–56. B replaces the existing engines on one of the aircraft with new engines. Assume each aircraft is a unit of property as determined under §1.263(a)–3(e)(3) and each engine of an aircraft is a major component or substantial structural part of the aircraft as determined under §1.263(a)–3(k)(6). Assume also that B treats each aircraft as the asset for disposition purposes in accordance with paragraph (c)(4) of this section. B makes the partial disposition election provided under paragraph (d)(2) of this section for the engines in the aircraft. Although the aircraft is the asset for disposition purposes, the result of B making the partial disposition election for the engines is that the retirement of the replaced engines is a disposition. Thus, depreciation for the retired engines ceases at the time of their retirement, taking into account the applicable convention, and B recognizes a loss upon this retirement. Further, B must capitalize the amount paid for the replacement engines pursuant to §1.263(a)–3(k)(1)(i), and the replacement engines are a separate asset for disposition purposes pursuant to paragraph (c)(4)(ii)(D) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 5. The facts are the same as in *Example 4*, except B does not make the partial disposition election provided under paragraph (d)(2) of this section for the engines. Thus, the retirement of the replaced engines on one of the aircraft is not a disposition. As a result, depreciation continues for the cost of the aircraft, including the cost of the retired engines, and B does not recognize a loss for these retired engines. If B must capitalize the amount paid for the replacement engines pursuant to §1.263(a)–3, the replacement engines are a separate asset for disposition purposes pursuant to paragraph (c)(4)(ii)(D) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 6. C, a corporation, owns several trucks that are used in its trade or business and described in asset class 00.241 of Rev. Proc. 87–56. C replaces the engine on one of the trucks with a new engine. Assume each truck is a unit of property as determined under §1.263(a)–3(e)(3) and each engine is a major component or substantial structural part of the truck as determined under §1.263(a)–3(k)(6). Because the trucks are described in asset class 00.241 of Rev. Proc. 87–56, C must treat each truck as the asset for disposition purposes. C does not make the partial disposition election provided under paragraph (d)(2) of this section for the engine. Thus, the retirement of the replaced engine on the truck is not a disposition. As a result, depreciation continues for the cost of the truck, including the cost of the retired engine, and C does not recognize a loss for this retired engine. If C must capitalize the amount paid for the replacement engine pursuant to §1.263(a)–3, the replacement engine is a separate asset for disposition purposes pursuant to paragraph (c)(4)(ii)(D) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 7. D owns a retail building. D replaces 60% of the roof of this building. In accordance with paragraph (c)(4)(ii)(A) of this section, the retail building, including its structural components, is the asset for disposition purposes. Assume D must capitalize the costs incurred for replacing 60% of the roof pursuant to §1.263(a)–3(k)(1)(vi). D makes the partial disposition election provided under paragraph (d)(2) of this section for the 60% of the replaced roof. Thus, the retirement of 60% of the roof is a disposition. As a result, depreciation for 60% of the roof ceases at the time of its retirement, taking into account the applicable convention, and D recognizes a loss upon this retirement. Further, D must capitalize the amount paid for the 60% of the roof pursuant to §1.263(a)–3(k)(1)(i) and (vi) and the replacement 60% of the roof is a separate asset for disposition purposes pursuant to paragraph (c)(4)(ii)(D) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 8. (i) The facts are the same as in *Example 7.* Ten years after replacing 60% of the roof, D replaces 55% of the roof of the building. In accordance with paragraph (c)(4)(ii)(A) and (D) of this section, for disposition purposes, the retail building, including its structural components, except the replacement 60% of the roof, is an asset and the replacement 60% of the roof is a separate asset. Assume D must capitalize the costs incurred for replacing 55% of the roof pursuant to §1.263(a)–3(k)(1)(vi). D makes the partial disposition election provided under paragraph (d)(2) of this section for the 55% of the replaced roof. Thus, the retirement of 55% of the roof is a disposition.

(ii) However, D cannot determine from its records whether the replaced 55% is part of the 60% of the roof replaced ten years ago or whether the replaced 55% includes part or all of the remaining 40% of the original roof. Pursuant to paragraph (g)(3) of this section, D identifies which asset it disposed of by using the first-in, first-out method of accounting. As a result, D disposed of the remaining 40% of the original roof and 25% of the 60% of the roof replaced ten years ago.

(iii) Thus, depreciation for the remaining 40% of the original roof ceases at the time of its retirement, taking into account the applicable convention, and D recognizes a loss upon this retirement. Further, depreciation for 25% of the 60% of the roof replaced ten years ago ceases at the time of its retirement, taking into account the applicable convention, and D recognizes a loss upon this retirement. Also, D must capitalize the amount paid for the 55% of the roof pursuant to §1.263(a)–3(k)(1)(i) and (vi), and the replacement 55% of the roof is a separate asset for disposition purposes pursuant to paragraph (c)(4)(ii)(D) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 9. (i) On July 1, 2011, E, a calendar-year taxpayer, purchased and placed in service an existing multi-story office building that costs $20,000,000. The cost of each structural component of the building was not separately stated. E accounts for the building and its structural components in its tax and financial accounting records as a single asset with a cost of $20,000,000. E depreciates the building as nonresidential real property and uses the optional depreciation table that corresponds with the general depreciation system, the straight-line method, a 39-year recovery period, and the mid-month convention. As of January 1, 2014, the depreciation reserve for the building is $1,261,000.

(ii) On June 30, 2014, E replaces one of the two elevators in the office building. E did not dispose of any other structural components of this building in 2014 and prior years. E makes the partial disposition election provided under paragraph (d)(2) of this section for this elevator. Although the office building, including its structural components, is the asset for disposition purposes, the result of E making the partial disposition election for the elevator is that the retirement of the replaced elevator is a disposition. Assume the replacement elevator is a restoration under §1.263(a)–3(k), and not a betterment under §1.263(a)–3(j) or an adaptation to a new or different use under §1.263(a)–3(l). Because E cannot identify the cost of the elevator from its records and the replacement elevator is a restoration under §1.263(a)–3(k), E determines the cost of the disposed elevator by discounting the cost of the replacement elevator to its placed-in-service year cost using the Producer Price Index for Final Demand. Using this reasonable method, E determines the cost of the retired elevator by discounting the cost of the replacement elevator to its cost in 2011 (the placed-in-service year) using the Producer Price Index for Final Demand, resulting in $150,000 of the $20,000,000 purchase price for the building to be the cost of the retired elevator. Using the optional depreciation table that corresponds with the general depreciation system, the straight-line method, a 39-year recovery period, and the mid-month convention, the depreciation allowed or allowable for the retired elevator as of December 31, 2013, is $9,458.

(iii) For E's 2014 Federal tax return, the loss for the retired elevator is determined as follows. The depreciation allowed or allowable for 2014 for the retired elevator is $1,763 ((unadjusted depreciable basis of $150,000 × depreciation rate of 2.564% for 2014) × 5.5/12 months). Thus, the adjusted depreciable basis of the retired elevator is $138,779 (the adjusted depreciable basis of $140,542 removed from the building cost less the depreciation allowed or allowable of $1,763 for 2014). As a result, E recognizes a loss of $138,779 for the retired elevator in 2014.

(iv) For E's 2014 Federal tax return, the depreciation allowance for the building is computed as follows. As of January 1, 2014, the unadjusted depreciable basis of the building is reduced from $20,000,000 to $19,850,000 ($20,000,000 less the unadjusted depreciable basis of $150,000 for the retired elevator), and the depreciation reserve of the building is reduced from $1,261,000 to $1,251,542 ($1,261,000 less the depreciation allowed or allowable of $9,458 for the retired elevator as of December 31, 2013). Consequently, the depreciation allowance for the building for 2014 is $508,954 ($19,850,000 × depreciation rate of 2.564% for 2014).

(v) E also must capitalize the amount paid for the replacement elevator pursuant to §1.263(a)–3(k)(1). The replacement elevator is a separate asset for disposition purposes pursuant to paragraph (c)(4)(ii)(D) of this section and for depreciation purposes pursuant to section 168(i)(6).

Example 10. (i) Since 2005, F, a calendar year taxpayer, has accounted for items of MACRS property that are mass assets in pools. Each pool includes only the mass assets that have the same depreciation method, recovery period, and convention, and are placed in service by F in the same taxable year. None of the pools are general asset accounts under section 168(i)(4) and the regulations under section 168(i)(4). F identifies any dispositions of these mass assets by specific identification.

(ii) During 2014, F sells 10 items of mass assets with a 5-year recovery period each for $100. Under the specific identification method, F identifies these mass assets as being from the pool established by F in 2012 for mass assets with a 5-year recovery period. Assume F depreciates this pool using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. F elected not to deduct the additional first year depreciation provided by section 168(k) for 5-year property placed in service during 2012. As of January 1, 2014, this pool contains 100 similar items of mass assets with a total cost of $25,000 and a total depreciation reserve of $13,000. Because all the items of mass assets in the pool are similar, F allocates the cost and depreciation allowed or allowable for the pool ratably among each item in the pool. This allocation is a reasonable method because all the items of mass assets in the pool are similar. Using this reasonable method, F allocates a cost of $250 ($25,000 × (1/100)) to each disposed of mass asset and depreciation allowed or allowable of $130 ($13,000 × (1/100)) to each disposed of mass asset. The depreciation allowed or allowable in 2014 for each disposed of mass asset is $24 (($250 × 19.2%)/2). As a result, the adjusted depreciable basis of each disposed of mass asset under section 1011 is $96 ($250 − $130 − $24). Thus, F recognizes a gain of $4 for each disposed of mass asset in 2014, which is subject to section 1245.

(iii) Further, as of January 1, 2014, the unadjusted depreciable basis of the 2012 pool of mass assets with a 5-year recovery period is reduced from $25,000 to $22,500 ($25,000 less the unadjusted depreciable basis of $2,500 for the 10 disposed of items), and the depreciation reserve of this 2012 pool is reduced from

$13,000 to $11,700 ($13,000 less the depreciation allowed or allowable of $1,300 for the 10 disposed of items as of December 31, 2013). Consequently, as of January 1, 2014, the 2012 pool of mass assets with a 5-year recovery period has 90 items with a total cost of $22,500 and a depreciation reserve of $11,700. Thus, the depreciation allowance for this pool for 2014 is $4,320 ($22,500 × 19.2%).

Example 11. (i) The facts are the same as in *Example 10*. Because of changes in F's recordkeeping in 2015, it is impracticable for F to continue to identify disposed of mass assets using specific identification and to determine the unadjusted depreciable basis of the disposed of mass assets. As a result, F files a Form 3115, Application for Change in Accounting Method, to change to a first-in, first-out method beginning with the taxable year beginning on January 1, 2015, on a modified cut-off basis. See §1.446–1(e)(2)(ii)(*d*)(*2*)(*vii*). Under the first-in, first-out method, the mass assets disposed of in a taxable year are deemed to be from the pool with the earliest placed-in-service year that has assets as of the beginning of the taxable year of the disposition with the same recovery period as the asset disposed of. The Commissioner of Internal Revenue consents to this change in method of accounting.

(ii) During 2015, F sells 20 items of mass assets with a 5-year recovery period each for $50. As of January 1, 2015, the 2008 pool is the pool with the earliest placed-in-service year for mass assets with a 5-year recovery period, and this pool contains 25 items of mass assets with a total cost of $10,000 and a total depreciation reserve of $10,000. Thus, F allocates a cost of $400 ($10,000 × (1/25)) to each disposed of mass asset and depreciation allowed or allowable of $400 to each disposed of mass asset. As a result, the adjusted depreciable basis of each disposed of mass asset is $0. Thus, F recognizes a gain of $50 for each disposed of mass asset in 2015, which is subject to section 1245.

(iii) Further, as of January 1, 2015, the unadjusted depreciable basis of the 2008 pool of mass assets with a 5-year recovery period is reduced from $10,000 to $2,000 ($10,000 less the unadjusted depreciable basis of $8,000 for the 20 disposed of items ($400 × 20)), and the depreciation reserve of this 2008 pool is reduced from $10,000 to $2,000 ($10,000 less the depreciation allowed or allowable of $8,000 for the 20 disposed of items as of December 31, 2014). Consequently, as of January 1, 2015, the 2008 pool of mass assets with a 5-year recovery period has 5 items with a total cost of $2,000 and a depreciation reserve of $2,000.

(j) *Effective/applicability dates*—(1) *In general*. Except as provided in paragraph (j)(5) of this section, this section applies to taxable years beginning on or after January 1, 2014.

(2) *Early application of this section*. A taxpayer may choose to apply the provisions of this section to taxable years beginning on or after January 1, 2012.

(3) *Early application of regulation project REG–110732–13*. A taxpayer may rely on the provisions of this section in regulation project REG–110732–13 (2013–43 IRB 404) (see §601.601(d)(2) of this chapter) for taxable years beginning on or after January 1, 2012. However, a taxpayer may not rely on the provisions of this section in regulation project REG–110732–13 for taxable years beginning on or after January 1, 2014.

(4) *Optional application of TD 9564*. A taxpayer may choose to apply §1.168(i)–8T as contained in 26 CFR part 1 edition revised as of April 1, 2014, to taxable years beginning on or after January 1, 2012. However, a taxpayer may not apply §1.168(i)–8T as contained in 26 CFR part 1 edition revised as of April 1, 2014, to taxable years beginning on or after January 1, 2014.

(5) *Application of paragraph (c)(4)(i)*. The language "and the distinct asset determination under §1.1031(a)–3(a)(4) do not apply." in the last sentence of paragraph (c)(4)(i) of this section applies on or after December 2, 2020. Paragraph (c)(4)(i) of this section as contained in 26 CFR part 1 edition revised as of April 1, 2020, applies before December 2, 2020.

(6) *Change in method of accounting*. A change to comply with this section for depreciable assets placed in service in a taxable year ending on or after December 30, 2003, is a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. A taxpayer also may treat a change to comply with this section for depreciable assets placed in service in a taxable year ending before December 30, 2003, as a change in method of accounting to which the provisions of section 446(e) and the regulations under section 446(e) apply. This paragraph (j)(5) does not apply to a change to comply with paragraph (d)(2) of this section, except as provided in paragraph (d)(2)(iii) or (iv)(B) of this section or otherwise provided by other guidance published in

the Internal Revenue Bulletin (see §601.601(d)(2) of this chapter).

[T.D. 9689, 79 FR 48678, Aug. 18, 2014, as amended at 79 FR 78697, Dec. 31, 2014; T.D. 9935, 85 FR 77378, Dec. 2, 2020]

§ 1.168(j)–1T Questions and answers concerning tax-exempt entity leasing rules (temporary).

The following questions and answers concern tax-exempt entity leasing under section 168(j) of the Internal Revenue Code of 1954, as enacted by section 31 of the Tax Reform Act of 1984 (''TRA'') (Pub. L. 98–369):

CONSEQUENCES OF TAX-EXEMPT USE STATUS

Q–1. If recovery property is subject to the tax-exempt entity leasing provisions of section 168(j), how must the taxpayer compute the property's recovery deductions?

A–1. The taxpayer must compute the property's recovery deductions in accordance with section 168(j) (1) and (2); that is, the taxpayer must use the straight line method and the specified recovery period. For property other than 18-year real property, the applicable recovery percentages for the specified recovery period are to be determined with reference to the tables contained in Prop. Treas. Reg. §1.168–2(g)(3)(iv)(A). For 18-year real property for which a 40-year recovery period is required, the applicable recovery percentages are to be determined under the following table:

40-YEAR STRAIGHT LINE METHOD (ASSUMING MID-MONTH CONVENTION)

If the recovery year is—	And the month in the first recovery year the property is placed in service is—											
	1	2	3	4	5	6	7	8	9	10	11	12
	The applicable recovery percentage is—											
1	2.4	2.2	2.0	1.8	1.6	1.4	1.1	0.9	0.7	0.5	0.3	0.1
2	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
3	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
4	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
6	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
7	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
8	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
9	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
10	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
11	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
12	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
13	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
14	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
15	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
16	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
17	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
18	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
19	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
20	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
21	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
22	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
23	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
24	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
25	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
26	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
27	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
28	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
29	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
30	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
31	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
32	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
33	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
34	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
35	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
36	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
37	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
38	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
39	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
40	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
41	0.1	0.3	0.5	0.7	0.9	1.1	1.4	1.6	1.8	2.0	2.2	2.4

Q–2. If recovery property that was placed in service after December 31, 1980 by a taxable entity subsequently becomes tax-exempt use property, how are such property's cost recovery deductions under section 168 affected?

A–2. A change to tax-exempt use property, as defined in section 168(j)(3), will cause the cost recovery deductions under the accelerated cost recovery system (ACRS) to be recomputed. The allowable recovery deduction for the taxable year in which the change occurs (and for subsequent taxable years) must be determined as if the property had originally been tax-exempt use property. Proper adjustment must be made under the principles of Prop. Treas. Reg. §1.168–2(j)(3)(i)(B) to account for the difference between the deductions allowable with respect to the property prior to the year of change and those which would have been allowable had the taxpayer used the recovery period and method for tax-exempt use property under section 168(j) (1) and (2). However, no adjustment is made pursuant to the provisions of this A–2 if section 168(j)(2)(C) applies, that is, if the taxpayer had selected a longer recovery period in the year the property was placed in service than the recovery period prescribed for such property under section 168(j)(1).

Example 1. On July 1, 1983, X, a calendar year taxpayer, places in service 5-year recovery property with an unadjusted basis of $100. For 1983, X's allowable deduction is $15 (*i.e.*, .15 × $100). In 1984, the property becomes tax-exempt use property. Under section 168(j), assume the prescribed recovery period is 12 years. For 1984 (and subsequent taxable years), X's allowable deduction is determined as if the property had been tax-exempt use property since 1983, that is, the year it was placed in service. Thus, taxable year 1984 is the property's second recovery year of its 12-year recovery period. Additionally, X must account for the excess allowable recovery deduction of $11 (*i.e.*, the difference between the recovery allowance for 1983 ($15) and the allowance for that year had the property been tax-exempt use property ($4)) in accordance with the principles of Prop. Treas. Reg. §1.168–2(j)(3)(i)(B). Thus, the recovery allowances in 1984 and 1985 are $7.97, determined as follows:

Unadjusted basis multiplied by the applicable recovery percentage for second recovery year ($100 × .09	$9.00
Excess allowable recovery deduction multiplied by the applicable recovery percentage for second recovery year divided by the sum of the remaining unused applicable percentages for tax-exempt use property existing as of the taxable year of change (1984) (($11 × .09)/.96)	−1.03
Difference—allowable deduction for 1984	$7.97
Unadjusted basis multiplied by the applicable recovery percentage for third recovery year ($100 × .09)	$9.00
Excess allowable recovery deduction multiplied by the applicable recovery percentage for third recovery year divided by the sum of the remaining unused applicable percentages for tax-exempt use property existing as of the taxable year of change (1984) (($11 × .09)/.96)	−1.03
Difference—allowable deduction for 1985	$7.97

Additionally, X must make a similar adjustment for the taxable years 1986 through 1995, that is, his fourth through thirteenth recovery years.

Example 2. Assume the same facts as in *Example (1)* except that in 1983, X elected under section 168 (b) (3) with respect to the 5-year property to use the optional recovery percentages over a 25-year recovery period. Based on these facts, the provisions of this A–2 do not apply.

DEFINITION OF TAX-EXEMPT USE PROPERTY

Mixed Leases of Real and Personal Property

Q–3. How is a mixed lease of real property and personal property (e.g., a building with furniture) to be treated for purposes of applying the rules of section 168(j)(3) defining which property constitutes tax-exempt use property?

A–3. The general rule is that 18-year real property and property other than 18-year real property are tested separately to determine whether each constitutes tax-exempt use property. However, if a lease of section 1245 class property is incidental to a lease of 18-year real property, and the 18-year real property is not tax-exempt use property, then the section 1245 class property also does not constitute tax-exempt use property. A lease of section 1245 class property will be considered incidental if the adjusted basis of all section 1245 class property leased in the same transaction is 1 percent or less of the adjusted basis of all 18-year real property leased in such transaction.

Buildings Which Are Partially Tax-Exempt Use Property

Q–4. If part of a building is leased to a tax-exempt entity in a disqualified lease and part of the building is leased other than to a tax-exempt entity in a disqualified lease, to what extent do the tax-exempt entity leasing rules apply to such building?

A–4. The taxpaper must determine the amount of the building's unadjusted basis that is properly allocable to the portion of the building that is tax-exempt use property; the section 168(j) rules apply to the allocated amount. Solely for purposes of determining what percentage of the building's basis is subject to the tax-exempt entity leasing rules, no part of the basis is allocated to common areas.

Example. A constructs a 3-story building in 1984 at a cost of $900,000. Each floor consists of 30,000 square feet. The only common area (10,000 square feet) in the building is on the first floor. A leases the first floor (other than the common areas) to a firm that is not a tax-exempt entity. A leases the top two floors to a tax-exempt entity in a 25-year lease. The top two floors constitute tax-exempt use property. Assume that square footage is the appropriate method for allocating basis in this case. Thus, A must allocate $675,000 of the $900,000 basis to the tax-exempt use portion, determined as follows:

$$\frac{\begin{array}{c}\text{square footage of building which is tax-exempt}\\ \text{use property (excluding common areas)}\end{array}}{\begin{array}{c}\text{total square footage in the building}\\ \text{(excluding common areas)}\end{array}} = \frac{60{,}000 \text{ sq. feet}}{80{,}000 \text{ sq. feet}} = 3/4$$

$$3/4 \times \$900{,}000 = \$675{,}000$$

A must compute his recovery deductions on this portion of the basis ($675,000) in accordance with the rules of section 168(j) (1) and (2).

Requirement of a Lease

Q–5. Can the use of property by a party other than a tax-exempt entity result in the property being treated as tax-exempt use property within the meaning of section 168(j)(3)?

A–5. Yes, if based on all the facts and circumstances it is more appropriate to characterize the transaction as a lease to a tax-exempt entity. A transaction can be characterized as a lease to a tax-exempt entity under section 168(j)(6)(A), which provides that "the term 'lease' includes any grant of a right to use property"; or under the service contract rules of section 7701(e). See Q&A #18 for rules regarding service contracts.

Example. A trust is executed on January 1, 1984, to create a pooled income fund (P) that meets the requirements of section 642(c)(5). A university (U) that is tax-exempt under section 501(c)(3) is the remainderman of the pooled income fund. P's purpose is to construct and operate an athletic center on land adjacent to U's campus. Construction of the athletic center, which has a 50-year useful life, was completed and the center was placed in service on February 1, 1985. The athletic center is managed for a fee by M, an unrelated taxable organization which operates athletic facilities open to the public. Office space at the facility is occupied rent-free by both the U athletic department and M. Scheduling of activities at the center is handled jointly by members of U's athletic department and M. General operating expenses of the athletic center are paid by P. Although the athletic center is open to the public for a membership fee, the majority of members are U's students who pay membership fees as part of their tuition. These fees are remitted by U to P. This arrangement is in substance a grant to U of a right to use the facility, and therefore a lease to U under section 168(j)(6)(A). U, as remainderman, will have obtained title to the entire building when the last pooled income fund donor dies. This arrangement is a disqualified lease because either (1) U has the equivalent of a fixed price purchase option under section 168(j)(3)(B)(ii)(II) (if U receives title as remainderman before the end of the useful life of the building), or (2) the lease has a term in excess of 20 years under section 168(j)(3)(B)(ii)(III) (if U does not receive title as remainderman until 20 years have elapsed), or both. Therefore, the allowable recovery deductions (without regard to salvage value) must be computed in accordance with section 168(j) (1) and (2). In addition, because this arrangement is treated as a lease under section 168(j), the facility is used by U for purposes of section 48(a)(4), and thus no investment tax credit is permitted with respect to any portion of the facility. This arrangement also may be treated as a lease to U for all purposes of chapter 1 of the Internal Revenue Code under section 7701 (e).

''More Than 35 Percent of the Property'' Test

Q–6. How is the percentage of 18-year real property leased to a tax-exempt entity in a disqualified lease to be determined for purposes of the ''more than 35 percent of the property'' test of section 168(j)(3)(B)(iii)?

A–6. The phrase ''more than 35 percent of the property'' means more than 35 percent of the net rentable floor space of the property. The net rentable floor space in a building does not include the common areas of the building, regardless of the terms of the lease. For purposes of the ''more than 35 percent of the property'' rule, two or more buildings will be treated as separate properties unless they are part of the same project, in which case they will be treated as one property. Two or more buildings will be treated as part of the same project if the buildings are constructed, under a common plan, within a reasonable time of each other on the same site and will be used in an integrated manner.

Q–7. Are disqualified leases to different tax-exempt entities (regardless of whether they are related) aggregated in determining whether 18-year real property is tax-exempt use property?

A–7. Yes.

Example. A tax-exempt entity participates in industrial development bond financing for the acquisition of a new building by a taxable entity. The tax-exempt entity leases 60 percent of the net rentable floor space in the building for 5 years. Sixty percent of the building is tax-exempt use property. If the same tax-exempt entity leased only 19 percent of the net rentable floor space in the building for 5 years, no portion of the building would be tax-exempt use property because not more than 35 percent of the property is leased to a tax-exempt entity pursuant to a disqualified lease. If such tax-exempt entity leased only 19 percent of the net rentable floor space in the building for 5 years and another tax-exempt entity leased 20 percent of the net rentable floor space in the building for a term in excess of 20 years (or a related entity leased 20 percent of the building for 5 years), 39 percent of the building would be tax-exempt use property. See A–4 regarding the determination of the amount of the building's unadjusted basis that is properly allocable to the portion of the building that is tax-exempt use property.

''Predominantly Used'' Test

Q–8. What does the term ''predominantly used'' mean for purposes of the section 168(j)(3)(D) exception to the tax-exempt use property rules?

A–8. ''Predominantly used'' means that for more than 50 percent of the time used, as determined for each taxable year, the real or personal property is used in an unrelated trade or business the income of which is subject to tax under section 511 (determined without regard to the debt-financed income rules of section 514). If only a portion of property is predominantly used in an unrelated trade or business, the remainder may nevertheless be tax-exempt use property.

Q–9. How is the ''predominantly used'' test of section 168(j)(3)(D) to be applied to a building?

A–9. The ''predominantly used'' test is to be applied to a building in the following manner:

(i) Identify the discrete portions (excluding common areas) of the building which are leased to a tax-exempt entity in a disqualified lease under section 168(j)(3)(B)(ii). A discrete portion of a building is an area physically separated from other areas. An area is physically separated from other areas if separated by permanent walls or by partitions serving as room dividers if such partitions remain in place throughout the taxable year. A discrete portion can be the entire building, floors, wings, offices, rooms, or a combination thereof. For example, a building whose entire internal space consists of a single large room used as a gymnasium has only one discrete portion. On the other hand, if the building has 3 stories with 10 offices on each floor, each of the 30 offices is a discrete portion.

(ii) Determine whether each discrete portion is predominantly used in an unrelated trade or business subject to tax under section 511. See A–8 for the rules regarding how to make this determination.

(iii) Once the discrete portions of the building that constitute tax-exempt use property have been identified, an appropriate allocation of basis must be made to such discrete portions. See A–4 for rules regarding how to make such allocation.

(iv) The application of these rules is illustrated by the following example:

Example. A building, constructed in 1985, is leased in its entirety to a tax-exempt entity (E) pursuant to a 25-year lease. The building has 25,000 square feet of net rentable floor space and consists of an auditorium (15,000 square feet), a retail shop (10,000 square feet), plus common area of 5,000 square feet. E uses the auditorium 80 percent of the time in its exempt activity and 20 percent of the time in an unrelated trade or business subject to tax under section 511. The retail shop is used 90 percent of the time in an unrelated trade or business subject to tax under section 511 and 10 percent of the time in an exempt activity. Thus, the auditorium is tax-exempt use property; the retail shop is not. An appropriate allocation of basis to the auditorium must be made. See A–4.

DEFINITION OF TAX-EXEMPT ENTITY

Q–10. What elections must be made in order to avoid the "5-year lookback" rule of section 168(j)(4)(E)(i)?

A–10. Only organizations which were exempt from tax under section 501(a) as organizations described in section 501(c)(12) (and which are no longer tax-exempt) may avoid the 5-year lookback rule of section 168(j)(4)(E)(i). In order to avoid the 5-year lookback rule with respect to any property, two elections are required. First, the organization must elect not to be exempt from tax under section 501(a) during the tax-exempt use period (as defined in section 168(j)(4)(E)(ii)(II)) with respect to the property. Second, the organization must elect to be taxed on the exempt arbitrage profits as provided in section 31(g)(16) of the Tax Reform Act of 1984. See Temp. Treas. Reg. § 301.9100–6T(a) for the time and manner of making these elections. These elections, once made, are irrevocable.

Q–11. Does the term "tax-exempt entity" include tax-exempt plans of deferred compensation and similar arrangements?

A–11. Yes. For purposes of section 168 (j), the term "tax-exempt entity" includes trusts or other entities that are tax-qualified under section 401 (a), individual retirement accounts, simplified employee pensions, and other tax-exempt arrangements described in subchapter D of chapter 1 of the Internal Revenue Code.

SPECIAL RULES FOR HIGH TECHNOLOGY EQUIPMENT

Q–12. What effect do the tax-exempt entity leasing provisions have on "qualified technological equipment"?

A–12. "Qualified technological equipment" which is leased to a tax-exempt entity for a term of 5 years or less shall not constitute tax-exempt use property. If "qualified technological equipment" which is leased to a tax-exempt entity for a term of more than 5 years constitutes tax-exempt use property (as defined in section 168(j)(3)) and is not used predominantly outside the United States, the rules of section 168(j) (1) and (2) apply except that the recovery period to be used for such equipment shall be 5 years regardless of the length of the lease term. For purposes of section 168(j)(5), "qualified technological equipment" means (1) any computer or peripheral equipment, (2) any high technology telephone station equipment installed on the customer's premises, and (3) any high technology medical equipment. For definitions of these terms, see A–13 through A–16.

Q–13. What is a "computer" as that term is used in section 168(j)(5)(C)(i)(I)?

A–13. Computers are electronically activated devices that are programmable by the user and that are capable of accepting information, applying prescribed processes to it, and supplying the results of those processes with or without human intervention. Computers consist of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities. A computer does not include any equipment which is an integral part of property that is not a user-programmable device, any video games or other devices used by the user primarily for amusement or entertainment purposes, or any typewriters, calculators, adding or accounting machines, copiers, duplicating equipment, or similar equipment. A computer does not include any equipment that is not tangible personal property.

Q–14. What is ''peripheral equipment'' as that term is used in section 168(j)(5)(C)(i)(I)?

A–14. Peripheral equipment means tangible personal property such as auxiliary machines, whether on-line or off-line, that are designed to be placed under the control of the central processing unit of the computer. Some examples of peripheral equipment are: card readers, card punches, magnetic tape feeds, high speed printers, optical character readers, tape cassettes, mass storage units, paper tape equipment, keypunches, data entry devices, teleprinters, terminals, tape drives, disc drives, disc files, disc packs, visual image projector tubes, card sorters, plotters, and collators. Peripheral equipment does not include equipment not included in Asset Depreciation Range (ADR) 00.12 listed in section 3 of Rev. Proc. 83–35, 1983–1 C.B. 745, 746. Peripheral equipment also does not include any equipment that is an integral part of property that is not a user-programmable device, any video games or other devices used by the user primarily for amusement or entertainment purposes, or any typewriters, calculators, adding or accounting machines, copiers, duplicating equipment, or similar equipment.

Q–15. What does ''high technology telephone station equipment'' mean as that term is used in section 168(j)(5)(C)(i)(II)?

A–15. High technology telephone station equipment includes only tangible personal property described in asset depreciation range (ADR) class 48.13 listed in section 3 of Rev. Proc. 83–35, 1983–1 C.B. 745, 758 that has a high technology content and which, because of such high technology content, can reasonably be expected to become obsolete before the expiration of its physical useful life. For example, telephone booths and telephones which include only a standard dialing feature are not high technology equipment. However, telephones with features such as an abbreviated dialing short program, an automatic callback, or conference call feature may qualify as high technology equipment. High technology telephone station equipment may include terminal equipment including such extra features but not terminal equipment used in conjunction with features offered through central office capacity. There are no current plans to utilize the regulatory authority provided in section 168(j)(5)(C)(iv).

Q–16. What is ''high technology medical equipment'' as that term is used in section 168 (j)(5)(C)(i)(III)?

A–16. High technology medical equipment is any electronic, electromechanical, or computer-based high technology equipment which is tangible personal property used in the screening, monitoring, observation, diagnosis, or treatment of human patients in a laboratory, medical, or hospital environment. High technology medical equipment includes only equipment that has a high technology content and which, because of such high technology content, can reasonably be expected to become obsolete before the expiration of its physical useful life. High technology medical equipment may include computer axial tomography (C.A.T.) scanners, nuclear magnetic resonance equipment, clinical chemistry analyzers, drug monitors, diagnostic ultrasound scanners, nuclear cameras, radiographic and fluoroscopic systems, Holter monitors, and bedside monitors. Incidental use of any such equipment for othe purposes, such as research, will not prevent it from qualifying as high technology medical equipment. There are no current plans to utilize the regulatory authority provided in section 168(j)(5)(C)(iv).

LEASE TERM

Q–17. What is included in determining the length of a lease term?

A–17. (i) The lease term starts when the property is first made available to the lessee under the lease. The lease term includes not only the stated duration, but also any additional period of time which is within the ''realistic contemplation of the parties at the time the property is first put into service. *Hokanson* v. *Commissioner*, 730 F.2d 1245, 1248 (9th Cir. 1984). A subsequent period of time is included in the term of the original lease if the circumstances indicate that the parties, upon entering into the original lease, had informally agreed that there would be an extension of the original lease.

(ii) With respect to personal property, the lease term includes all periods for which the tax-exempt lessee or a related party (as defined under section 168(j)(7)) has a legally enforceable option to renew the lease, or the lessor has a legally enforceable option to compel its renewal by the tax-exempt entity or a related party. This is true regardless of the renewal terms of the lease agreement or whether the lease is in fact renewed.

(iii) With respect to real property, the lease term includes all periods for which the tax-exempt lessee or a related party (as defined under section 168(j)(7)) has a legally enforceable option to renew the lease, or the lessor has a legally enforceable option to compel its renewal by the tax-exempt entity or a related party, unless the option to renew is at fair market value, determined at the time of renewal. The *Hokanson* facts and circumstances test (see (i) above) may cause the term of a fair market value renewal option to be treated as part of the original lease term.

(iv) Successive leases that are part of the same transaction or a series of related transactions concerning the same or substantially similar property shall be treated as one lease. This rule applies if at substantially the same time or as part of one arrangement the parties enter into multiple leases covering the same or substantially similar property, each having a different term. If so, then the original lease term will be treated as running through the term of the lease that has the last expiration date of the multiple leases. The multiple lease rule will not apply merely because the parties enter into a new lease at fair market rental value at the end of the original lease term.

(v) The application of the above rules is illustrated by the following examples:

Example 1. On December 30, 1984, X, a taxable corporation, and Y, a tax-exempt entity, enter into a requirements contract for a period of 3 years. The requirements contract sets the terms and conditions under which X and Y will do business on those occasions when X actually leases items of personal property to Y. The requirements contract imposes no obligation on either party to actually enter into a lease agreement. Pursuant to this requirements contract, on January 1, 1985, X and Y enter into three separate leases. Under the leases, Y obtained the use of three identical items of personal property, each for a term of six months beginning on January 1, 1985. On March 1, 1985, Y entered into a fourth lease for the use of a fourth item of personal property substantially similar to the other three items for a term of 20 months beginning on that date. The mere fact that all 4 leases were entered into pursuant to the same requirements contract and involved the same or substantially similar property does not require aggregation of the terms of such leases under section 168(j)(6)(B).

Example 2. Assume the same facts as in *example* (1) except that, instead of the 4 leases entered into in example (1), on January 1, 1985, pursuant to the requirements contract, X and Y enter into a lease for an item of personal property for one year. On January 10, 1986, after the end of the one-year lease term, X and Y enter into a second lease with respect to the same or substantially similar equipment. Assuming that the requirements contract itself is not a lease and assuming that the parties did not have any informal or implicit understanding (other than the general expectation of doing some business in the future) to enter into the second lease when the first lease was entered into, these two leases are not aggregated. The mere fact that the parties entered into two leases under the requirements contract does not result in the application of the section 168(j)(6)(B) rules for successive leases.

Example 3. The facts are the same as in *example* (2) except that the parties did have an understanding, informal or otherwise, at the time of the first lease that they would enter into a second lease of the same personal property. The terms of the leases are aggregated.

Example 4. The facts are the same as in *example* (2) except that, instead of the leases entered into in example (2), on January 1, 1985, X and Y enter into two separate leases, each for a term of one year. One lease is for the period beginning on January 1, 1985 and ending on December 31, 1985. The other lease is for the period beginning on January 1, 1986 and ending on December 31, 1986. Both leases involve the same or substantially similar personal property. Under the successive lease rule, the terms of both leases are aggregated for purposes of determining the term of either lease under section 168(j)(6)(B). This result occurs because the two leases were entered into as part of the same transaction, and they relate to the same or substantially similar personal property.

SERVICE CONTRACT ISSUES

Q–18. How is the treatment of service contracts affected by the service contract rules set forth in section 7701(e)?

A–18. If a contract which purports to be a service contract is treated as a lease under section 7701(e), such contract is to be treated as a lease for all purposes of Chapter 1 of the Internal Revenue Code (including, for example, section 168(j) and section 48(a) (4) and (5)).

Q–19. Does a contract to provide heating, maintenance, etc. services in low-income housing come within the low-income housing exception in section 7701(e)(5) to the service contract rules set forth in section 7701(e)?

A–19. No. Although certain low-income housing operated by or for an organization described in paragraphs (3) or (4) of section 501(c) is not subject to the service contract rules in section 7701(e), a contract, for instance, to provide heating services to low-income housing units, such as by installing and operating a furnace, does not constitute ''low-income housing'' within the meaning of section 7701(e)(5). Thus, the rules of section 7701(e) apply to such contracts in determining whether they are properly treated as leases.

PARTNERSHIP ISSUES

Q–20. Do the provisions applicable to property leased to partnerships, set forth in section 168(j)(8), and the provisions applicable to property owned by partnerships, set forth in section 168(j)(9), apply to pass-through entities other than partnerships?

A–20. Yes. Rules similar to those provided in paragraphs (8), (9)(A), (9)(B), and (9)(C) of section 168(j) and those provided in Q & A's 21–26 apply to pass-through entities other than partnerships.

Q–21. What rules apply to property owned by a partnership in which one or more partners is a tax-exempt entity?

A–21. If property is owned by a partnership having both taxable and tax-exempt entities as partners, and any allocation to a tax-exempt entity partner is not a ''qualified allocation'' under section 168(j)(9)(B), then such entity's proportionate share of the property is to be treated as tax-exempt use property for all purposes. However, the property will not be tax-exempt use property if it is predominantly used by the partnership in an activity which, with respect to the tax-exempt entity, is an unrelated trade or business. An activity is an unrelated trade or business with respect to a tax-exempt entity if such entity's distributive share of the partnership's gross income from the activity is includible in computing its unrelated business taxable income under section 512(c) (determined without regard to the debt-financed income rules of section 514). A tax-exempt entity partner's proportionate share of property of a partnership equals such partner's share of that item of the partnership's income or gain (excluding income or gain allocated under section 704(c)) in which the tax-exempt entity has the highest share. If the tax-exempt entity partner's share of any item of income or gain (excluding income or gain allocated under section 704(c)) may vary during the period it is a partner, the previous sentence shall be applied with reference to the highest share of any such item that it may receive at any time during such period. The application of these rules is illustrated by the following example:

Example. A partnership (P) operates a factory, which consists of a building and various items of machinery. P has one tax-exempt entity (E) as a partner, and E's proportionate share is 10 percent (*i.e.*, 10 percent is the largest share of any item of income or gain that E may receive during the time E is a partner). Unless P's allocations to E are qualified under section 168(j)(9)(B), 10 percent of each item of partnership property (including the building) is tax-exempt use property, notwithstanding the 35 percent threshold test of section 168(j)(3)(B)(iii) that is otherwise applicable to 18-year real property. However, the property will not be tax-exempt use property if it is predominantly used by the partnership in an activity which, with respect to E, is an unrelated trade or business (determined without regard to the debt-financed income rules of section 514).

Q–22. What consititutes a ''qualified allocation'' under section 168(j)(9)(B)?

A–22. (i) A ''qualified allocation'' means any allocation to a tax-exempt entity which is consistent with such entity's being allocated the same share (*i.e.*, the identical percentage) of each and every item of partnership income, gain, loss, deduction, credit, and basis during the entire period such entity is a partner. Except as provided in A–23, an allocation is not qualified if it does not have substantial economic effect under section 704(b). However, for purposes of the two preceding sentences, items allocated under section 704(c) (relating to contributed property) are not taken into account. An allocation is not a "qualified allocation" under section 168(j)(9)(B) if the partnership agreement provides for, or the partners have otherwise formally or informally agreed to, any change (regardless of whether such change is contingent upon the happening of one or more events) in the tax-exempt entity's distributive share of income, gain, loss, deduction, credit, or basis at any time during the entire period the tax-exempt entity is a partner.

(ii) A change in a tax-exempt entity's distributive share of income, gain, loss, deduction, credit, or basis which occurs as a result of a sale or redemption of a partnership interest (or portion thereof) or a contribution of cash or property to the partnership shall be disregarded in determining whether the partnership allocations are qualified, provided that such transaction is based on fair market value at the time of the transaction and that the allocations are qualified after the change. For this purpose, the consideration determined by the parties dealing at arm's length and with adverse interests normally will be deemed to satisfy the fair market value requirement. In addition, a change in a tax-exempt entity's distributive share which occurs as a result of a partner's default (other than a prearranged default) under the terms of the partnership agreement will be disregarded, provided that the allocations are qualified after the change, and that the change does not have the effect of avoiding the restrictions of section 168(j)(9). Any of the above-described transactions between existing partners (and parties related to them) will be closely scrutinized.

Example 1. A, a taxable entity, and B, a tax-exempt entity, form a partnership in 1985. A contributes $800,000 to the partnership; B contributes $200,000. The partnership agreement allocates 95 percent of each item of income, gain, loss, deduction, credit, and basis to A; B's share of each of these items is 5 percent. Liquidation proceeds are, throughout the term of the partnership, to be distributed in accordance with the partner's capital account balances, and any partner with a deficit in his capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the partnership. Assuming that these allocations have substantial economic effect within the meaning of section 704(b)(2), they are qualified because B's distributive share of each item of income, gain, loss, deduction, credit, and basis will remain the same during the entire period that B is a partner. The fact that the liquidation proceeds may be distributed in a ratio other than 95 percent/5 percent does not cause the allocations not to be qualified.

Example 2. A, B, and E are members of a partnership formed on July 1, 1984. On that date the partnership places in service a building and section 1245 class property. A and B are taxable entities; E is a tax-exempt entity. The partnership agreement provides that during the first 5 years of the partnership, A and B are each allocated 40 percent of each item of income, gain, loss, deduction, credit, and basis; E is allocated 20 percent. Thereafter, A, B, and E are each allocated 33⅓ percent of each item of income, gain, loss, deduction, credit, and basis. Assume that these allocations meet the substantial economic effect test of section 704(b)(2) and E's distributive share of the partnership's income is not unrelated trade or business income subject to tax under section 511. The allocations to E are not qualified allocations under section 168(j)(9)(B) because E's distributive share of partnership items does not remain the same during the entire period that E is a partner in the partnership. Thus, 33⅓ percent of the building and 33⅓ percent of the section 1245 class property are tax-exempt use property from the time each is placed in service by the partnership and are thus subject to the cost recovery rules of section 168(j) (1) and (2). In addition, no investment tax credit is allowed for 33⅓ percent of the section 1245 class property because of section 48(a)(4).

Q–23. In determining whether allocations constitute qualified allocations, what rules are applied to test allocations that are not governed by the substantial economic effect rules?

A–23. A–22 provides the general rules to be used in determining whether an allocation is a qualified allocation, including the rule that the allocation must have substantial economic effect. However, certain allocations are not governed by the substantial economic effect rules (e.g., an allocation of basis of an oil and gas property is generally governed by section 613A(c)(7)(D), rather than section 704(b)), and other allocations cannot satisfy the substantial economic effect rules (e.g., allocations of credits, allocations of deduction and loss attributable to nonrecourse debt, and allocations of percentage depletion in excess of basis). Since allocations in either of these categories cannot be tested under the substantial economic effect test, these allocations, in order to be qualified, must comply with the relevant Code or regulation section that governs the particular allocation (e.g., in the case of an allocation of basis of an oil and gas property, section 613A(c)(7)(D)).

Q–24. Will the Internal Revenue Service issue letter rulings on the issue of whether an allocation is a "qualified allocation" for purposes of section 168(j)(9)?

A–24. The Internal Revenue Service will accept requests for rulings on the question of whether an allocation is a "qualified allocation" for purposes of section 168(j)(9). Such requests should be submitted in accordance with the appropriate revenue procedure. One requirement of a qualified allocation is that such allocation must have substantial economic effect under section 704(b)(2). Currently, the Service will not rule on the question of whether an allocation has substantial economic effect under section 704(b)(2). Therefore, unless and until this policy is changed, a ruling request regarding a qualified allocation must contain a representation that the subject allocation has substantial economic effect (or complies with A–23, if applicable).

Q–25. Do priority cash distributions which constitute guaranteed payments under section 707(c) disqualify an otherwise qualified allocation?

A–25. Priority cash distributions to partners which constitute guaranteed payments will not disqualify an otherwise qualified allocation if the priority cash distributions are reasonable in amount (e.g., equal to the Federal short-term rate described in section 1274(d)) and are made in equal priorities to all partners in proportion to their capital in the partnership. Other guaranteed payments will be closely scrutinized and, in appropriate cases, will disqualify an otherwise qualified allocation.

Example. A and B form Partnership AB to operate a manufacturing business. A is a tax-exempt entity; B is a taxable person. A contributes $500,000 to the partnership; B contributes $100,000. The partnership agreement provides that A and B are each entitled to cash distributions each year, in equal priority, in an amount equal to 8 percent of their capital contribution. Assume that these payments are reasonable in amount and constitute guaranteed payments under section 707(c). Without taking into consideration the guaranteed payments, all allocations constitute qualified allocations under section 168(j)(9)(B) and A–22. These guaranteed payments will not disqualify such allocations.

Q–26. Can property be treated as tax-exempt use property under both the general rule of section 168(j)(3) and the partnership provisions of section 168(j)(9)?

A–26. Yes. For example, a tax-exempt entity may be a partner in a partnership that owns a building 60 percent of which is tax-exempt use property because it is leased to an unrelated tax-exempt entity under a 25-year lease. The status of the remaining 40 percent depends on whether or not allocations under the partnership agreement are qualified under section 168(j)(9). If the allocations are not qualified under section 168(j)(9), the tax-exempt entity's proportionate share (as determined under section 168(j)(9)(C)) of the remaining 40 percent will be tax-exempt use property. For example, if the tax-exempt entity's proportionate share is 30 percent, then 12 percent of the remaining 40 percent (*i.e.*, .30 times .40) is tax-exempt use property and a total of 72 percent of the property (60 percent + 12 percent) is tax-exempt use property.

EFFECTIVE DATE QUESTIONS

Q–27. Does an amendment to a lease (or sublease) to a tax-exempt entity of property which, pursuant to the effective date provisions of section 31(g) of TRA, is not subject to section 168(j) cause such property to be subject to the provisions of section 168(j)?

A–27. An amendment to such a lease (or sublease) does not cause such property to be subject to the provisions of section 168(j) unless the amendment increases the term of the lease (or sublease). However, if the amendment increases the amount of property subject to the lease, the additional property must be tested independently under the effective date provisions of section

31(g) of TRA. See A–31 for special rules regarding improvements to property.

Example. On May 1, 1983, X, a taxable entity, and E, a tax-exempt entity, enter into a lease whereby X will lease to E the top 4 floors of a ten-story building for a lease term of 25 years. In 1985, the lease is amended to provide that E will lease an additional floor for the balance of the lease term. At that time the annual rent due under the lease is increased. Pursuant to the provisions of section 31(g)(2)(A) of TRA, section 168(j) does not apply to the lease to E of the top 4 floors of the building. Assuming that no other provision of section 31(g) of TRA provides otherwise, the floor added to the lease in 1985 is subject to the provisions of section 168(j).

Q–28. If property which is not subject to section 168(j) by virtue of the effective date provisions of section 31(g) of TRA is sold, subject to the lease to the tax-exempt entity, what are the consequences?

A–28. Property to which section 168(j) does not apply by virtue of the effective date provisions set forth in section 31(g) (2), (3), and (4) of TRA will not become subject to section 168(j) merely by reason of a transfer of the property subject to the lease by the lessor (or a transfer of the contract to acquire, construct, reconstruct, or rehabilitate the property), so long as the lessee (or party obligated to lease) does not change. For purposes of the preceding sentence, the term ''transfer'' includes the sale-leaseback by a taxable lessor of its interest in the property, subject to the underlying lease to the tax-exempt entity. However, if property is transferred to a partnership or other pass-through entity after the effective date of section 168(j)(9) (see section 31(g) of TRA), such property is subject to the provisions of section 168(j)(9).

Q–29. Can property which was leased to a tax-exempt entity after May 23, 1983 and acquired by a partnership before October 22, 1983 be tax-exempt use property?

A–29. Yes. Because the property was leased to a tax-exempt entity after May 23, 1983, it may be tax-exempt use property under section 168(j)(3) and section 31(g)(1) of TRA. However, if the partnership included a tax-exempt entity as a partner, section 168(j)(9) would be inapplicable under section 31(g)(3)(B) of TRA because the partnership acquired the property before October 22, 1983.

Q–30. What is a binding contract for purposes of the transitional rules in section 31(g) of TRA?

A–30. (i) A contract is binding only if it is enforceable under State law against the taxpayer or a predecessor and does not limit damages to a specified amount, as for example, by a liquidated damages provision. A contract that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages for this purpose. In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account. For example, if a taxpayer entered into an irrevocable contract to purchase an asset for $100 and the contract contained no provision for liquidated damages, the contract is considered binding notwithstanding the fact that the property had a fair market value of $99 and under local law the seller would only recover the difference in the event the purchaser failed to perform. If the contract provided for a refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation, the contract is not considered binding.

(ii) A contract is binding even if subject to a condition, so long as the condition is not within the control of either party or a predecessor in interest. A contract will not be treated as ceasing to be binding merely because the parties make insubstantial changes in its terms or because any term is to be determined by a standard beyond the control of either party. A contract which imposes significant obligations on the taxpayer (or a predecessor) will be treated as binding notwithstanding the fact that insubstantial terms remain to be negotiated by the parties to the contract.

(iii) A binding contract to acquire a component part of a larger piece of property will not be treated as a binding contract to acquire the larger piece of property. For example, if a tax-exempt entity entered into a binding contract on May 1, 1983 to acquire a new aircraft engine, there would be a binding contract to acquire only the engine, not the entire aircraft.

Q–31. If an improvement is made to a property that is ‘‘grandfathered’’ (*i.e.*, property that is not subject to section 168(j) because of the effective date provisions of section 31(g) of TRA), to what extent will such improvement be grandfathered?

A–31. Section 31(g)(20)(B) provides that a ‘‘substantial improvement’’ to property is treated as a separate property for purposes of the effective date provisions of section 31(g) of TRA. As a result, a ‘‘substantial improvement’’ will not be grandfathered unless such ‘‘substantial improvement’’ is grandfathered under a provision other than section 31(g)(20)(B). A property that is grandfathered will not become subject to section 168(j) merely because an improvement is made to such property, regardless of whether the improvement is a ‘‘substantial improvement’’. If an improvement other than a ‘‘substantial improvement’’ is made to property (other than land) that is grandfathered, that improvement also will be grandfathered. The determination of whether new construction constitutes an improvement to property or the creation of a new separate property will be based on all facts and circumstances. Furthermore, any improvement to land will be treated as a separate property.

Example. On January 3, 1983, T, a taxable entity, entered into a lease of a parking lot to E, a tax-exempt entity. On January 1, 1985, T begins construction of a building for use by E on the site of the parking lot. The building is completed and placed in service in November 1985. The building is treated as a separate property, and is thus subject to the provisions of section 168(j), unless the building is grandfathered under a provision other than section 31(g)(20)(B) of TRA.

Q–32. What is ‘‘significant official governmental action’’ for purposes of the section 31(g)(4) transitional rule of TRA?

A–32. (i) ‘‘Significant official governmental action’’ involves three separate requirements. First, the action must be an official action. Second, the action must be specific action with respect to a particular project. Third, the action must be taken by a governmental entity having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under State or local law.

(ii) The first requirement of official action means that the governing body must adopt a resolution or ordinance, or take similar official action, on or before November 1, 1983. The action qualifies only if it conforms with Federal, State, and local law (as applicable) and is a proper exercise of the powers of the governing body. Moreover, the action must not have been withdrawn. There must be satisfactory written evidence of the action that was in existence on or before November 1, 1983. Satisfactory written evidence includes a formal resolution or ordinance, minutes of meetings, and binding contracts with third parties pursuant to which third parties are to render services in furtherance of the project.

(iii) The second requirement of specific action is directed at the substance of the action taken. The action must be a specific action with respect to a particular project in which the governing body indicates an intent to have the project (or the design work for it) proceed. This requires that a specific project have been formulated and that the significant official action be a step toward consummation of the project. If the action does not relate to a specific project or merely directs that a proposal or recommendation be formulated, it will not qualify. The following set of actions with respect to a particular project constitute specific action: the hiring of bond counsel or bond underwriters necessary to assist in the issuance and sale of bonds to finance a particular project or the adoption of an inducement resolution relating to bonds to be issued for such a project; applying for an Urban Development Action Grant on behalf of the project described in the application, receiving such a grant concerning the project, or the recommendation of a city planning authority to proceed with a project; the enactment of a State law authorizing the sale, lease, or construction of the property; the appropriation of funds for the property or authorization of a feasibility study or a development services contract with respect to it; the approval of financing arrangements by a regulatory agency; the enactment of a State law designed to provide funding for a project; the certification of a building as a historic structure by a State agency and the Department of the Interior; or the endorsement of the application for a certification of need with respect to a medical facility by a regulatory agency other than the agency empowered to issue such a certificate.

(iv) The third requirement for significant official governmental action is that the action must be taken by a Federal, State, or local governing body having authority to commit the tax-exempt entity to the project, to provide funds for it, or to approve the project under applicable law.

If the chief executive or another representative of a governing body has such authority, action by such representative would satisfy the requirement of this (iv). A governing body may have the authority to commit the tax-exempt entity to a project notwithstanding the fact that the project cannot be consummated without other governmental action being taken. For example, a city council will be treated as having authority to commit a city to do a sale-leaseback of its city hall notwithstanding the fact that State law needs to be amended to permit such a transaction. Similarly, if a local project cannot be completed without Federal approval, either legislative or administrative, the obtaining of such approval satisfies the requirements of this (iv).

(v) Routine governmental action at a local level will not qualify as significant official governmental action. Routine governmental action includes the granting of building permits or zoning changes and the issuance of environmental impact statements.

(vi) In order to qualify under the transitional rule of TRA section 31(g)(4), a sale and leaseback pursuant to a binding contract entered into before January 1, 1985 must be part of the project as to which there was significant official governmental action. Except as provided in the following sentence, where there has been significant official governmental action on or before November 1, 1983 with respect to the construction, reconstruction or rehabilitation of a property, the sale and leaseback of such property pursuant to a binding contract entered into before January 1, 1985 will be treated as part of the project which was the subject of the significant official governmental action. However, if the construction, reconstruction or rehabilitation was substantially completed prior to January 1, 1983, the sale and leaseback of such property will be treated as a separate project, unless the sale and leaseback was contemplated at the time of the significant official governmental action. Nevertheless, where the sale and leaseback is treated as a separate project, section 31(g)(4) may apply if there was significant official governmental action on or before November 1, 1983, with respect to such sale and leaseback. The application of this provision is illustrated by the following example:

Example. In the summer of 1927, the Board of Aldermen of City C passed a resolution authorizing the design and contruction of a new city hall and appropriated the funds necessary for such project. Construction was completed in 1928. At the time of the significant official governmental action, City C had no plan to enter into a sale-leaseback arrangement with respect to the facility. On December 15, 1984, City C entered into a binding sale-leaseback arrangement concerning the city hall. This transaction will not qualify for exclusion from section 168(j) under the section 31(g)(4) of TRA since construction of the facility in question was substantially completed before January 1, 1983. If, however, there had been significant official governmental action on or before November 1, 1983 with respect to the sale-leaseback project, then the transitional rule of section 31(g)(4) of TRA would apply.

[T.D. 8033, 50 FR 27224, July 2, 1985, as amended by T.D. 8435, 57 FR 43896, Sept. 23, 1992]

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§ 1.168(k)–1 Additional first year depreciation deduction.

(a) *Scope and definitions*—(1) *Scope.* This section provides the rules for determining the 30-percent additional first year depreciation deduction allowable under section 168(k)(1) for qualified property and the 50-percent additional first year depreciation deduction allowable under section 168(k)(4) for 50-percent bonus depreciation property.

(2) *Definitions.* For purposes of section 168(k) and this section, the following definitions apply:

(i) *Depreciable property* is property that is of a character subject to the allowance for depreciation as determined under section 167 and the regulations thereunder.

(ii) *MACRS property* is tangible, depreciable property that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143) and subject to section 168, except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule.

(iii) *Unadjusted depreciable basis* is the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under section 179 or section 179C, and for any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations thereunder (other than section 1016(a)(2) and (3)) (for example, a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)). For property subject to a lease, see section 167(c)(2).

(iv) *Adjusted depreciable basis* is the unadjusted depreciable basis of the property, as defined in §1.168(k)–1(a)(2)(iii), less the adjustments described in section 1016(a)(2) and (3).

(b) *Qualified property or 50-percent bonus depreciation property*—(1) *In general.* Qualified property or 50-percent bonus depreciation 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 §1.168(k)–1(b)(2) (description of property);

(ii) The requirements in §1.168(k)–1(b)(3) (original use);

(iii) The requirements in §1.168(k)–1(b)(4) (acquisition of property); and

(iv) The requirements in §1.168(k)–1(b)(5) (placed-in-service date).

(2) *Description of qualified property or 50-percent bonus depreciation property*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (b)(2) if the property is—

(A) MACRS property (as defined in §1.168(k)–1(a)(2)(ii)) that has a recovery period of 20 years or less. For purposes of this paragraph (b)(2)(i)(A) and section 168(k)(2)(B)(i)(II) and 168(k)(4)(C), the recovery period is determined in accordance with section 168(c) regardless of any election made by the taxpayer under section 168(g)(7);

(B) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder;

(C) Water utility property as defined in section 168(e)(5) and depreciated under section 168; or

(D) Qualified leasehold improvement property as defined in paragraph (c) of this section and depreciated under section 168.

(ii) *Property not eligible for additional first year depreciation deduction*—(A) *Property that is not qualified property.* For purposes of the 30-percent additional first year depreciation deduction, depreciable property will not meet the requirements of this paragraph (b)(2) if the property is—

(*1*) Described in section 168(f);

(*2*) 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 as defined in section 263A(e)(2)(B)) has made an election under section 263A(d)(3), or property described in section 280F(b)(1)).

(*3*) Included in any class of property for which the taxpayer elects not to deduct the 30-percent additional first year depreciation (for further guidance, see paragraph (e) of this section); or

(*4*) Qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

(B) *Property that is not 50-percent bonus depreciation property.* For purposes of the 50-percent additional first year depreciation deduction, depreciable property will not meet the requirements of this paragraph (b)(2) if the property is—

(*1*) Described in paragraph (b)(2)(ii)(A)(*1*), (*2*), or (*4*) of this section; or

(*2*) Included in any class of property for which the taxpayer elects the 30-percent, instead of the 50-percent, additional first year depreciation deduction or elects not to deduct any additional first year depreciation (for further guidance, see paragraph (e) of this section).

(3) *Original use*—(i) *In general.* For purposes of the 30-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(3) if the original use of the property commences with the taxpayer after September 10, 2001. For purposes of the 50-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(3) if the original use of the property commences with the taxpayer after May 5, 2003. Except as provided in paragraphs (b)(3)(iii) and (iv) of this section, original use means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer. Thus, additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfies the original use requirement. However, the cost of reconditioned or rebuilt property does not satisfy the original use requirement. The question of whether property is reconditioned or rebuilt property is a question of fact. For purposes of this paragraph (b)(3)(i), property that contains used parts will not be treated as reconditioned or rebuilt if the cost of the used parts is not more than 20 percent of the total cost of the property, whether acquired or self-constructed.

(ii) *Conversion to business or income-producing use*—(A) *Personal use to business or income-producing use.* If a taxpayer initially acquires new property for personal use and subsequently uses the property in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is considered the original user of the property. If a person initially acquires new property for personal use and a taxpayer subsequently acquires the property from the person for use in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is not considered the original user of the property.

(B) *Inventory to business or income-producing use.* If a taxpayer initially acquires new property and holds the property primarily for sale to customers in the ordinary course of the taxpayer's business and subsequently withdraws the property from inventory and uses the property primarily in the taxpayer's trade or business or primarily for the taxpayer's production of income, the taxpayer is considered the original user of the property. If a person initially acquires new property and holds the property primarily for sale to customers in the ordinary course of the person's business and a taxpayer subsequently acquires the property from the person for use primarily in the taxpayer's trade or business or primarily for the taxpayer's production of income, the taxpayer is considered the original user of the property. For purposes of this paragraph (b)(3)(ii)(B), the original use of the property by the taxpayer commences on the date on which the taxpayer uses the property primarily in the taxpayer's trade or business or primarily for the taxpayer's production of income.

(iii) *Sale-leaseback, syndication, and certain other transactions*—(A) *Sale-leaseback transaction.* If new property is originally placed in service by a person after September 10, 2001 (for qualified property), or after May 5, 2003 (for 50-percent bonus depreciation property), and is sold to a taxpayer and leased back to the person by the taxpayer within three months after the date the property was originally placed in service by the person, the taxpayer-lessor is considered the original user of the property.

(B) *Syndication transaction and certain other transactions.* If new property is originally placed in service by a lessor (including by operation of paragraph (b)(5)(ii)(A) of this section) after September 10, 2001 (for qualified property), or after May 5, 2003 (for 50-percent bonus depreciation property), and is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor (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), and the user of the property after the last sale during the three-month period remains the same as when the property was originally placed in service by the lessor, the purchaser of the property in the last sale during the three-month period is considered the original user of the property.

(C) *Sale-leaseback transaction followed by a syndication transaction and certain other transactions.* If a sale-leaseback transaction that satisfies the requirements in paragraph (b)(3)(iii)(A) of this section is followed by a transaction that satisfies the requirements in paragraph (b)(3)(iii)(B) of this section, the original user of the property is determined in accordance with paragraph (b)(3)(iii)(B) of this section.

(iv) *Fractional interests in property.* If, in the ordinary course of its business, a taxpayer sells fractional interests in property to third parties unrelated to the taxpayer, each first fractional owner of the property is considered as the original user of its proportionate share of the property. Furthermore, if the taxpayer uses the property before all of the fractional interests of the property are sold but the property continues to be held primarily for sale by the taxpayer, the original use of any fractional interest sold to a third party unrelated to the taxpayer subsequent to the taxpayer's use of the property begins with the first purchaser of that fractional interest. For purposes of this paragraph (b)(3)(iv), persons are not related if they do not have a relationship described in section 267(b) or 707(b) and the regulations thereunder.

(v) *Examples.* The application of this paragraph (b)(3) is illustrated by the following examples:

Example 1. On August 1, 2002, *A* buys from *B* for $20,000 a machine that has been previously used by *B* in *B*'s trade or business. On March 1, 2003, *A* makes a $5,000 capital expenditure to recondition the machine. The $20,000 purchase price does not qualify for the additional first year depreciation deduction because the original use requirement of this paragraph (b)(3) is not met. However, the $5,000 expenditure satisfies the original use requirement of this paragraph (b)(3) and, assuming all other requirements are met, qualifies for the 30-percent additional first year depreciation deduction, regardless of whether the $5,000 is added to the basis of the machine or is capitalized as a separate asset.

Example 2. C, an automobile dealer, uses some of its automobiles as demonstrators in order to show them to prospective customers. The automobiles that are used as demonstrators by *C* are held by *C* primarily for sale to customers in the ordinary course of its business. On September 1, 2002, *D* buys from *C* an automobile that was previously used as a demonstrator by *C*. *D* will use the automobile solely for business purposes. The use of the automobile by *C* as a demonstrator does not constitute a "use" for purposes of the original use requirement and, therefore, *D* will be considered the original user of the automobile for purposes of this paragraph (b)(3). Assuming all other requirements are met, *D*'s purchase price of the automobile qualifies for the 30-percent additional first year depreciation deduction for *D*, subject to any limitation under section 280F.

Example 3. On April 1, 2000, *E* acquires a horse to be used in *E*'s thoroughbred racing business. On October 1, 2003, *F* buys the horse from *E* and will use the horse in *F*'s horse breeding business. The use of the horse by *E* in its racing business prevents the original use of the horse from commencing with *F*. Thus, *F*'s purchase price of the horse does not qualify for the additional first year depreciation deduction.

Example 4. In the ordinary course of its business, *G* sells fractional interests in its aircraft to unrelated parties. *G* holds out for sale eight equal fractional interests in an aircraft. On January 1, 2003, *G* sells five of the eight fractional interests in the aircraft to *H*, an unrelated party, and *H* begins to use its proportionate share of the aircraft immediately upon purchase. On June 1, 2003, G sells to I, an unrelated party to G, the remaining unsold 3⁄8 fractional interests in the aircraft. *H* is considered the original user as to its 5⁄8 fractional interest in the aircraft and *I* is considered the original user as to its 3⁄8 fractional interest in the aircraft. Thus, assuming all other requirements are met, *H*'s purchase price for its 5⁄8 fractional interest in the aircraft qualifies for the 30-percent additional first year depreciation deduction and I's purchase price for its 3⁄8 fractional interest in the aircraft qualifies for the 50-percent additional first year depreciation deduction.

Example 5. On September 1, 2001, JJ, an equipment dealer, buys new tractors that are held by JJ primarily for sale to customers in the ordinary course of its business. On October 15, 2001, JJ withdraws the tractors from inventory and begins to use the tractors primarily for producing rental income. The holding of the tractors by JJ as inventory does not constitute a "use" for purposes of the original use requirement and, therefore, the original use of the tractors commences with JJ on October 15, 2001, for purposes of paragraph (b)(3) of this section. However, the tractors are not eligible for the additional first year depreciation deduction because JJ acquired the tractors before September 11, 2001.

(4) *Acquisition of property*—(i) *In general*—(A) *Qualified property.* For purposes of the 30-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(4) if the property is—

(*1*) Acquired by the taxpayer after September 10, 2001, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001; or

(*2*) Acquired by the taxpayer pursuant to a written binding contract that was entered into after September 10, 2001, and before January 1, 2005.

(B) *50-percent bonus depreciation property.* For purposes of the 50-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(4) if the property is—

(*1*) Acquired by the taxpayer after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before May 6, 2003; or

(*2*) Acquired by the taxpayer pursuant to a written binding contract that was entered into after May 5, 2003, and before January 1, 2005.

(ii) *Definition of binding contract*—(A) *In general.* A contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). For this purpose, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account. For example, if a taxpayer entered into an irrevocable written contract to purchase an asset for $100 and the contract contained no provision for liquidated damages, the contract is considered binding notwithstanding the fact that the asset had a fair market value of $99 and under local law the seller would only recover the difference in the event the purchaser failed to perform. If the contract provided for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation, the contract is not considered binding.

(B) *Conditions.* A contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions or because any term is to be determined by a standard beyond the control of either party. A contract that imposes significant obligations on the taxpayer or a predecessor will be treated as binding notwithstanding the fact that certain terms remain to be negotiated by the parties to the contract.

(C) *Options.* An option to either acquire or sell property is not a binding contract.

(D) *Supply agreements.* A binding contract does not include a supply or similar agreement if the amount and design specifications of the property to be purchased have not been specified. The contract will not be a binding contract for the property to be purchased until both the amount and the design specifications are specified. For example, if the provisions of a supply or similar agreement state the design specifications of the property to be purchased, a purchase order under the agreement for a specific number of assets is treated as a binding contract.

(E) *Components.* A binding contract to acquire one or more components of a larger property will not be treated as a binding contract to acquire the larger property. If a binding contract to acquire the component does not satisfy the requirements of this paragraph (b)(4), the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable.

(iii) *Self-constructed property*—(A) *In general.* If a taxpayer manufactures, constructs, or produces property for use by the taxpayer in its trade or business (or for its production of income), the acquisition rules in paragraph (b)(4)(i) of this section are treated as met for qualified property if the taxpayer begins manufacturing, constructing, or producing the property after September 10, 2001, and before January 1, 2005, and for 50-percent bonus depreciation property if the taxpayer begins manufacturing, constructing, or producing the property after May 5, 2003, and before January 1, 2005. Property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract (as defined in paragraph (b)(4)(ii) of this section) that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business (or for its production of income) is considered to be manufactured, constructed, or produced by the taxpayer. If a taxpayer enters into a written binding contract (as defined in paragraph (b)(4)(ii) of this section) after September 10, 2001, and before January 1, 2005, with another person to manufacture, construct, or produce property described in section 168(k)(2)(B) (longer production period property) or section 168(k)(2)(C) (certain aircraft) and the manufacture, construction, or production of this property begins after December 31, 2004, the acquisition rule in paragraph (b)(4)(i)(A)(*2*) or (b)(4)(i)(B)(*2*) of this section is met.

(B) *When does manufacture, construction, or production begin*—(*1*) *In general.* For purposes of paragraph (b)(4)(iii) of this section, 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 retail motor fuels outlet or other facility is to be constructed on-site, construction begins when physical work of a significant nature commences at the site; that is, when work begins on the excavation for footings, pouring the pads for the outlet, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings) does not constitute the beginning of construction. However, if a retail motor fuels outlet or other facility is to be assembled on-site from modular units manufactured off-site and delivered to the site where the outlet will be used, manufacturing begins when physical work of a significant nature commences at the off-site location.

(*2*) *Safe harbor.* For purposes of paragraph (b)(4)(iii)(B)(*1*) of this section, a taxpayer may choose to determine when physical work of a significant nature begins in accordance with this paragraph (b)(4)(iii)(B)(*2*). Physical work of a significant nature will not be considered to begin before the taxpayer incurs (in the case of an accrual basis taxpayer) or pays (in the case of a cash basis taxpayer) 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). When property is manufactured, constructed, or produced for the taxpayer by another person, this safe harbor test must be satisfied by the taxpayer. For example, if a retail motor fuels outlet or other facility is to be constructed for an accrual basis taxpayer by another person for the total cost of $200,000 (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching), construction is deemed to begin for purposes of this paragraph (b)(4)(iii)(B)(*2*) when the taxpayer has incurred more than 10 percent (more than $20,000) of the total cost of the property. A taxpayer chooses to apply this paragraph (b)(4)(iii)(B)(*2*) by filing an income tax return for the placed-in-service year of the property that determines when physical work of a significant nature begins consistent with this paragraph (b)(4)(iii)(B)(*2*).

(C) *Components of self-constructed property*—(*1*) *Acquired components.* If a binding contract (as defined in paragraph (b)(4)(ii) of this section) to acquire a component does not satisfy the requirements of paragraph (b)(4)(i) of this section, the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. A binding contract (as defined in paragraph (b)(4)(ii) of this section) to acquire one or more components of a larger self-constructed property will not preclude the larger self-constructed property from satisfying the acquisition rules in paragraph (b)(4)(iii)(A) of this section. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the 30-percent or 50-percent additional first year depreciation deduction, as applicable (assuming all other requirements are met), must not include the unadjusted depreciable basis of any component that does not satisfy the requirements of paragraph (b)(4)(i) of this section. If the manufacture, construction, or production of the larger self-constructed property begins before September 11, 2001, for qualified property, or before May 6, 2003, for 50-percent bonus depreciation property, the larger self-constructed property and any acquired components related to the larger self-constructed property do not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. If a binding contract to acquire the component is entered into after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2005, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not.

(*2*) *Self-constructed components.* If the manufacture, construction, or production of a component does not satisfy the requirements of paragraph (b)(4)(iii)(A) of this section, the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. However, if the manufacture, construction, or production of a component does not satisfy the requirements of paragraph (b)(4)(iii)(A) of this section, but the manufacture, construction, or production of the larger self-constructed property satisfies the requirements of paragraph (b)(4)(iii)(A) of this section, the larger self-constructed property qualifies for the 30-percent or 50-percent additional first year depreciation deduction, as applicable (assuming all other requirements are met) even though the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the 30-percent or 50-percent additional first year depreciation deduction, as applicable (assuming all other requirements are met), must not include the unadjusted depreciable basis of any component that does not qualify for the 30-percent or 50-percent additional first year depreciation deduction. If the manufacture, construction, or production of the larger self-constructed property began before September 11, 2001, for qualified property, or before May 6, 2003, for 50-percent bonus depreciation property, the larger self-constructed property and any self-constructed components related to the larger self-constructed property do not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. If the manufacture, construction, or production of a component begins after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2005, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not.

(iv) *Disqualified transactions*—(A) *In general*. Property does not satisfy the requirements of this paragraph (b)(4) if the user of the property as of the date on which the property was originally placed in service (including by operation of paragraphs (b)(5)(ii), (iii), and (iv) of this section), or a related party to the user or to the taxpayer, acquired, or had a written binding contract (as defined in paragraph (b)(4)(ii) of this section) in effect for the acquisition of the property at any time before September 11, 2001 (for qualified property), or before May 6, 2003 (for 50-percent bonus depreciation property). In addition, property manufactured, constructed, or produced for the use by the user of the property or by a related party to the user or to the taxpayer does not satisfy the requirements of this paragraph (b)(4) if the manufacture, construction, or production of the property for the user or the related party began at any time before September 11, 2001 (for qualified property), or before May 6, 2003 (for 50-percent bonus depreciation property).

(B) *Related party defined*. For purposes of this paragraph (b)(4)(iv), persons are related if they have a relationship specified in section 267(b) or 707(b) and the regulations thereunder.

(v) *Examples*. The application of this paragraph (b)(4) is illustrated by the following examples:

Example 1. On September 1, 2001, *J*, a corporation, entered into a written agreement with *K*, a manufacturer, to purchase 20 new lamps for $100 each within the next two years. Although the agreement specifies the number of lamps to be purchased, the agreement does not specify the design of the lamps to be purchased. Accordingly, the agreement is not a binding contract pursuant to paragraph (b)(4)(ii)(D) of this section.

Example 2. Same facts as *Example 1*. On December 1, 2001, *J* placed a purchase order with *K* to purchase 20 new model XPC5 lamps for $100 each for a total amount of $2,000. Because the agreement specifies the number of lamps to be purchased and the purchase order specifies the design of the lamps to be purchased, the purchase order placed by *J* with *K* on December 1, 2001, is a binding contract pursuant to paragraph (b)(4)(ii)(D) of this section. Accordingly, the cost of the 20 lamps qualifies for the 30-percent additional first year depreciation deduction.

Example 3. Same facts as *Example 1* except that the written agreement between *J* and *K* is to purchase 100 model XPC5 lamps for $100 each within the next two years. Because this agreement specifies the amount and design of the lamps to be purchased, the agreement is a binding contract pursuant to paragraph (b)(4)(ii)(D) of this section. Accordingly, because the agreement was entered into before September 11, 2001, any lamp acquired by *J* under this contract does not qualify for the additional first year depreciation deduction.

Example 4. On September 1, 2001, *L* began constructing an electric generation power plant for its own use. On November 1, 2002, *L* ceases construction of the power plant prior to its completion. Between September 1, 2001, and November 1, 2002, *L* incurred $3,000,000 for the construction of the power plant. On May 6, 2003, *L* resumed construction of the power plant and completed its construction on August 31, 2003. Between May 6, 2003, and August 31, 2003, *L* incurred another $1,600,000 to complete the construction of the power plant and, on September 1, 2003, *L* placed the power plant in service. None of *L*'s total expenditures of $4,600,000 qualify for the additional first year depreciation deduction because, pursuant to paragraph (b)(4)(iii)(A) of this section, *L* began constructing the power plant before September 11, 2001.

Example 5. Same facts as *Example 4* except that *L* began constructing the electric generation power plant for its own use on October 1, 2001. *L*'s total expenditures of $4,600,000 qualify for the additional first year depreciation deduction because, pursuant to paragraph (b)(4)(iii)(A) of this section, *L* began constructing the power plant after September 10, 2001, and placed the power plant in service before January 1, 2005. Accordingly, the additional first year depreciation deduction for the power plant will be $1,380,000, computed as $4,600,000 multiplied by 30 percent.

Example 6. On August 1, 2001, *M* entered into a written binding contract to acquire a new turbine. The new turbine is a component part of a new electric generation power plant that is being constructed on *M*'s behalf. The construction of the new electric generation power plant commenced in November 2001, and the new electric generation power plant was completed in November 2002. Because *M* entered into a written binding contract to acquire a component part (the new turbine) prior to September 11, 2001, pursuant to paragraph (b)(4)(iii)(C) of this section, the component part does not qualify for the additional first year depreciation deduction. However, pursuant to paragraphs (b)(4)(iii)(A) and (C) of this section, the new plant constructed for *M* will qualify for the 30-percent additional first year depreciation deduction because construction of the new plant began after September 10, 2001, and before May 6, 2003. Accordingly, the unadjusted depreciable basis of the new plant that is eligible for the 30-percent additional first year depreciation deduction must not include the unadjusted depreciable basis of the new turbine.

Example 7. Same facts as *Example 6* except that *M* entered into the written binding contract to acquire the new turbine on September 30, 2002, and construction of the new plant commenced on August 1, 2001. Because *M* began construction of the new plant prior to September 11, 2001, pursuant to paragraphs (b)(4)(iii)(A) and (C) of this section, neither the new plant constructed for *M* nor the turbine will qualify for the additional first year depreciation deduction because self-construction of the new plant began prior to September 11, 2001.

Example 8. On September 1, 2001, *N* began constructing property for its own use. On October 1, 2001, *N* sold its rights to the property to *O*, a related party under section 267(b). Pursuant to paragraph (b)(4)(iv) of this section, the property is not eligible for the additional first year depreciation deduction because *N* and *O* are related parties and construction of the property by *N* began prior to September 11, 2001.

Example 9. On September 1, 2001, *P* entered into a written binding contract to acquire property. On October 1, 2001, *P* sold its rights to the property to *Q*, a related party under section 267(b). Pursuant to paragraph (b)(4)(iv) of this section, the property is not eligible for the additional first year depreciation deduction because *P* and *Q* are related parties and a written binding contract for the acquisition of the property was in effect prior to September 11, 2001.

Example 10. Prior to September 11, 2001, *R* began constructing an electric generation power plant for its own use. On May 1, 2003, prior to the completion of the power plant, *R* transferred the rights to own and use this power plant to *S*, an unrelated party, for $6,000,000. Between May 6, 2003, and June 30, 2003, *S*, a calendar-year taxpayer, began construction, and incurred another $1,200,000 to complete the construction, of the power plant and, on August 1, 2003, *S* placed the power plant in service. Because *R* and *S* are not related parties, the transaction between *R* and *S* will not be a disqualified transaction pursuant to paragraph (b)(4)(iv) of this section. Accordingly, *S*'s total expenditures of $7,200,000 for the power plant qualify for the additional first year depreciation deduction. *S*'s additional first year depreciation deduction for the power plant will be $2,400,000, computed as $6,000,000 multiplied by 30 percent, plus $1,200,000 multiplied by 50 percent. The $6,000,000 portion of the total $7,200,000 unadjusted depreciable basis qualifies for the 30-percent additional first year depreciation deduction because that portion of the total unadjusted depreciable basis was acquired by *S* after September 10, 2001, and before May 6, 2003. However, because *S* began construction to complete the power plant after May 5, 2003, the $1,200,000 portion of the total $7,200,000 unadjusted depreciable basis qualifies for the 50-percent additional first year depreciation deduction.

Example 11. On September 1, 2001, *T* acquired and placed in service equipment. On October 15, 2001, *T* sells the equipment to *U*, an unrelated party, and leases the property back from *U* in a sale-leaseback transaction. Pursuant to paragraph (b)(4)(iv) of this section, the equipment does not qualify for the additional first year depreciation deduction because *T*, the user of the equipment, acquired the equipment prior to September 11, 2001. In addition, the sale-leaseback rules in paragraphs (b)(3)(iii)(A) and (b)(5)(ii)(A) of this section do not apply because the equipment was originally placed in service by *T* before September 11, 2001.

Example 12. On July 1, 2001, KK began constructing property for its own use. KK placed this property in service on September 15, 2001. On October 15, 2001, KK sells the property to LL, an unrelated party, and leases the property back from LL in a sale-leaseback transaction. Pursuant to paragraph (b)(4)(iv) of this section, the property does not qualify for the additional first year depreciation deduction because the property was constructed for KK, the user of the property, and that construction began prior to September 11, 2001.

Example 13. On June 1, 2004, MM decided to construct property described in section 168(k)(2)(B) for its own use. However, one of the component parts of the property had to be manufactured by another person for MM. On August 15, 2004, MM entered into a written binding contract with NN to acquire this component part of the property for $100,000. The manufacture of the component part commenced on September 1, 2004, and MM received the completed component part on February 1, 2005. The cost of this component part is 9 percent of the total cost of the property to be constructed by MM. MM began constructing the property described in section 168(k)(2)(B) on January 15, 2005, and placed this property (including all component parts) in service on November 1, 2005.

Pursuant to paragraph (b)(4)(iii)(C)(*2*) of this section, the self-constructed component part of $100,000 manufactured by NN for MM is eligible for the additional first year depreciation deduction (assuming all other requirements are met) because the manufacturing of the component part began after September 10, 2001, and before January 1, 2005, and the property described in section 168(k)(2)(B), the larger self-constructed property, was placed in service by MM before January 1, 2006. However, pursuant to paragraph (b)(4)(iii)(A) of this section, the cost of the property described in section 168(k)(2)(B) (excluding the cost of the self-constructed component part of $100,000 manufactured by NN for MM) is not eligible for the additional first year depreciation deduction because construction of the property began after December 31, 2004.

Example 14. On December 1, 2004, OO entered into a written binding contract (as defined in paragraph (b)(4)(ii) of this section) with PP to manufacture an aircraft described in section 168(k)(2)(C) for use in OO's trade or business. PP begins to manufacture the aircraft on February 1, 2005. OO places the aircraft in service on August 1, 2005. Pursuant to paragraph (b)(4)(iii)(A) of this section, the aircraft meets the requirements of paragraph (b)(4)(i)(B)(*2*) of this section because the aircraft was acquired by OO pursuant to a written binding contract entered into after May 5, 2003, and before January 1, 2005.

(5) *Placed-in-service date*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (b)(5) if the property is placed in service by the taxpayer for use in its trade or business or for production of income before January 1, 2005, or, in the case of property described in section 168(k)(2)(B) or (C), is placed in service by the taxpayer for use in its trade or business or for production of income before January 1, 2006 (or placed in service by the taxpayer for use in its trade or business or for production of income before January 1, 2007, in the case of property described in section 168(k)(2)(B) or (C) to which section 105 of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 2577) applies (for further guidance, see Announcement 2006–29 (2006–19 I.R.B. 879) and §601.601(d)(2)(ii)(*b*) of this chapter)).

(ii) *Sale-leaseback, syndication, and certain other transactions*—(A) *Sale-leaseback transaction.* If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a person and sold to a taxpayer and leased back to the person by the taxpayer within three months after the date the property was originally placed in service by the person, the property is treated as originally placed in service by the taxpayer-lessor not earlier than the date on which the property is used by the lessee under the leaseback.

(B) *Syndication transaction and certain other transactions.* If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a lessor (including by operation of paragraph (b)(5)(ii)(A) of this section) and is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor (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), and the user of the property after the last sale during this three-month period remains the same as when the property was originally placed in service by the lessor, the property is treated as originally placed in service by the purchaser of the property in the last sale during the three-month period but not earlier than the date of the last sale.

(C) *Sale-leaseback transaction followed by a syndication transaction and certain other transactions.* If a sale-leaseback transaction that satisfies the requirements in paragraph (b)(5)(ii)(A) of this section is followed by a transaction that satisfies the requirements in paragraph (b)(5)(ii)(B) of this section, the placed-in-service date of the property is determined in accordance with paragraph (b)(5)(ii)(B) of this section.

(iii) *Technical termination of a partnership.* For purposes of this paragraph (b)(5), in the case of a technical termination of a partnership under section 708(b)(1)(B), qualified property or 50-percent bonus depreciation property placed in service by the terminated partnership during the taxable year of termination is treated as originally placed in service by the new partnership on the date the qualified property or the 50-percent bonus depreciation property is contributed by the terminated partnership to the new partnership.

(iv) *Section 168(i)(7) transactions.* For purposes of this paragraph (b)(5), if qualified property or 50-percent bonus depreciation property is transferred in a transaction described in section 168(i)(7) in the same taxable year that the qualified property or the 50-percent bonus depreciation property is placed in service by the transferor, the transferred property is treated as originally placed in service on the date the transferor placed in service the qualified property or the 50-percent bonus depreciation property, as applicable. In the case of multiple transfers of qualified property or 50-percent bonus depreciation property in multiple transactions described in section 168(i)(7) in the same taxable year, the placed in service date of the transferred property is deemed to be the date on which the first transferor placed in service the qualified property or the 50-percent bonus depreciation property, as applicable.

(v) *Example.* The application of this paragraph (b)(5) is illustrated by the following example:

Example. On September 15, 2004, QQ acquired and placed in service new equipment. This equipment is not described in section 168(k)(2)(B) or (C). On December 1, 2004, QQ sells the equipment to RR and leases the equipment back from RR in a sale-leaseback transaction. On February 15, 2005, RR sells the equipment to TT subject to the lease with QQ. As of February 15, 2005, QQ is still the user of the equipment. The sale-leaseback transaction of December 1, 2004, between QQ and RR satisfies the requirements of paragraph (b)(5)(ii)(A) of this section. The sale transaction of February 15, 2005, between RR and TT satisfies the requirements of paragraph (b)(5)(ii)(B) of this section. Consequently, pursuant to paragraph (b)(5)(ii)(C) of this section, the equipment is treated as originally placed in service by TT on February 15, 2005. Further, pursuant to paragraph (b)(3)(iii)(C) of this section, TT is considered the original user of the equipment. Accordingly, the equipment is not eligible for the additional first year depreciation deduction.

(c) *Qualified leasehold improvement property*—(1) *In general.* For purposes of section 168(k), qualified leasehold improvement property means any improvement, which is section 1250 property, to an interior portion of a building that is nonresidential real property if—

(i) The improvement is made under or pursuant to a lease by the lessee (or any sublessee) of the interior portion, or by the lessor of that interior portion;

(ii) The interior portion of the building is to be occupied exclusively by the lessee (or any sublessee) of that interior portion; and

(iii) The improvement is placed in service more than 3 years after the date the building was first placed in service by any person.

(2) *Certain improvements not included.* Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to:

(i) The enlargement of the building;

(ii) Any elevator or escalator;

(iii) Any structural component benefiting a common area; or

(iv) The internal structural framework of the building.

(3) *Definitions.* For purposes of this paragraph (c), the following definitions apply:

(i) *Building* has the same meaning as that term is defined in § 1.48–1(e)(1).

(ii) *Common area* means any portion of a building that is equally available to all users of the building on the same basis for uses that are incidental to the primary use of the building. For example, stairways, hallways, lobbies, common seating areas, interior and exterior pedestrian walkways and pedestrian bridges, loading docks and areas, and rest rooms generally are treated as common areas if they are used by different lessees of a building.

(iii) *Elevator* and *escalator* have the same meanings as those terms are defined in § 1.48–1(m)(2).

(iv) *Enlargement* has the same meaning as that term is defined in § 1.48–12(c)(10).

(v) *Internal structural framework* has the same meaning as that term is defined in § 1.48–12(b)(3)(i)(D)(iii).

(vi) *Lease* has the same meaning as that term is defined in section 168(h)(7). In addition, a commitment to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and lessee. However, a lease between related persons is not considered a lease. For purposes of the preceding sentence, related persons are—

(A) Members of an affiliated group (as defined in section 1504 and the regulations thereunder); and

(B) Persons having a relationship described in section 267(b) and the regulations thereunder. For purposes of applying section 267(b), the language ''80 percent or more'' is used instead of ''more than 50 percent.''

(vii) *Nonresidential real property* has the same meaning as that term is defined in section 168(e)(2)(B).

(viii) *Structural component* has the same meaning as that term is defined in §1.48–1(e)(2).

(d) *Computation of depreciation deduction for qualified property or 50-percent bonus depreciation property*—(1) *Additional first year depreciation deduction*—(i) *In general.* Except as provided in paragraph (f) of this section, the additional first year depreciation deduction is allowable in the first taxable year in which the qualified property or 50-percent bonus depreciation property is placed in service by the taxpayer for use in its trade or business or for the production of income. Except as provided in paragraph (f)(5) of this section, the allowable additional first year depreciation deduction for qualified property is determined by multiplying the unadjusted depreciable basis (as defined in §1.168(k)–1(a)(2)(iii)) of the qualified property by 30 percent. Except as provided in paragraph (f)(5) of this section, the allowable additional first year depreciation deduction for 50-percent bonus depreciation property is determined by multiplying the unadjusted depreciable basis (as defined in §1.168(k)–1(a)(2)(iii)) of the 50-percent bonus depreciation property by 50 percent. Except as provided in paragraph (f)(1) of this section, the 30-percent or 50-percent additional first year depreciation deduction is not affected by a taxable year of less than 12 months. See paragraph (f)(1) of this section for qualified property or 50-percent bonus depreciation property placed in service and disposed of in the same taxable year. See paragraph (f)(5) of this section for qualified property or 50-percent bonus depreciation property acquired in a like-kind exchange or as a result of an involuntary conversion.

(ii) *Property having a longer production period.* For purposes of paragraph (d)(1)(i) of this section, the unadjusted depreciable basis (as defined in §1.168(k)–1(a)(2)(iii)) of qualified property or 50-percent bonus depreciation property described in section 168(k)(2)(B) is limited to the property's unadjusted depreciable basis attributable to the property's manufacture, construction, or production after September 10, 2001 (for qualified property), or May 5, 2003 (for 50-percent bonus depreciation property), and before January 1, 2005.

(iii) *Alternative minimum tax.* The 30-percent or 50-percent additional first year depreciation deduction is allowed for alternative minimum tax purposes for the taxable year in which the qualified property or the 50-percent bonus depreciation property is placed in service by the taxpayer. In general, the 30-percent or 50-percent additional first year depreciation deduction for alternative minimum tax purposes is based on the unadjusted depreciable basis of the property for alternative minimum tax purposes. However, see paragraph (f)(5)(iii)(D) of this section for qualified property or 50-percent bonus depreciation property acquired in a like-kind exchange or as a result of an involuntary conversion.

(2) *Otherwise allowable depreciation deduction.* (i) *In general.* Before determining the amount otherwise allowable as a depreciation deduction for the qualified property or the 50-percent bonus depreciation property for the placed-in-service year and any subsequent taxable year, the taxpayer must determine the remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property. This remaining adjusted depreciable basis is equal to the unadjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property reduced by the amount of the additional first year

depreciation allowed or allowable, whichever is greater. The remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property is then depreciated using the applicable depreciation provisions under the Internal Revenue Code for the qualified property or the 50-percent bonus depreciation property. The remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property that is MACRS property is also the basis to which the annual depreciation rates in the optional depreciation tables apply (for further guidance, see section 8 of Rev. Proc. 87–57 (1987–2 C.B. 687) and §601.601(d)(2)(ii)(*b*) of this chapter). The depreciation deduction allowable for the remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property is affected by a taxable year of less than 12 months.

(ii) *Alternative minimum tax.* For alternative minimum tax purposes, the depreciation deduction allowable for the remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property is based on the remaining adjusted depreciable basis for alternative minimum tax purposes. The remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciable property for alternative minimum tax purposes is depreciated using the same depreciation method, recovery period (or useful life in the case of computer software), and convention that apply to the qualified property or the 50-percent bonus depreciation property for regular tax purposes.

(3) *Examples.* This paragraph (d) is illustrated by the following examples:

Example 1. On March 1, 2003, *V*, a calendar-year taxpayer, purchased and placed in service qualified property that costs $1 million and is 5-year property under section 168(e). *V* depreciates its 5-year property placed in service in 2003 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. For 2003, *V* is allowed a 30-percent additional first year depreciation deduction of $300,000 (the unadjusted depreciable basis of $1 million multiplied by .30). Next, *V* must reduce the unadjusted depreciable basis of $1 million by the additional first year depreciation deduction of $300,000 to determine the remaining adjusted depreciable basis of $700,000. Then, *V*'s depreciation deduction allowable in 2003 for the remaining adjusted depreciable basis of $700,000 is $140,000 (the remaining adjusted depreciable basis of $700,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

Example 2. On June 1, 2003, *W*, a calendar-year taxpayer, purchased and placed in service 50-percent bonus depreciation property that costs $126,000. The property qualifies for the expensing election under section 179 and is 5-year property under section 168(e). *W* did not purchase any other section 179 property in 2003. *W* makes the election under section 179 for the property and depreciates its 5-year property placed in service in 2003 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. For 2003, *W* is first allowed a $100,000 deduction under section 179. Next, *W* must reduce the cost of $126,000 by the section 179 deduction of $100,000 to determine the unadjusted depreciable basis of $26,000. Then, for 2003, *W* is allowed a 50-percent additional first year depreciation deduction of $13,000 (the unadjusted depreciable basis of $26,000 multiplied by .50). Next, *W* must reduce the unadjusted depreciable basis of $26,000 by the additional first year depreciation deduction of $13,000 to determine the remaining adjusted depreciable basis of $13,000. Then, *W*'s depreciation deduction allowable in 2003 for the remaining adjusted depreciable basis of $13,000 is $2,600 (the remaining adjusted depreciable basis of $13,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(e) *Election not to deduct additional first year depreciation*—(1) *In general.* If a taxpayer makes an election under this paragraph (e), the election applies to all qualified property or 50-percent bonus depreciation property, as applicable, that is in the same class of property and placed in service in the same taxable year. The rules of this paragraph (e) apply to the following elections provided under section 168(k):

(i) *Qualified property.* A taxpayer may make an election not to deduct the 30-percent additional first year depreciation for any class of property that is qualified property placed in service during the taxable year. If this election is made, no additional first year depreciation deduction is allowable for the property placed in service during the taxable year in the class of property.

(ii) *50-percent bonus depreciation property*. For any class of property that is 50-percent bonus depreciation property placed in service during the taxable year, a taxpayer may make an election—

(A) To deduct the 30-percent, instead of the 50-percent, additional first year depreciation. If this election is made, the allowable additional first year depreciation deduction is determined as though the class of property is qualified property under section 168(k)(2); or

(B) Not to deduct both the 30-percent and the 50-percent additional first year depreciation. If this election is made, 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) and (iv) 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; or

(iv) Qualified leasehold improvement property as defined in paragraph (c) of this section and depreciated under section 168.

(3) *Time and manner for making election*—(i) *Time for making election*. Except as provided in paragraph (e)(4) of this section, any 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 property or the 50-percent bonus depreciation property, as applicable, is placed in service by the taxpayer.

(ii) *Manner of making election*. Except as provided in paragraph (e)(4) of this section, any 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 property or 50-percent bonus depreciation 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)(i) of this section for qualified 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 applicable election specified in paragraph (e)(1) of this section within the time and in the manner prescribed in paragraph (e)(3) or (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, any 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 specified in paragraph (e)(1) of this section for a class of property, the depreciation adjustments under section 56 and the regulations under section 56 apply to the property to which that 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 specified in paragraph (e)(1) of this section, 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 specified in paragraph (e)(1) of this section 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*—(i) *In general.* Except as provided in paragraphs (f)(1)(ii) and (iii) of this section, the additional first year depreciation deduction is not allowed for qualified property or 50-percent bonus depreciation property placed in service and disposed of during the same taxable year. Also if qualified property or 50-percent bonus depreciation property is placed in service and disposed of during the same taxable year and then reacquired and again placed in service in a subsequent taxable year, the additional first year depreciation deduction is not allowable for the property in the subsequent taxable year.

(ii) *Technical termination of a partnership.* In the case of a technical termination of a partnership under section 708(b)(1)(B), the additional first year depreciation deduction is allowable for any qualified property or 50-percent bonus depreciation property placed in service by the terminated partnership during the taxable year of termination and contributed by the terminated partnership to the new partnership. The allowable additional first year depreciation deduction for the qualified property or the 50-percent bonus depreciation property shall not be claimed by the terminated partnership but instead shall be claimed by the new partnership for the new partnership's taxable year in which the qualified property or the 50-percent bonus depreciation property was contributed by the terminated partnership to the new partnership. However, if qualified property or 50-percent bonus depreciation property is both placed in service and contributed to a new partnership in a transaction described in section 708(b)(1)(B) by the terminated partnership during the taxable year of termination, and if such property is disposed of by the new partnership in the same taxable year the new partnership received such property from the terminated partnership, then no additional first year depreciation deduction is allowable to either partnership.

(iii) *Section 168(i)(7) transactions.* If any qualified property or 50-percent bonus depreciation property is transferred in a transaction described in section 168(i)(7) in the same taxable year that the qualified property or the 50-percent bonus depreciation property is placed in service by the transferor, the additional first year depreciation deduction is allowable for the qualified property or the 50-percent bonus depreciation property. The allowable additional first year depreciation deduction for the qualified property or the 50-percent bonus depreciation property for the transferor's taxable year in which the property is placed in service is allocated between the transferor and the transferee on a monthly basis. This allocation shall be made in accordance with the rules in §1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee. However, if qualified property or 50-percent bonus depreciation property is both placed in service and transferred in a transaction described in section 168(i)(7) by the transferor during the same taxable year, and if such property is disposed of by the transferee (other than by a transaction described in section 168(i)(7)) during the same taxable year the transferee received such property from the transferor, then no additional first year depreciation deduction is allowable to either party.

(iv) *Examples.* The application of this paragraph (f)(1) is illustrated by the following examples:

Example 1. X and *Y* are equal partners in *Partnership XY,* a general partnership. On February 1, 2002, *Partnership XY* purchased and placed in service new equipment at a cost of $30,000. On March 1, 2002, *X* sells its entire 50 percent interest to *Z* in a transfer that terminates the partnership under section 708(b)(1)(B). As a result, terminated *Partnership XY* is deemed to have contributed the equipment to new *Partnership XY.* Pursuant to paragraph (f)(1)(ii) of this section, new *Partnership XY,* not terminated *Partnership XY,* is eligible to claim the 30-percent additional first year depreciation deduction allowable for the equipment for the taxable year 2002 (assuming all other requirements are met).

Example 2. On January 5, 2002, *BB* purchased and placed in service new office desks for a total amount of $8,000. On August 20, 2002, *BB* transferred the office desks to *Partnership BC* in a transaction described in section 721. *BB* and *Partnership BC* are calendar-year taxpayers. Because the transaction between *BB* and *Partnership BC* is a transaction described in section 168(i)(7), pursuant to paragraph (f)(1)(iii) of this section the 30-percent additional first year depreciation deduction allowable for the desks is allocated between *BB* and *Partnership BC* in accordance with the rules in §1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee. Accordingly, the 30-percent additional first year depreciation deduction allowable for the desks for 2002 of $2,400 (the unadjusted depreciable basis of $8,000 multiplied by .30) is allocated between *BB* and *Partnership BC* based on the number of months that *BB* and *Partnership BC* held the desks in service. Thus, because the desks were held in service by *BB* for 7 of 12 months, which includes the month in which *BB* placed the desks in service but does not include the month in which the desks were transferred, *BB* is allocated $1,400 ($7/12 \times$ $2,400 additional first year depreciation deduction). *Partnership BC* is allocated $1,000, the remaining $5/12$ of the $2,400 additional first year depreciation deduction allowable for the desks.

(2) *Redetermination of basis.* If the unadjusted depreciable basis (as defined in §1.168(k)–1(a)(2)(iii)) of qualified property or 50-percent bonus depreciation property is redetermined (for example, due to contingent purchase price or discharge of indebtedness) before January 1, 2005, or, in the case of property described in section 168(k)(2)(B) or (C), is redetermined before January 1, 2006 (or redetermined before January 1, 2007, in the case of property described in section 168(k)(2)(B) or (C) to which section 105 of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 2577) applies (for further guidance, see Announcement 2006–29 (2006–19 I.R.B. 879) and §601.601(d)(2)(ii)(*b*) of this chapter)), the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property is redetermined as follows:

(i) *Increase in basis.* For the taxable year in which an increase in basis of qualified property or 50-percent bonus depreciation property occurs, the taxpayer shall claim an additional first year depreciation deduction for qualified property by multiplying the amount of the increase in basis for this property by 30 percent or, for 50-percent bonus depreciation property, by multiplying the amount of the increase in basis for this property by 50 percent. For purposes of this paragraph (f)(2)(i), the 30-percent additional first year depreciation deduction applies to the increase in basis if the underlying property is qualified property and the 50-percent additional first year depreciation deduction applies to the increase in basis if the underlying property is 50-percent bonus depreciation property. To determine the amount otherwise allowable as a depreciation deduction for the increase in basis of qualified property or 50-percent bonus depreciation property, the amount of the increase in basis of the qualified property or the 50-percent bonus depreciation property must be reduced by the additional first year depreciation deduction allowed or allowable, whichever is greater, for the increase in basis and the remaining increase in basis of—

(A) Qualified property or 50-percent bonus depreciation property (except for computer software described in paragraph (b)(2)(i)(B) of this section) is depreciated over the recovery period of the qualified property or the 50-percent bonus depreciation property, as applicable, remaining as of the beginning of the taxable year in which the increase in basis occurs, and using the same depreciation method and convention applicable to the qualified property or 50-percent bonus depreciation property, as applicable, that applies for the taxable year in which the increase in basis occurs; and

(B) Computer software (as defined in paragraph (b)(2)(i)(B) of this section) that is qualified property or 50-percent bonus depreciation property is depreciated ratably over the remainder of the 36-month period (the useful life under section 167(f)(1)) as of the beginning of the first day of the month in which the increase in basis occurs.

(ii) *Decrease in basis*. For the taxable year in which a decrease in basis of qualified property or 50-percent bonus depreciation property occurs, the taxpayer shall reduce the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property by the excess additional first year depreciation deduction previously claimed for the qualified property or the 50-percent bonus depreciation property. If, for such taxable year, the excess additional first year depreciation deduction exceeds the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property, the taxpayer shall take into account a negative depreciation deduction in computing taxable income. The excess additional first year depreciation deduction for qualified property is determined by multiplying the amount of the decrease in basis for this property by 30 percent. The excess additional first year depreciation deduction for 50-percent bonus depreciation property is determined by multiplying the amount of the decrease in basis for this property by 50 percent. For purposes of this paragraph (f)(2)(ii), the 30-percent additional first year depreciation deduction applies to the decrease in basis if the underlying property is qualified property and the 50-percent additional first year depreciation deduction applies to the decrease in basis if the underlying property is 50-percent bonus depreciation property. Also, if the taxpayer establishes by adequate records or other sufficient evidence that the taxpayer claimed less than the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property before the decrease in basis or if the taxpayer claimed more than the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property before the decrease in basis, the excess additional first year depreciation deduction is determined by multiplying the amount of the decrease in basis by the additional first year depreciation deduction percentage actually claimed by the taxpayer for the qualified property or the 50-percent bonus depreciation property, as applicable, before the decrease in basis. To determine the amount to reduce the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property for the excess depreciation previously claimed (other than the additional first year depreciation deduction) resulting from the decrease in basis of the qualified property or the 50-percent bonus depreciation property, the amount of the decrease in basis of the qualified property or the 50-percent bonus depreciation property must be adjusted by the excess additional first year depreciation deduction that reduced the total amount otherwise allowable as a depreciation deduction (as determined under this paragraph) and the remaining decrease in basis of—

(A) Qualified property or 50-percent bonus depreciation property (except for computer software described in paragraph (b)(2)(i)(B) of this section) reduces the amount otherwise allowable as a depreciation deduction over the recovery period of the qualified property or the 50-percent bonus depreciation property, as applicable, remaining as of the beginning of the taxable year in which the decrease in basis occurs, and using the same depreciation method and convention of the qualified property or 50-percent bonus depreciation property, as applicable, that applies in the taxable year in which the decrease in basis occurs. If, for any taxable year, the reduction to the amount otherwise allowable as a depreciation deduction (as determined under this paragraph (f)(2)(ii)(A)) exceeds the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property, the taxpayer shall take into account a negative depreciation deduction in computing taxable income; and

(B) Computer software (as defined in paragraph (b)(2)(i)(B) of this section) that is qualified property or 50-percent bonus depreciation property reduces the amount otherwise allowable as a depreciation deduction over the remainder of the 36-month period (the useful life under section 167(f)(1)) as of the beginning of the first day of the month in which the decrease in basis occurs. If, for any taxable year, the reduction to the amount otherwise allowable as a depreciation deduction (as determined under this paragraph (f)(2)(ii)(B)) exceeds the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property, the taxpayer shall take into account a negative depreciation deduction in computing taxable income.

(iii) *Definition.* Except as otherwise expressly provided by the Internal Revenue Code (for example, section 1017(a)), the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter), for purposes of this paragraph (f)(2):

(A) An increase in basis occurs in the taxable year an amount is taken into account under section 461; and

(B) A decrease in basis occurs in the taxable year an amount would be taken into account under section 451.

(iv) *Examples.* The application of this paragraph (f)(2) is illustrated by the following examples:

Example 1. (i) On May 15, 2002, *CC*, a cash-basis taxpayer, purchased and placed in service qualified property that is 5-year property at a cost of $200,000. In addition to the $200,000, *CC* agrees to pay the seller 25 percent of the gross profits from the operation of the property in 2002. On May 15, 2003, *CC* paid to the seller an additional $10,000. *CC* depreciates the 5-year property placed in service in 2002 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention.

(ii) For 2002, *CC* is allowed a 30-percent additional first year depreciation deduction of $60,000 (the unadjusted depreciable basis of $200,000 multiplied by .30). In addition, *CC*'s depreciation deduction for 2002 for the remaining adjusted depreciable basis of $140,000 (the unadjusted depreciable basis of $200,000 reduced by the additional first year depreciation deduction of $60,000) is $28,000 (the remaining adjusted depreciable basis of $140,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, *CC*'s depreciation deduction for the remaining adjusted depreciable basis of $140,000 is $44,800 (the remaining adjusted depreciable basis of $140,000 multiplied by the annual depreciation rate of .32 for recovery year 2). In addition, pursuant to paragraph (f)(2)(i) of this section, *CC* is allowed an additional first year depreciation deduction for 2003 for the $10,000 increase in basis of the qualified property. Consequently, *CC* is allowed an additional first year depreciation deduction of $3,000 (the increase in basis of $10,000 multiplied by .30). Also, *CC* is allowed a depreciation deduction for 2003 attributable to the remaining increase in basis of $7,000 (the increase in basis of $10,000 reduced by the additional first year depreciation deduction of $3,000). The depreciation deduction allowable for 2003 attributable to the remaining increase in basis of $7,000 is $3,111 (the remaining increase in basis of $7,000 multiplied by .4444, which is equal to 1/remaining recovery period of 4.5 years at January 1, 2003, multiplied by 2). Accordingly, for 2003, *CC*'s total depreciation deduction allowable for the qualified property is $50,911.

Example 2. (i) On May 15, 2002, DD, a calendar-year taxpayer, purchased and placed in service qualified property that is 5-year property at a cost of $400,000. To purchase the property, DD borrowed $250,000 from Bank2. On May 15, 2003, Bank2 forgives $50,000 of the indebtedness. DD makes the election provided in section 108(b)(5) to apply any portion of the reduction under section 1017 to the basis of the depreciable property of the taxpayer. DD depreciates the 5-year property placed in service in 2002 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention.

(ii) For 2002, DD is allowed a 30-percent additional first year depreciation deduction of $120,000 (the unadjusted depreciable basis of $400,000 multiplied by .30). In addition, DD's depreciation deduction allowable for 2002 for the remaining adjusted depreciable basis of $280,000 (the unadjusted depreciable basis of $400,000 reduced by the additional first year depreciation deduction of $120,000) is $56,000 (the remaining adjusted depreciable basis of $280,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, DD's deduction for the remaining adjusted depreciable basis of $280,000 is $89,600 (the remaining adjusted depreciable basis of $280,000 multiplied by the annual depreciation rate .32 for recovery year 2). Although Bank2 forgave the indebtedness in 2003, the basis of the property is reduced on January 1, 2004, pursuant to sections 108(b)(5) and 1017(a) under which basis is reduced at the beginning of the taxable year following the taxable year in which the discharge of indebtedness occurs.

(iv) For 2004, DD's deduction for the remaining adjusted depreciable basis of $280,000 is $53,760 (the remaining adjusted depreciable basis of $280,000 multiplied by the annual depreciation rate .192 for recovery year 3). However, pursuant to paragraph (f)(2)(ii) of this section, DD must reduce the amount otherwise allowable as a depreciation deduction for 2004 by the excess depreciation previously claimed for the $50,000 decrease in basis of the qualified property. Consequently, DD must reduce the amount of depreciation otherwise allowable for 2004 by the excess additional first year depreciation of $15,000 (the decrease in basis of $50,000 multiplied by .30). Also, DD must reduce the amount of depreciation otherwise allowable for 2004 by the excess depreciation attributable to the remaining decrease in basis of $35,000 (the decrease in basis of $50,000 reduced by the excess additional first year depreciation of $15,000). The reduction in the amount of depreciation otherwise allowable for 2004 for the remaining decrease in basis of $35,000 is $19,999 (the remaining decrease in basis of $35,000 multiplied by .5714, which is equal to 1/remaining recovery period of 3.5 years at January 1, 2004, multiplied by 2). Accordingly, assuming the qualified property is the only depreciable property owned by DD, for 2004, DD's total depreciation deduction allowable for the qualified property is $18,761 ($53,760 minus $15,000 minus $19,999).

(3) *Section 1245 and 1250 depreciation recapture*. For purposes of section 1245 and the regulations thereunder, the additional first year depreciation deduction is an amount allowed or allowable for depreciation. Further, for purposes of section 1250(b) and the regulations thereunder, the additional first year depreciation deduction is not a straight line method.

(4) *Coordination with section 169*. The additional first year depreciation deduction is allowable in the placed-in-service year of a certified pollution control facility (as defined in §1.169–2(a)) that is qualified property or 50-percent bonus depreciation property, even if the taxpayer makes the election to amortize the certified pollution control facility under section 169 and the regulations thereunder in the certified pollution control facility's placed-in-service year.

(5) *Like-kind exchanges and involuntary conversions*—(i) *Scope*. The rules of this paragraph (f)(5) apply to acquired MACRS property or acquired computer software that is qualified property or 50-percent bonus depreciation property at the time of replacement provided the time of replacement is after September 10, 2001, and before January 1, 2005, or, in the case of acquired MACRS property or acquired computer software that is qualified property, or 50-percent bonus depreciation property, described in section 168(k)(2)(B) or (C), the time of replacement is after September 10, 2001, and before January 1, 2006 (or the time of replacement is after September 10, 2001, and before January 1, 2007, in the case of property described in section 168(k)(2)(B) or (C) to which section 105 of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 2577) applies (for further guidance, see Announcement 2006–29 (2006–19 I.R.B. 879) and §601.601(d)(2)(ii)(*b*) of this chapter)).

(ii) *Definitions*. For purposes of this paragraph (f)(5), the following definitions apply:

(A) *Acquired MACRS property* is MACRS property in the hands of the acquiring taxpayer that is acquired in a transaction described in section 1031(a), (b), or (c) for other MACRS property or that is acquired in connection with an involuntary conversion of other MACRS property in a transaction to which section 1033 applies.

(B) *Exchanged or involuntarily converted MACRS property* is MACRS property that is transferred by the taxpayer in a transaction described in section 1031(a), (b), or (c), or that is converted as a result of an involuntary conversion to which section 1033 applies.

(C) *Acquired computer software* is computer software (as defined in paragraph (b)(2)(i)(B) of this section) in the hands of the acquiring taxpayer that is acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033.

(D) *Exchanged or involuntarily converted computer software* is computer software (as defined in paragraph (b)(2)(i)(B) of this section) that is transferred by the taxpayer in a like-kind exchange under section 1031 or that is converted as a result of an involuntary conversion under section 1033.

(E) *Time of disposition* is when the disposition of the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software, as applicable, takes place.

(F) Except as provided in paragraph (f)(5)(v) of this section, the *time of replacement* is the later of—

(*1*) When the acquired MACRS property or acquired computer software is placed in service; or

(*2*) The time of disposition of the exchanged or involuntarily converted property.

(G) *Carryover basis* is the lesser of:

(*1*) The basis in the acquired MACRS property or acquired computer software, as applicable and as determined under section 1031(d) or 1033(b) and the regulations thereunder; or

(*2*) The adjusted depreciable basis of the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software, as applicable.

(H) *Excess basis* is any excess of the basis in the acquired MACRS property or acquired computer software, as applicable and as determined under section 1031(d) or 1033(b) and the regulations thereunder, over the carryover basis as determined under paragraph (f)(5)(ii)(G) of this section.

(I) *Remaining carryover basis* is the carryover basis as determined under paragraph (f)(5)(ii)(G) of this section reduced by—

(*1*) The percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); and

(*2*) Any adjustments to basis provided by other provisions of the Code and the regulations thereunder (including section 1016(a)(2) and (3)) for periods prior to the disposition of the exchanged or involuntarily converted property.

(J) *Remaining excess basis* is the excess basis as determined under paragraph (f)(5)(ii)(H) of this section reduced by—

(*1*) The percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income);

(*2*) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179 or section 179C;

(*3*) Any adjustments to basis provided by other provisions of the Code and the regulations thereunder.

(K) *Year of disposition* is the taxable year that includes the time of disposition.

(L) *Year of replacement* is the taxable year that includes the time of replacement.

(iii) *Computation*—(A) *In general.* Assuming all other requirements of section 168(k) and this section are met, the remaining carryover basis for the year of replacement and the remaining excess basis, if any, for the year of replacement for the acquired MACRS property or the acquired computer software, as applicable, are eligible for the additional first year depreciation deduction. The 30-percent additional first year depreciation deduction applies to the remaining carryover basis and the remaining excess basis, if any, of the acquired MACRS property or the acquired computer software if the time of replacement is after September 10, 2001, and before May 6, 2003, or if the taxpayer made the election provided in paragraph (e)(1)(ii)(A) of this section. The 50-percent additional first year depreciation deduction applies to the remaining carryover basis and the remaining excess basis, if any, of the acquired MACRS property or the acquired computer software if the time of replacement is after May 5, 2003, and before January 1, 2005, or, in the case of acquired MACRS property or acquired computer software that is 50-percent bonus depreciation property described in section 168(k)(2)(B) or (C), the time of replacement is after May 5, 2003, and before January 1, 2006 (or the time of replacement is after May 5, 2003, and before January 1, 2007, in the case of 50-percent bonus depreciation property described in section 168(k)(2)(B) or (C) to which section 105 of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 2577) applies (for further guidance, see Announcement 2006–29 (2006–19 I.R.B. 879) and §601.601(d)(2)(ii)(*b*) of this chapter)). The additional first year depreciation deduction is computed separately for the remaining carryover basis and the remaining excess basis.

(B) *Year of disposition and year of replacement.* The additional first year depreciation deduction is allowable for the acquired MACRS property or acquired computer software in the year of replacement. However, the additional first year depreciation deduction is not allowable for the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software if the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software, as applicable, is placed in service and disposed of in an exchange or involuntary conversion in the same taxable year.

(C) *Property having a longer production period.* For purposes of paragraph (f)(5)(iii)(A) of this section, the total of the remaining carryover basis and the remaining excess basis, if any, of the acquired MACRS property that is qualified property or 50-percent bonus depreciation property described in section 168(k)(2)(B) is limited to the total of the property's remaining carryover basis and remaining excess basis, if any, attributable to the property's manufacture, construction, or production after September 10, 2001 (for qualified property), or May 5, 2003 (for 50-percent bonus depreciation property), and before January 1, 2005.

(D) *Alternative minimum tax.* The 30-percent or 50-percent additional first year depreciation deduction is allowed for alternative minimum tax purposes for the year of replacement of acquired MACRS property or acquired computer software that is qualified property or 50-percent bonus depreciation property. The 30-percent or 50-percent additional first year depreciation deduction for alternative minimum tax purposes is based on the remaining carryover basis and the remaining excess basis, if any, of the acquired MACRS property or the acquired computer software for alternative minimum tax purposes.

(iv) *Sale-leaseback transaction.* For purposes of this paragraph (f)(5), if MACRS property or computer software is sold to a taxpayer and leased back to a person by the taxpayer within three months after the time of disposition of the MACRS property or computer software, as applicable, the time of replacement for this MACRS property or computer software, as applicable, shall not be earlier than the date on which the MACRS property or computer software, as applicable, is used by the lessee under the leaseback.

(v) *Acquired MACRS property or acquired computer software that is acquired and placed in service before disposition of involuntarily converted MACRS property or involuntarily converted computer software.* If, in an involuntary conversion, a taxpayer acquires and places in service the acquired MACRS property or the acquired computer software before the time of disposition of the involuntarily converted MACRS property or the involuntarily converted computer software and the time of disposition of the involuntarily converted MACRS property or the involuntarily converted computer software is after December 31, 2004, or, in the case of property described in section 168(k)(2)(B) or (C), after December 31, 2005 (or after December 31, 2006, in the case of property described in section 168(k)(2)(B) or (C) to which section 105 of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 2577) applies (for further guidance, see Announcement 2006–29 (2006–19 I.R.B. 879) and §601.601(d)(2)(ii)(*b*) of this chapter)), then—

(A) *Time of replacement.* The time of replacement for purposes of this paragraph (f)(5) is when the acquired MACRS property or acquired computer software is placed in service by the taxpayer, provided the threat or imminence of requisition or condemnation of the involuntarily converted MACRS property or involuntarily converted computer software existed before January 1, 2005, or, in the case of property described in section 168(k)(2)(B) or (C), existed before January 1, 2006 (or existed before January 1, 2007, in the case of property described in section 168(k)(2)(B) or (C) to which section 105 of the Gulf Opportunity Zone Act of 2005 (Pub. L. 109–135, 119 Stat. 2577) applies (for further guidance, see Announcement 2006–29 (2006–19 I.R.B. 879) and §601.601(d)(2)(ii)(*b*) of this chapter)); and

(B) *Depreciation of acquired MACRS property or acquired computer software.* The taxpayer depreciates the acquired

MACRS property or acquired computer software in accordance with paragraph (d) of this section. However, at the time of disposition of the involuntarily converted MACRS property, the taxpayer determines the exchanged basis (as defined in §1.168(i)–6(b)(7)) and the excess basis (as defined in §1.168(i)–6(b)(8)) of the acquired MACRS property and begins to depreciate the depreciable exchanged basis (as defined in §1.168(i)–6(b)(9) of the acquired MACRS property in accordance with §1.168(i)–6(c). The depreciable excess basis (as defined in §1.168(i)–6(b)(10)) of the acquired MACRS property continues to be depreciated by the taxpayer in accordance with the first sentence of this paragraph (f)(5)(v)(B). Further, in the year of disposition of the involuntarily converted MACRS property, the taxpayer must include in taxable income the excess of the depreciation deductions allowable, including the additional first year depreciation deduction allowable, on the unadjusted depreciable basis of the acquired MACRS property over the additional first year depreciation deduction that would have been allowable to the taxpayer on the remaining carryover basis of the acquired MACRS property at the time of replacement (as defined in paragraph (f)(5)(v)(A) of this section) plus the depreciation deductions that would have been allowable, including the additional first year depreciation deduction allowable, to the taxpayer on the depreciable excess basis of the acquired MACRS property from the date the acquired MACRS property was placed in service by the taxpayer (taking into account the applicable convention) to the time of disposition of the involuntarily converted MACRS property. Similar rules apply to acquired computer software.

(vi) *Examples*. The application of this paragraph (f)(5) is illustrated by the following examples:

Example 1. (i) In December 2002, EE, a calendar-year corporation, acquired for $200,000 and placed in service Canopy V1, a gas station canopy. Canopy V1 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). EE depreciated Canopy V1 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. EE elected to use the optional depreciation tables to compute the depreciation allowance for Canopy V1. On January 1, 2003, Canopy V1 was destroyed in a fire and was no longer usable in EE's business. On June 1, 2003, in an involuntary conversion, EE acquired and placed in service new Canopy W1 with all of the $160,000 of insurance proceeds EE received due to the loss of Canopy V1. Canopy W1 is 50-percent bonus depreciation property under section 168(k)(4) and is 5-year property under section 168(e). Pursuant to paragraph (g)(3)(ii) of this section and §1.168(i)–6(k)(2)(i), EE decided to apply §1.168(i)–6 to the involuntary conversion of Canopy V1 with the replacement of Canopy W1, the acquired MACRS property.

(ii) For 2002, EE is allowed a 30-percent additional first year depreciation deduction of $60,000 for Canopy V1 (the unadjusted depreciable basis of $200,000 multiplied by .30), and a regular MACRS depreciation deduction of $28,000 for Canopy V1 (the remaining adjusted depreciable basis of $140,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, EE is allowed a regular MACRS depreciation deduction of $22,400 for Canopy V1 (the remaining adjusted depreciable basis of $140,000 multiplied by the annual depreciation rate of .32 for recovery year 2 × ½ year).

(iv) Pursuant to paragraph (f)(5)(iii)(A) of this section, the additional first year depreciation deduction allowable for Canopy W1 equals $44,800 (.50 of Canopy W1's remaining carryover basis at the time of replacement of $89,600 (Canopy V1's remaining adjusted depreciable basis of $140,000 minus 2002 regular MACRS depreciation deduction of $28,000 minus 2003 regular MACRS depreciation deduction of $22,400)).

Example 2. (i) Same facts as in *Example 1*, except EE elected not to deduct the additional first year depreciation for 5-year property placed in service in 2002. EE deducted the additional first year depreciation for 5-year property placed in service in 2003.

(ii) For 2002, EE is allowed a regular MACRS depreciation deduction of $40,000 for Canopy V1 (the unadjusted depreciable basis of $200,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, EE is allowed a regular MACRS depreciation deduction of $32,000 for Canopy V1 (the unadjusted depreciable basis of $200,000 multiplied by the annual depreciation rate of .32 for recovery year 2 × ½ year).

(iv) Pursuant to paragraph (f)(5)(iii)(A) of this section, the additional first year depreciation deduction allowable for Canopy W1 equals $64,000 (.50 of Canopy W1's remaining carryover basis at the time of replacement of $128,000 (Canopy V1's unadjusted depreciable basis of $200,000 minus 2002 regular MACRS depreciation deduction of $40,000 minus 2003 regular MACRS depreciation deduction of $32,000)).

Example 3. (i) In December 2001, FF, a calendar-year corporation, acquired for $10,000 and placed in service Computer X2. Computer X2 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). FF depreciated Computer X2 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. FF elected to use the optional depreciation tables to compute the depreciation allowance for Computer X2. On January 1, 2002, FF acquired new Computer Y2 by exchanging Computer X2 and $1,000 cash in a like-kind exchange. Computer Y2 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). Pursuant to paragraph (g)(3)(ii) of this section and § 1.168(i)–6(k)(2)(i), FF decided to apply § 1.168(i)–6 to the exchange of Computer X2 for Computer Y2, the acquired MACRS property.

(ii) For 2001, FF is allowed a 30-percent additional first year depreciation deduction of $3,000 for Computer X2 (unadjusted basis of $10,000 multiplied by .30), and a regular MACRS depreciation deduction of $1,400 for Computer X2 (the remaining adjusted depreciable basis of $7,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2002, FF is allowed a regular MACRS depreciation deduction of $1,120 for Computer X2 (the remaining adjusted depreciable basis of $7,000 multiplied by the annual depreciation rate of .32 for recovery year 2 × ½ year).

(iv) Pursuant to paragraph (f)(5)(iii)(A) of this section, the 30-percent additional first year depreciation deduction for Computer Y2 is allowable for the remaining carryover basis at the time of replacement of $4,480 (Computer X2's unadjusted depreciable basis of $10,000 minus additional first year depreciation deduction allowable of $3,000 minus 2001 regular MACRS depreciation deduction of $1,400 minus 2002 regular MACRS depreciation deduction of $1,120) and for the remaining excess basis at the time of replacement of $1,000 (cash paid for Computer Y2). Thus, the 30-percent additional first year depreciation deduction for the remaining carryover basis at the time of replacement equals $1,344 ($4,480 multiplied by .30) and for the remaining excess basis at the time of replacement equals $300 ($1,000 multiplied by .30), which totals $1,644.

Example 4. (i) In September 2002, GG, a June 30 year-end corporation, acquired for $20,000 and placed in service Equipment X3. Equipment X3 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). GG depreciated Equipment X3 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. GG elected to use the optional depreciation tables to compute the depreciation allowance for Equipment X3. In December 2002, GG acquired new Equipment Y3 by exchanging Equipment X3 and $5,000 cash in a like-kind exchange. Equipment Y3 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). Pursuant to paragraph (g)(3)(ii) of this section and § 1.168(i)–6(k)(2)(i), GG decided to apply § 1.168(i)–6 to the exchange of Equipment X3 for Equipment Y3, the acquired MACRS property.

(ii) Pursuant to paragraph (f)(5)(iii)(B) of this section, no additional first year depreciation deduction is allowable for Equipment X3 and, pursuant to § 1.168(d)–1T(b)(3)(ii), no regular depreciation deduction is allowable for Equipment X3, for the taxable year ended June 30, 2003.

(iii) Pursuant to paragraph (f)(5)(iii)(A) of this section, the 30-percent additional first year depreciation deduction for Equipment Y3 is allowable for the remaining carryover basis at the time of replacement of $20,000 (Equipment X3's unadjusted depreciable basis of $20,000) and for the remaining excess basis at the time of replacement of $5,000 (cash paid for Equipment Y3). Thus, the 30-percent additional first year depreciation deduction for the remaining carryover basis at the time of replacement equals $6,000 ($20,000 multiplied by .30) and for the remaining excess basis at the time of replacement equals $1,500 ($5,000 multiplied by .30), which totals $7,500.

Example 5. (i) Same facts as in *Example 4*. GG depreciated Equipment Y3 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. GG elected to use the optional depreciation tables to compute the depreciation allowance for Equipment Y3. On July 1, 2003, GG acquired new Equipment Z1 by exchanging Equipment Y3 in a like-kind exchange. Equipment Z1 is 50-percent bonus depreciation property under section 168(k)(4) and is 5-year property under section 168(e). Pursuant to paragraph (g)(3)(ii) of this section and § 1.168(i)–6(k)(2)(i), GG decided to apply § 1.168(i)–6 to the exchange of Equipment Y3 for Equipment Z1, the acquired MACRS property.

(ii) For the taxable year ending June 30, 2003, the regular MACRS depreciation deduction allowable for the remaining carryover basis at the time of replacement (after taking into account the additional first year depreciation deduction) of Equipment Y3 is $2,800 (the remaining carryover basis at the time of replacement of $20,000 minus the additional first year depreciation deduction of $6,000, multiplied by the annual depreciation rate of .20 for recovery year 1) and for the remaining excess basis at the time of replacement (after taking into account the additional first year depreciation deduction) of Equipment Y3 is $700 (the remaining excess basis at the time of replacement of $5,000 minus the additional first year depreciation deduction of $1,500, multiplied by the annual depreciation rate of .20 for recovery year 1), which totals $3,500.

(iii) For the taxable year ending June 30, 2004, the regular MACRS depreciation deduction allowable for the remaining carryover basis (after taking into account the additional first year depreciation deduction) of Equipment Y3 is $2,240 (the remaining carryover basis at the time of replacement of $20,000 minus the additional first year depreciation deduction of $6,000, multiplied by the annual depreciation rate of .32 for recovery year 2 × ½ year) and for the remaining excess basis (after taking into account the additional first year depreciation deduction) of Equipment Y3 is $560 (the remaining excess basis at the time of replacement of $5,000 minus the additional first year depreciation deduction of $1,500, multiplied by the annual depreciation rate of .32 for recovery year 2 × ½ year), which totals $2,800.

(iv) For the taxable year ending June 30, 2004, pursuant to paragraph (f)(5)(iii)(A) of this section, the 50-percent additional first year depreciation deduction for Equipment Z1 is allowable for the remaining carryover basis at the time of replacement of $11,200 (Equipment Y3's unadjusted depreciable basis of $25,000 minus the total additional first year depreciation deduction of $7,500 minus the total 2003 regular MACRS depreciation deduction of $3,500 minus the total 2004 regular depreciation deduction (taking into account the half-year convention) of $2,800). Thus, the 50-percent additional first year depreciation deduction for the remaining carryover basis at the time of replacement equals $5,600 ($11,200 multiplied by .50).

Example 6. (i) In April 2004, SS, a calendar year-end corporation, acquired and placed in service Equipment K89. Equipment K89 is 50-percent bonus depreciation property under section 168(k)(4). In November 2004, SS acquired and placed in service used Equipment N78 by exchanging Equipment K89 in a like-kind exchange.

(ii) Pursuant to paragraph (f)(5)(iii)(B) of this section, no additional first year deduction is allowable for Equipment K89 and, pursuant to §1.168(d)–1T(b)(3)(ii), no regular depreciation deduction is allowable for Equipment K89, for the taxable year ended December 31, 2004.

(iii) Equipment N78 is not qualified property under section 168(k)(1) or 50-percent bonus depreciation property under section 168(k)(4) because the original use requirement of paragraph (b)(3) of this section is not met. Accordingly, no additional first year depreciation deduction is allowable for Equipment N78.

(6) *Change in use*—(i) *Change in use of depreciable property.* The determination of whether the use of depreciable property changes is made in accordance with section 168(i)(5) and regulations thereunder.

(ii) *Conversion to personal use.* If qualified property or 50-percent bonus depreciation property is converted from business or income-producing use to personal use in the same taxable year in which the property is placed in service by a taxpayer, the additional first year depreciation deduction is not allowable for the property.

(iii) *Conversion to business or income-producing use*—(A) *During the same taxable year.* If, during the same taxable year, property is acquired by a taxpayer for personal use and is converted by the taxpayer from personal use to business or income-producing use, the additional first year depreciation deduction is allowable for the property in the taxable year the property is converted to business or income-producing use (assuming all of the requirements in paragraph (b) of this section are met). See paragraph (b)(3)(ii) of this section relating to the original use rules for a conversion of property to business or income-producing use.

(B) *Subsequent to the acquisition year.* If property is acquired by a taxpayer for personal use and, during a subsequent taxable year, is converted by the taxpayer from personal use to business or income-producing use, the additional first year depreciation deduction is allowable for the property in the taxable year the property is converted to business or income-producing use (assuming all of the requirements in paragraph (b) of this section are met). For purposes of paragraphs (b)(4) and (5) of this section, the property must be acquired by the taxpayer for personal use after September 10, 2001 (for qualified property), or after May 5, 2003 (for 50-percent bonus depreciation property), and converted by the taxpayer from personal use to business or income-producing use by January 1, 2005. See paragraph (b)(3)(ii) of this section relating to the original use rules for a conversion of property to business or income-producing use.

(iv) *Depreciable property changes use subsequent to the placed-in-service year*—(A) If the use of qualified property or 50-percent bonus depreciation property changes in the hands of the same taxpayer subsequent to the taxable year the qualified property or the 50-percent bonus depreciation property, as applicable, is placed in service and, as a result of the change in use, the property is no longer qualified property or 50-percent bonus depreciation property, as applicable, the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property, as applicable, is not redetermined.

(B) If depreciable property is not qualified property or 50-percent bonus depreciation property in the taxable year the property is placed in service by the taxpayer, the additional first year depreciation deduction is not allowable for the property even if a change in the use of the property subsequent to the taxable year the property is placed in service results in the property being qualified property or 50-percent bonus depreciation property in the taxable year of the change in use.

(v) *Examples.* The application of this paragraph (f)(6) is illustrated by the following examples:

Example 1. (i) On January 1, 2002, HH, a calendar year corporation, purchased and placed in service several new computers at a total cost of $100,000. HH used these computers within the United States for 3 months in 2002 and then moved and used the computers outside the United States for the remainder of 2002. On January 1, 2003, HH permanently returns the computers to the United States for use in its business.

(ii) For 2002, the computers are considered as used predominantly outside the United States in 2002 pursuant to §1.48–1(g)(1)(i). As a result, the computers are required to be depreciated under the alternative depreciation system of section 168(g). Pursuant to paragraph (b)(2)(ii)(A)*2*) of this section, the computers are not qualified property in 2002, the placed-in-service year. Thus, pursuant to (f)(6)(iv)(B) of this section, no additional first year depreciation deduction is allowed for these computers, regardless of the fact that the computers are permanently returned to the United States in 2003.

Example 2. (i) On February 8, 2002, *II*, a calendar year corporation, purchased and placed in service new equipment at a cost of $1,000,000 for use in its California plant. The equipment is 5-year property under section 168(e) and is qualified property under section 168(k). *II* depreciates its 5-year property placed in service in 2002 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. On June 4, 2003, due to changes in *II*'s business circumstances, *II* permanently moves the equipment to its plant in Mexico.

(ii) For 2002, *II* is allowed a 30-percent additional first year depreciation deduction of $300,000 (the adjusted depreciable basis of $1,000,000 multiplied by .30). In addition, *II*'s depreciation deduction allowable in 2002 for the remaining adjusted depreciable basis of $700,000 (the unadjusted depreciable basis of $1,000,000 reduced by the additional first year depreciation deduction of $300,000) is $140,000 (the remaining adjusted depreciable basis of $700,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, the equipment is considered as used predominantly outside the United States pursuant to §1.48–1(g)(1)(i). As a result of this change in use, the adjusted depreciable basis of $560,000 for the equipment is required to be depreciated under the alternative depreciation system of section 168(g) beginning in 2003. However, the additional first year depreciation deduction of $300,000 allowed for the equipment in 2002 is not redetermined.

(7) *Earnings and profits.* The additional first year depreciation deduction is not allowable for purposes of computing earnings and profits.

(8) *Limitation of amount of depreciation for certain passenger automobiles.* For a passenger automobile as defined in section 280F(d)(5), the limitation under section 280F(a)(1)(A)(i) is increased by—

(i) $4,600 for qualified property acquired by a taxpayer after September 10, 2001, and before May 6, 2003; and

(ii) $7,650 for qualified property or 50-percent bonus depreciation property acquired by a taxpayer after May 5, 2003.

(9) *Section 754 election.* In general, for purposes of section 168(k) any increase in basis of qualified property or 50-percent bonus depreciation property due to a section 754 election is not eligible for the additional first year depreciation deduction. However, if qualified property or 50-percent bonus depreciation property is placed in service by a partnership in the taxable year the partnership terminates under section 708(b)(1)(B), any increase in basis of the

qualified property or the 50-percent bonus depreciation property due to a section 754 election is eligible for the additional first year depreciation deduction.

(10) *Coordination with section 47*—(i) *In general.* If qualified rehabilitation expenditures (as defined in section 47(c)(2) and §1.48–12(c)) incurred by a taxpayer with respect to a qualified rehabilitated building (as defined in section 47(c)(1) and §1.48–12(b)) are qualified property or 50-percent bonus depreciation property, the taxpayer may claim the rehabilitation credit provided by section 47(a) (provided the requirements of section 47 are met)—

(A) With respect to the portion of the basis of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures if the taxpayer makes the applicable election under paragraph (e)(1)(i) or (e)(1)(ii)(B) of this section not to deduct any additional first year depreciation for the class of property that includes the qualified rehabilitation expenditures; or

(B) With respect to the portion of the remaining rehabilitated basis of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures if the taxpayer claims the additional first year depreciation deduction on the unadjusted depreciable basis (as defined in paragraph (a)(2)(iii) of this section but before the reduction in basis for the amount of the rehabilitation credit) of the qualified rehabilitation expenditures and the taxpayer depreciates the remaining adjusted depreciable basis (as defined in paragraph (d)(2)(i) of this section) of such expenditures using straight line cost recovery in accordance with section 47(c)(2)(B)(i) and §1.48–12(c)(7)(i). For purposes of this paragraph (f)(10)(i)(B), the remaining rehabilitated basis is equal to the unadjusted depreciable basis (as defined in paragraph (a)(2)(iii) of this section but before the reduction in basis for the amount of the rehabilitation credit) of the qualified rehabilitation expenditures that are qualified property or 50-percent bonus depreciation property reduced by the additional first year depreciation allowed or allowable, whichever is greater.

(ii) *Example.* The application of this paragraph (f)(10) is illustrated by the following example.

Example. (i) Between February 8, 2004, and June 4, 2004, UU, a calendar-year taxpayer, incurred qualified rehabilitation expenditures of $200,000 with respect to a qualified rehabilitated building that is nonresidential real property under section 168(e). These qualified rehabilitation expenditures are 50-percent bonus depreciation property and qualify for the 10-percent rehabilitation credit under section 47(a)(1). UU's basis in the qualified rehabilitated building is zero before incurring the qualified rehabilitation expenditures and UU placed the qualified rehabilitated building in service in July 2004. UU depreciates its nonresidential real property placed in service in 2004 under the general depreciation system of section 168(a) by using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. UU elected to use the optional depreciation tables to compute the depreciation allowance for its depreciable property placed in service in 2004. Further, for 2004, UU did not make any election under paragraph (e) of this section.

(ii) Because UU did not make any election under paragraph (e) of this section, UU is allowed a 50-percent additional first year depreciation deduction of $100,000 for the qualified rehabilitation expenditures for 2004 (the unadjusted depreciable basis of $200,000 (before reduction in basis for the rehabilitation credit) multiplied by .50). For 2004, UU also is allowed to claim a rehabilitation credit of $10,000 for the remaining rehabilitated basis of $100,000 (the unadjusted depreciable basis (before reduction in basis for the rehabilitation credit) of $200,000 less the additional first year depreciation deduction of $100,000). Further, UU's depreciation deduction for 2004 for the remaining adjusted depreciable basis of $90,000 (the unadjusted depreciable basis (before reduction in basis for the rehabilitation credit) of $200,000 less the additional first year depreciation deduction of $100,000 less the rehabilitation credit of $10,000) is $1,059.30 (the remaining adjusted depreciable basis of $90,000 multiplied by the depreciation rate of .01177 for recovery year 1, placed in service in month 7).

(11) *Coordination with section 514(a)(3).* The additional first year depreciation deduction is not allowable for purposes of section 514(a)(3).

(g) *Effective date*—(1) *In general.* Except as provided in paragraphs (g)(2), (3), and (5) of this section, this section applies to qualified property under section 168(k)(2) acquired by a taxpayer after September 10, 2001, and to 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003.

(2) *Technical termination of a partnership or section 168(i)(7) transactions.* If qualified property or 50 percent bonus depreciation 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)(ii) or (iii) of this section, as applicable, 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)(i) *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 property or 50-percent bonus depreciation 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.

(ii) Paragraphs (f)(5)(ii)(F)(*2*) and (f)(5)(v) of this section apply to a like-kind exchange or an involuntary conversion of MACRS property and computer software for which the time of disposition and the time of replacement both occur after February 27, 2004. For a like-kind exchange or an involuntary conversion of MACRS property for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, see §1.168(i)–6(k)(2)(ii). For a like-kind exchange or involuntary conversion of computer software for which the time of disposition, the time of replacement, or both occur on or before February 27, 2004, a taxpayer may rely on prior guidance issued by the Internal Revenue Service for determining the depreciation deductions of the acquired computer software and the exchanged or involuntarily converted computer software (for further guidance, see §1.168(k)–1T(f)(5) published in the FEDERAL REGISTER on September 8, 2003 (68 FR 53000)). In relying on such guidance, a taxpayer may use any reasonable, consistent method of determining depreciation in the year of disposition and the year of replacement.

(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 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 property or 50-percent bonus depreciation 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).

(5) *Revision to paragraphs (b)(3)(iii)(B) and (b)(5)(ii)(B) of this section.* 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 paragraphs (b)(3)(iii)(B) and (b)(5)(ii)(B) of this section applies to property sold after June 4, 2004.

(6) *Rehabilitation credit.* If a taxpayer did not claim on a Federal tax return for any 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 property or 50-percent bonus depreciation property, and the taxpayer did not make the applicable election specified in paragraph (e)(1)(i) or (e)(1)(ii)(B) 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 paragraph (f)(10)(i)(B) of this section) 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)(10)(i)(B) 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 52992, Sept. 8, 2003; 68 FR 63734, Nov. 10, 2003, as amended by T.D. 9115, 69 FR 9546, Mar. 1, 2004; 69 FR 17586, 17587, Apr. 5, 2004. Redesignated and amended by T.D. 9283, 71 FR 51738, Aug. 31, 2006; T.D. 9314, 72 FR 9261, Mar. 1, 2007]

§ 1.168(k)–2 Additional first year depreciation deduction for property acquired and placed in service after September 27, 2017.

(a) *Scope and definitions*—(1) *Scope.* This section provides rules for determining the additional first year depreciation deduction allowable under section 168(k) for qualified property acquired and placed in service after September 27, 2017, except as provided in paragraph (c) of this section.

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

(i) *Act* is the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054 (December 22, 2017));

(ii) *Applicable percentage* is the percentage provided in section 168(k)(6);

(iii) *Initial live staged performance* is the first commercial exhibition of a production to an audience. However, the term *initial live staged performance* does not include limited exhibition prior to commercial exhibition to general audiences if the limited exhibition is primarily for purposes of publicity, determining the need for further production activity, or raising funds for the completion of production. For example, an initial live staged performance does not include a preview of the production if the preview is primarily to determine the need for further production activity; and

(iv) *Predecessor* includes—

(A) A transferor of an asset to a transferee in a transaction to which section 381(a) applies;

(B) A transferor of the asset to a transferee in a transaction in which the transferee's basis in the asset is determined, in whole or in part, by reference to the basis of the asset in the hands of the transferor;

(C) A partnership that is considered as continuing under section 708(b)(2) and §1.708–1; or

(D) The decedent in the case of an asset acquired by the estate.

(b) *Qualified property*—(1) *In general.* Qualified property is depreciable property, as defined in §1.168(b)–1(a)(1), 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 §1.168(k)–2(b)(2) (description of qualified property);

(ii) The requirements in §1.168(k)–2(b)(3) (original use or used property acquisition requirements);

(iii) The requirements in §1.168(k)–2(b)(4) (placed-in-service date); and

(iv) The requirements in §1.168(k)–2(b)(5) (acquisition of property).

(2) *Description of qualified property*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (b)(2) if the property is—

(A) MACRS property, as defined in §1.168(b)–1(a)(2), that has a recovery period of 20 years or less. For purposes of this paragraph (b)(2)(i)(A) and section 168(k)(2)(A)(i)(I), the recovery period is determined in accordance with section 168(c) regardless of any election made by the taxpayer under section 168(g)(7). This paragraph (b)(2)(i)(A) includes the following MACRS property that is acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer after September 27, 2017, and before January 1, 2018:

(*1*) Qualified leasehold improvement property as defined in section 168(e)(6) as in effect on the day before amendment by section 13204(a)(1) of the Act;

(*2*) Qualified restaurant property, as defined in section 168(e)(7) as in effect on the day before amendment by section 13204(a)(1) of the Act, that is qualified improvement property as defined in §1.168(b)–1(a)(5)(i)(C) and (a)(5)(ii); and

(*3*) Qualified retail improvement property as defined in section 168(e)(8) as in effect on the day before amendment by section 13204(a)(1) of the Act;

(B) Computer software as defined in, and depreciated under, section 167(f)(1) and §1.167(a)–14;

(C) Water utility property as defined in section 168(e)(5) and depreciated under section 168;

(D) Qualified improvement property as defined in §1.168(b)–1(a)(5)(i)(C) and (a)(5)(ii) and depreciated under section 168;

(E) A qualified film or television production, as defined in section 181(d) and §1.181–3, for which a deduction would have been allowable under section 181 and §§1.181–1 through 1.181–6 without regard to section 181(a)(2) and (g), §1.181–1(b)(1)(i) and (ii), and (b)(2)(i), or section 168(k). Only production costs of a qualified film or television production are allowable as a deduction under section 181 and §§1.181–1 through 1.181–6 without regard, for purposes of section 168(k), to section 181(a)(2) and (g), §1.181–1(b)(1)(i) and (ii), and (b)(2)(i). The taxpayer that claims the additional first year depreciation deduction under this section for the production costs of a qualified film or television production must be the owner, as defined in §1.181–1(a)(2), of the qualified film or television production. See §1.181–1(a)(3) for the definition of production costs;

(F) A qualified live theatrical production, as defined in section 181(e), for which a deduction would have been allowable under section 181 and §§1.181–1 through 1.181–6 without regard to section 181(a)(2) and (g), §1.181–1(b)(1)(i) and (ii), and (b)(2)(i), or section 168(k). Only production costs of a qualified live theatrical production are allowable as a deduction under section 181 and §§1.181–1 through 1.181–6 without regard, for purposes of section 168(k), to section 181(a)(2) and (g), §1.181–1(b)(1)(i) and (ii), and (b)(2)(i). The taxpayer that claims the additional first year depreciation deduction under this section for the production costs of a qualified live theatrical production must be the owner, as defined in §1.181–1(a)(2), of the qualified live theatrical production. In applying §1.181–1(a)(2)(ii) to a person that acquires a finished or partially-finished qualified live theatrical production, such person is treated as an owner of that production, but only if the production is acquired prior to its initial live staged performance. Rules similar to the rules in §1.181–1(a)(3) for the definition of production costs of a qualified film or television production apply for defining production costs of a qualified live theatrical production; or

(G) A specified plant, as defined in section 168(k)(5)(B), for which the taxpayer has properly made an election to apply section 168(k)(5) for the taxable year in which the specified plant is planted, or grafted to a plant that has already been planted, by the taxpayer in the ordinary course of the taxpayer's farming business, as defined in section 263A(e)(4) (for further guidance, see paragraph (f) of this section).

(ii) *Property not eligible for additional first year depreciation deduction.* Depreciable property will not meet the requirements of this paragraph (b)(2) if the property is—

(A) Described in section 168(f) (for example, automobiles for which the taxpayer uses the optional business standard mileage rate);

(B) Required to be depreciated under the alternative depreciation system of section 168(g) pursuant to section 168(g)(1)(A), (B), (C), (D), (F), or (G), 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, as defined in section 263A(e)(2)(B), has made an election under section 263A(d)(3), or property described in section 280F(b)(1)). If section 168(h)(6) applies to the property, only the tax-exempt entity's proportionate share of the property, as determined under section 168(h)(6), is treated as tax-exempt use property described in section 168(g)(1)(B) and in this paragraph (b)(2)(ii)(B). This paragraph (b)(2)(ii)(B) does not apply to property for which the adjusted basis is required to be determined using the alternative depreciation system of section 168(g) pursuant to section 250(b)(2)(B) or 951A(d)(3), as applicable, or to property for which the adjusted basis is required to be determined using the alternative depreciation system of section 168(g) for allocating business interest expense between excepted and non-excepted trades or businesses under section 163(j), but only if the property is not required to be depreciated under the alternative depreciation system of section 168(g) pursuant to section 168(g)(1)(A), (B), (C), (D), (F), or (G), or other provisions of the Code, other than section 163(j), 250(b)(2)(B), or 951A(d)(3), as applicable;

(C) Included in any class of property for which the taxpayer elects not to deduct the additional first year depreciation (for further guidance, see paragraph (f) of this section);

(D) A specified plant that is placed in service by the taxpayer during the taxable year and for which the taxpayer made an election to apply section 168(k)(5) for a prior taxable year;

(E) Included in any class of property for which the taxpayer elects to apply section 168(k)(4). This paragraph (b)(2)(ii)(E) applies to property placed in service by the taxpayer in any taxable year beginning before January 1, 2018;

(F) Primarily used in a trade or business described in section 163(j)(7)(A)(iv) and §§1.163(j)–1(b)(15)(i) and 1.163(j)–10(c)(3)(iii)(C)(*3*), and placed in service by the taxpayer in any taxable year beginning after December 31, 2017. For purposes of section 168(k)(9)(A) and this paragraph (b)(2)(ii)(F), the term *primarily used* has the same meaning as that term is used in §1.167(a)–11(b)(4)(iii)(*b*) and (e)(3)(iii) for classifying property. This paragraph (b)(2)(ii)(F) does not apply to property that is leased to a lessee's trade or business described in section 163(j)(7)(A)(iv) and §§1.163(j)–1(b)(15)(i) and 1.163(j)–10(c)(3)(iii)(C)(*3*), by a lessor's trade or business that is not described in section 163(j)(7)(A)(iv) and §§1.163(j)–1(b)(15)(i) and 1.163(j)–10(c)(3)(iii)(C)(*3*) for the taxable year; or

(G) Used in a trade or business that has had floor plan financing indebtedness, as defined in section 163(j)(9)(B) and §1.163(j)–1(b)(18), if the floor plan financing interest expense, as defined in section 163(j)(9)(A) and §1.163(j)–1(b)(19), related to such indebtedness is taken into account under section 163(j)(1)(C) for the taxable year. Such property also must be placed in service by the taxpayer in any taxable year beginning after December 31, 2017. Solely for purposes of section 168(k)(9)(B) and this paragraph (b)(2)(ii)(G), floor plan financing interest expense is taken into account for the taxable year by a trade or business that has had floor plan financing indebtedness only if the business interest expense, as defined in section 163(j)(5) and §1.163(j)–1(b)(3), of the trade or business for the taxable year (which includes floor plan financing interest expense) exceeds the sum of the amounts calculated under section 163(j)(1)(A) and (B) for the trade or business for the taxable year. If the trade or business has taken floor plan financing interest expense into account pursuant to this paragraph (b)(2)(ii)(G) for a taxable year, this paragraph (b)(2)(ii)(G) applies to any property placed in service by that trade or business in that taxable year. This paragraph (b)(2)(ii)(G) does not apply to property that is leased to a lessee's trade or business that has had floor plan financing indebtedness, by a lessor's trade or business that has not had floor plan financing indebtedness during the taxable year or that has had floor plan financing indebtedness but did not take into account floor plan financing interest expense for the taxable year pursuant to this paragraph (b)(2)(ii)(G).

(iii) *Examples*. The application of this paragraph (b)(2) is illustrated by the following examples. Unless the facts specifically indicate otherwise, assume that the parties are not related within the meaning of section 179(d)(2)(A) or (B) and §1.179–4(c), and are not described in section 163(j)(3):

(A) *Example 1*. On February 8, 2018, *A* finishes the production of a qualified film, as defined in §1.181–3. On June 4, 2018, *B* acquires this finished production from *A*. The initial release or broadcast, as defined in §1.181–1(a)(7), of this qualified film is on July 28, 2018. Because *B* acquired the qualified film before its initial release or broadcast, *B* is treated as the owner of the qualified film for purposes of section 181 and §1.181–1(a)(2). Assuming all other requirements of this section are met and all requirements of section 181 and §§1.181–1 through 1.181–6, other than section 181(a)(2) and (g), and §1.181–1(b)(1)(i) and (ii), and (b)(2)(i), are met, *B*'s acquisition cost of the qualified film qualifies for the additional first year depreciation deduction under this section.

(B) *Example 2*. The facts are the same as in *Example 1* of paragraph (b)(2)(iii)(A) of this section, except that *B* acquires a limited license or right to release the qualified film in Europe. As a result, *B* is not treated as the owner of the qualified film pursuant to §1.181–1(a)(2). Accordingly, paragraph (b)(2)(i)(E) of this section is not satisfied, and *B*'s acquisition cost of the license or right does not qualify for the additional first year depreciation deduction.

(C) *Example 3*. *C* owns a film library. All of the films in this film library are completed and have been released or broadcasted. In 2018, *D* buys this film library from *C*. Because *D* acquired the films after their initial release or broadcast, *D*'s acquisition cost of the film library does not qualify for a deduction under section 181. As a result, paragraph (b)(2)(i)(E) of this section is not satisfied, and *D*'s acquisition cost of the film library does not qualify for the additional first year depreciation deduction.

(D) *Example 4*. During 2019, E Corporation, a domestic corporation, acquired new equipment for use in its manufacturing trade or business in Mexico. To determine its qualified business asset investment for purposes of section 250, E Corporation must determine the adjusted basis of the new equipment using the alternative depreciation system of section 168(g) pursuant to sections 250(b)(2)(B) and 951A(d)(3). E Corporation also is required to depreciate the new equipment under the alternative depreciation system of section 168(g) pursuant to section 168(g)(1)(A). As a result, the new equipment does not qualify for the additional first year depreciation deduction pursuant to paragraph (b)(2)(ii)(B) of this section.

(E) *Example 5*. The facts are the same as in *Example 4* of paragraph (b)(2)(iii)(D) of this section, except E Corporation acquired the new equipment for use in its manufacturing trade or business in California. The new equipment is not described in section 168(g)(1)(A), (B), (C), (D), (F), or (G). No other provision of the Internal Revenue Code, other than section 250(b)(2)(B) or 951A(d)(3), requires the new equipment to be depreciated using the alternative depreciation system of section 168(g). To determine its qualified business asset investment for purposes of section 250, E Corporation must determine the adjusted basis of the new equipment using the alternative depreciation system of section 168(g) pursuant to sections 250(b)(2)(B) and 951A(d)(3). Because E Corporation is not required to depreciate the new equipment under the alternative depreciation system of section 168(g), paragraph (b)(2)(ii)(B) of this section does not apply to this new equipment. Assuming all other requirements are met, the new equipment qualifies for the additional first year depreciation deduction under this section.

(F) *Example 6*. In 2019, a financial institution buys new equipment for $1 million and then leases this equipment to a lessee that primarily uses the equipment in a trade or business described in section 163(j)(7)(A)(iv) and §§1.163(j)–1(b)(15)(i) and 1.163(j)–10(c)(3)(iii)(C)(*3*). The financial institution is not described in section 163(j)(7)(A)(iv) and §§1.163(j)–1(b)(15)(i) and §1.163(j)–10(c)(3)(iii)(C)(*3*). As a result, paragraph (b)(2)(ii)(F) of this section does not apply to this new equipment. Assuming all other requirements are met, the financial institution's purchase price of $1 million for the new equipment qualifies for the additional first year depreciation deduction under this section.

(G) *Example 7*. During its taxable year beginning in 2020, *F*, a corporation that is an automobile dealer, buys new computers for $50,000 for use in its trade or business of selling automobiles. For purposes of section 163(j), *F* has the following for 2020: $700 of adjusted taxable income, $40 of business interest income, $400 of business interest expense (which includes $100 of floor plan financing interest expense). The sum of the amounts calculated under section 163(j)(1)(A) and (B) for *F* for 2020 is $390 ($40 + ($700 × 50 percent)). *F*'s business interest expense, which includes floor plan financing interest expense, for 2020 is $400. As a result, *F*'s floor plan financing interest expense is taken into account by *F* for 2020 pursuant to paragraph (b)(2)(ii)(G) of this section. Accordingly, *F*'s purchase price of $50,000 for the computers does not qualify for the additional first year depreciation deduction under this section.

(H) *Example 8*. The facts are the same as in *Example 7* in paragraph (b)(2)(iii)(G) of this section, except *F* buys new computers for $30,000 for use in its trade or business of selling automobiles and, for purposes of section 163(j), *F* has $1,300 of adjusted taxable income. The sum of the amounts calculated under section 163(j)(1)(A) and (B) for *F* for 2020 is $690 ($40 + ($1,300 × 50 percent)). *F*'s business interest expense, which includes floor plan financing interest expense, for 2020 is $400. As a result, *F*'s floor plan financing interest expense is not taken into account by *F* for 2020 pursuant to paragraph (b)(2)(ii)(G) of this section. Assuming all other requirements are met, *F*'s purchase price of $30,000 for the computers qualifies for the additional first year depreciation deduction under this section.

(I) *Example 9*. (*1*) *G*, a calendar-year taxpayer, owns an office building for use in its trade or business and *G* placed in service such building in 2000. In November 2018, *G* made and placed in service an improvement to the inside of such building at a cost of $100,000. In January 2019, *G* entered into a written contract with *H* for *H* to construct an improvement to the inside of the building. In March 2019, *H* completed construction of the improvement at a cost of $750,000 and *G* placed in service such improvement. Both improvements to the building are section 1250 property and are not described in §1.168(b)–1(a)(5)(ii).

(*2*) Both the improvement to the office building made by *G* in November 2018 and the improvement to the office building that was constructed by *H* for

G in 2019 are improvements made by *G* under §1.168(b)–1(a)(5)(i)(A). Further, each improvement is made to the inside of the office building, is section 1250 property, and is not described in §1.168(b)–1(a)(5)(ii). As a result, each improvement meets the definition of qualified improvement property in section 168(e)(6) and §1.168(b)–1(a)(5)(i)(A) and (a)(5)(ii). Accordingly, each improvement is 15-year property under section 168(e)(3) and is described in §1.168(k)–2(b)(2)(i)(A). Assuming all other requirements of this section are met, each improvement made by *G* qualifies for the additional first year depreciation deduction for *G* under this section.

(3) *Original use or used property acquisition requirements*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (b)(3) if the property meets the original use requirements in paragraph (b)(3)(ii) of this section or if the property meets the used property acquisition requirements in paragraph (b)(3)(iii) of this section.

(ii) *Original use*—(A) *In general.* Depreciable property will meet the requirements of this paragraph (b)(3)(ii) if the original use of the property commences with the taxpayer. Except as provided in paragraphs (b)(3)(ii)(B) and (C) of this section, original use means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer. Additional capital expenditures paid or incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfy the original use requirement. However, the cost of reconditioned or rebuilt property does not satisfy the original use requirement (but may satisfy the used property acquisition requirements in paragraph (b)(3)(iii) of this section). The question of whether property is reconditioned or rebuilt property is a question of fact. For purposes of this paragraph (b)(3)(ii)(A), property that contains used parts will not be treated as reconditioned or rebuilt if the cost of the used parts is not more than 20 percent of the total cost of the property, whether acquired or self-constructed.

(B) *Conversion to business or income-producing use*—(*1*) *Personal use to business or income-producing use.* If a taxpayer initially acquires new property for personal use and subsequently uses the property in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is considered the original user of the property. If a person initially acquires new property for personal use and a taxpayer subsequently acquires the property from the person for use in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is not considered the original user of the property.

(*2*) *Inventory to business or income-producing use.* If a taxpayer initially acquires new property and holds the property primarily for sale to customers in the ordinary course of the taxpayer's business and subsequently withdraws the property from inventory and uses the property primarily in the taxpayer's trade or business or primarily for the taxpayer's production of income, the taxpayer is considered the original user of the property. If a person initially acquires new property and holds the property primarily for sale to customers in the ordinary course of the person's business and a taxpayer subsequently acquires the property from the person for use primarily in the taxpayer's trade or business or primarily for the taxpayer's production of income, the taxpayer is considered the original user of the property. For purposes of this paragraph (b)(3)(ii)(B)(*2*), the original use of the property by the taxpayer commences on the date on which the taxpayer uses the property primarily in the taxpayer's trade or business or primarily for the taxpayer's production of income.

(C) *Fractional interests in property.* If, in the ordinary course of its business, a taxpayer sells fractional interests in new property to third parties unrelated to the taxpayer, each first fractional owner of the property is considered as the original user of its proportionate share of the property. Furthermore, if the taxpayer uses the property before all of the fractional interests of the property are sold but the property continues to be held primarily for sale by the taxpayer, the original use of any fractional interest sold to a third party unrelated to the taxpayer subsequent to the taxpayer's use of the property begins with the first purchaser of that fractional interest. For purposes of this paragraph (b)(3)(ii)(C), persons are not related if they do not have a relationship described in section 267(b) and §1.267(b)–1, or section 707(b) and §1.707–1.

(iii) *Used property acquisition requirements*—(A) *In general.* Depreciable property will meet the requirements of this paragraph (b)(3)(iii) if the acquisition of the used property meets the following requirements:

(*1*) Such property was not used by the taxpayer or a predecessor at any time prior to such acquisition;

(*2*) The acquisition of such property meets the requirements of section 179(d)(2)(A), (B), and (C), and §1.179–4(c)(1)(ii), (iii), and (iv); or §1.179–4(c)(2) (property is acquired by purchase); and

(*3*) The acquisition of such property meets the requirements of section 179(d)(3) and §1.179–4(d) (cost of property) (for further guidance regarding like-kind exchanges and involuntary conversions, see paragraph (g)(5) of this section).

(B) *Property was not used by the taxpayer at any time prior to acquisition*—(*1*) *In general.* Solely for purposes of paragraph (b)(3)(iii)(A)(*1*) of this section, the property is treated as used by the taxpayer or a predecessor at any time prior to acquisition by the taxpayer or predecessor if the taxpayer or the predecessor had a depreciable interest in the property at any time prior to such acquisition, whether or not the taxpayer or the predecessor claimed depreciation deductions for the property. To determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to the acquisition, only the five calendar years immediately prior to the current calendar year in which the property is placed in service by the taxpayer, and the portion of such current calendar year before the placed-in-service date of the property without taking into account the applicable convention, are taken into account (lookback period). If either the taxpayer or a predecessor, or both, have not been in existence for the entire lookback period, only the portion of the lookback period during which the taxpayer or a predecessor, or both, as applicable, have been in existence is taken into account to determine if the taxpayer or a predecessor had a depreciable interest in the property at any time prior to the acquisition. If a lessee has a depreciable interest in the improvements made to leased property and subsequently the lessee acquires the leased property of which the improvements are a part, the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3), of the acquired property that is eligible for the additional first year depreciation deduction, assuming all other requirements are met, must not include the unadjusted depreciable basis attributable to the improvements.

(*2*) *Taxpayer has a depreciable interest in a portion of the property.* If a taxpayer initially acquires a depreciable interest in a portion of the property and subsequently acquires a depreciable interest in an additional portion of the same property, such additional depreciable interest is not treated as used by the taxpayer at any time prior to its acquisition by the taxpayer under paragraphs (b)(3)(iii)(A)(*1*) and (b)(3)(iii)(B)(*1*) of this section. This paragraph (b)(3)(iii)(B)(*2*) does not apply if the taxpayer or a predecessor previously had a depreciable interest in the subsequently acquired additional portion. For purposes of this paragraph (b)(3)(iii)(B)(*2*), a portion of the property is considered to be the percentage interest in the property. If a taxpayer holds a depreciable interest in a portion of the property, sells that portion or a part of that portion, and subsequently acquires a depreciable interest in another portion of the same property, the taxpayer will be treated as previously having a depreciable interest in the property up to the amount of the portion for which the taxpayer held a depreciable interest in the property before the sale.

(*3*) *Substantial renovation of property.* If a taxpayer acquires and places in service substantially renovated property and the taxpayer or a predecessor previously had a depreciable interest in the property before it was substantially renovated, the taxpayer's or predecessor's depreciable interest in the property before it was substantially renovated is not taken into account for determining whether the substantially renovated property was used by the taxpayer or a predecessor at any time prior to its acquisition by the taxpayer under paragraphs (b)(3)(iii)(A)(*1*) and (b)(3)(iii)(B)(*1*) of this section. For purposes of this paragraph (b)(3)(iii)(B)(*3*), property is substantially renovated if the cost of the used parts is not more than 20 percent of the total cost of the substantially renovated property, whether acquired or self-constructed.

(*4*) *De minimis use of property.* If a taxpayer acquires and places in service property, the taxpayer or a predecessor did not previously have a depreciable interest in the property, the taxpayer disposes of the property to an unrelated party within 90 calendar days after the date the property was originally placed in service by the taxpayer, without taking into account the applicable convention, and the taxpayer reacquires and again places in service the property, then the taxpayer's depreciable interest in the property during that 90-day period is not taken into account for determining whether the property was used by the taxpayer or a predecessor at any time prior to its reacquisition by the taxpayer under paragraphs (b)(3)(iii)(A)(*1*) and (b)(3)(iii)(B)(*1*) of this section. If the taxpayer originally acquired the property before September 28, 2017, as determined under §1.168(k)–1(b)(4), and the taxpayer reacquires and again places in service the property during the same taxable year the taxpayer disposed of the property to the unrelated party, then this paragraph (b)(3)(iii)(B)(*4*) does not apply. For purposes of this paragraph (b)(3)(iii)(B)(*4*), an *unrelated party* is a person not described in section 179(d)(2)(A) or (B), and §1.179–4(c)(1)(ii) or (iii) or (c)(2).

(C) *Special rules for a series of related transactions*—(*1*) *In general.* Solely for purposes of paragraph (b)(3)(iii) of this section, each transferee in a series of related transactions tests its relationship under section 179(d)(2)(A) or (B) with the transferor from which the transferee directly acquires the depreciable property (immediate transferor) and with the original transferor of the depreciable property in the series. The transferee is treated as related to the immediate transferor or the original transferor if the relationship exists either when the transferee acquires, or immediately before the first transfer of, the depreciable property in the series. A series of related transactions may include, for example, a transfer of partnership assets followed by a transfer of an interest in the partnership that owned the assets; or a disposition of property and a disposition, directly or indirectly, of the transferor or transferee of the property. For special rules that may apply when the transferor and transferee of the property are members of a consolidated group, as defined in §1.1502–1(h), see §1.1502–68.

(*2*) *Special rules*—(*i*) *Property placed in service and disposed of in same taxable year or property not placed in service.* Any party in a series of related transactions that is neither the original transferor nor the ultimate transferee is disregarded (disregarded party) for purposes of testing the relationships under paragraph (b)(3)(iii)(C)(*1*) of this section if the party places in service and disposes of the depreciable property subject to the series, other than in a transaction described in paragraph (g)(1)(iii) of this section, during the party's same taxable year, or if the party does not place in service the depreciable property subject to the series for use in the party's trade or business or production of income. In either case, the party to which the disregarded party disposed of the depreciable property tests its relationship with the party from which the disregarded party acquired the depreciable property and with the original transferor of the depreciable property in the series. If the series has consecutive disregarded parties, the party to which the last disregarded party disposed of the depreciable property tests its relationship with the party from which the first disregarded party acquired the depreciable property and with the original transferor of the depreciable property in the series. The rules for testing the relationships in paragraph (b)(3)(iii)(C)(*1*) of this section continue to apply for the other transactions in the series.

(*ii*) *All section 168(i)(7) transactions.* This paragraph (b)(3)(iii)(C) does not apply if all transactions in a series of related transactions are described in paragraph (g)(1)(iii) of this section (section 168(i)(7) transactions in which property is transferred in the same taxable year that the property is placed in service by the transferor).

(*iii*) *One or more section 168(i)(7) transactions.* Any step in a series of related transactions that is neither the original step nor the ultimate step is disregarded (disregarded step) for purposes of testing the relationships under paragraph (b)(3)(iii)(C)(*1*) of this section if the step is a transaction described in paragraph (g)(1)(iii) of this section. In this case, the relationship is not tested between the transferor and transferee of that transaction. Instead, the relationship is tested between the transferor in the disregarded step and the party to which the transferee in the disregarded step disposed of the depreciable property, the transferee in the disregarded step and the party to which the transferee in the disregarded step disposed of the depreciable property, and the original transferor of the depreciable property in the series and the party to which the transferee in the disregarded step disposed of the depreciable property. If the series has consecutive disregarded steps, the relationship is tested between the transferor in the first disregarded step and the party to which the transferee in the last disregarded step disposed of the depreciable property, the transferee in the last disregarded step and the party to which the transferee in the last disregarded step disposed of the depreciable property, and the original transferor of the depreciable property in the series and the party to which the transferee in the last disregarded step disposed of the depreciable property. The rules for testing the relationships in paragraph (b)(3)(iii)(C)(*1*) of this section continue to apply for the other transactions in the series.

(*iv*) *Syndication transaction.* This paragraph (b)(3)(iii)(C) does not apply to a syndication transaction described in paragraph (b)(3)(vi) of this section.

(*v*) *Certain relationships disregarded.* If a party acquires depreciable property in a series of related transactions in which the party acquires stock, meeting the requirements of section 1504(a)(2), of a corporation in a fully taxable transaction followed by a liquidation of the acquired corporation under section 331, any relationship created as part of such series of related transactions is disregarded in determining whether any party is related to such acquired corporation for purposes of testing the relationships under paragraph (b)(3)(iii)(C)(*1*) of this section.

(*vi*) *Transferors that cease to exist for Federal tax purposes.* Any transferor in a series of related transactions that ceases to exist for Federal tax purposes during the series is deemed, for purposes of testing the relationships under paragraph (b)(3)(iii)(C)(*1*) of this section, to be in existence at the time of any transfer in the series.

(*vii*) *Newly created party.* If a transferee in a series of related transactions acquires depreciable property from a transferor that was not in existence immediately prior to the first transfer of such property in such series (new transferor), the transferee tests its relationship with the party from which the new transferor acquired such property and with the original transferor of the depreciable property in the series for purposes of paragraph (b)(3)(iii)(C)(*1*) of this section. If the series has consecutive new transferors, the party to which the last new transferor disposed of the depreciable property tests its relationship with the party from which the first new transferor acquired the depreciable property and with the original transferor of the depreciable property in the series. The rules for testing the relationships in paragraph (b)(3)(iii)(C)(*1*) of this section continue to apply for the other transactions in the series.

(*viii*) *Application of paragraph (g)(1) of this section.* Paragraph (g)(1) of this section applies to each step in a series of related transactions.

(iv) *Application to partnerships*—(A) *Section 704(c) remedial allocations.* Remedial allocations under section 704(c) do not satisfy the requirements of paragraph (b)(3) of this section. See §1.704–3(d)(2).

(B) *Basis determined under section 732.* Any basis of distributed property determined under section 732 does not satisfy the requirements of paragraph (b)(3) of this section.

(C) *Section 734(b) adjustments.* Any increase in basis of depreciable property under section 734(b) does not satisfy the requirements of paragraph (b)(3) of this section.

(D) *Section 743(b) adjustments*—(*1*) *In general.* For purposes of determining whether the transfer of a partnership interest meets the requirements of paragraph (b)(3)(iii)(A) of this section, each partner is treated as having a depreciable interest in the partner's proportionate share of partnership property. Any increase in basis of depreciable property under section 743(b) satisfies the requirements of paragraph (b)(3)(iii)(A) of this section if—

(*i*) At any time prior to the transfer of the partnership interest that gave rise to such basis increase, neither the transferee partner nor a predecessor of the transferee partner had any depreciable interest in the portion of the property deemed acquired to which the section 743(b) adjustment is allocated under section 755 and §1.755–1; and

(*ii*) The transfer of the partnership interest that gave rise to such basis increase satisfies the requirements of paragraphs (b)(3)(iii)(A)(*2*) and (*3*) of this section.

(*2*) *Relatedness tested at partner level.* Solely for purposes of paragraph (b)(3)(iv)(D)(*1*)(*ii*) of this section, whether the parties are related or unrelated is determined by comparing the transferor and the transferee of the transferred partnership interest.

(v) *Application to members of a consolidated group.* For rules applicable to the acquisition of depreciable property by a member of a consolidated group, see §1.1502–68.

(vi) *Syndication transaction.* If new property is acquired and placed in service by a lessor, or if used property is acquired and placed in service by a lessor and the lessor or a predecessor did not previously have a depreciable interest in the used property, and the property is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor (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), and the user of the property after the last sale during the three-month period remains the same as when the property was originally placed in service by the lessor, the purchaser of the property in the last sale during the three-month period is considered the taxpayer that acquired the property for purposes of applying paragraphs (b)(3)(ii) and (iii) of this section. The purchaser of the property in the last sale during the three-month period is treated, for purposes of applying paragraph (b)(3) of this section, as—

(A) The original user of the property in this transaction if the lessor acquired and placed in service new property; or

(B) The taxpayer having the depreciable interest in the property in this transaction if the lessor acquired and placed in service used property.

(vii) *Examples.* The application of this paragraph (b)(3) is illustrated by the following examples. Unless the facts specifically indicate otherwise, assume that the parties are not related within the meaning of section 179(d)(2)(A) or (B) and §1.179–4(c), no corporation is a member of a consolidated or controlled group, and the parties do not have predecessors:

(A) *Example 1.* (*1*) On August 1, 2018, *A* buys a new machine for $35,000 from an unrelated party for use in *A*'s trade or business. On July 1, 2020, *B* buys that machine from *A* for $20,000 for use in *B*'s trade or business. On October 1, 2020, *B* makes a $5,000 capital expenditure to recondition the machine. *B* did not have any depreciable interest in the machine before *B* acquired it on July 1, 2020.

(*2*) *A*'s purchase price of $35,000 satisfies the original use requirement of paragraph (b)(3)(ii) of this section and, assuming all other requirements are met, qualifies for the additional first year depreciation deduction under this section.

(*3*) *B*'s purchase price of $20,000 does not satisfy the original use requirement of paragraph (b)(3)(ii) of this section, but it does satisfy the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Assuming all other requirements are met, the $20,000 purchase price qualifies for the additional first year depreciation deduction under this section. Further, *B*'s $5,000 expenditure satisfies the original use requirement of paragraph (b)(3)(ii) of this section and, assuming all other requirements are met, qualifies for the additional first year depreciation deduction under this section, regardless of whether the $5,000 is added to the basis of the machine or is capitalized as a separate asset.

(B) *Example 2*. *C*, an automobile dealer, uses some of its automobiles as demonstrators in order to show them to prospective customers. The automobiles that are used as demonstrators by *C* are held by *C* primarily for sale to customers in the ordinary course of its business. On November 1, 2017, *D* buys from *C* an automobile that was previously used as a demonstrator by *C*. *D* will use the automobile solely for business purposes. The use of the automobile by *C* as a demonstrator does not constitute a ''use'' for purposes of the original use requirement and, therefore, *D* will be considered the original user of the automobile for purposes of paragraph (b)(3)(ii) of this section. Assuming all other requirements are met, *D*'s purchase price of the automobile qualifies for the additional first year depreciation deduction for *D* under this section, subject to any limitation under section 280F.

(C) *Example 3*. On April 1, 2015, *E* acquires a horse to be used in *E*'s thoroughbred racing business. On October 1, 2018, *F* buys the horse from *E* and will use the horse in *F*'s horse breeding business. *F* did not have any depreciable interest in the horse before *F* acquired it on October 1, 2018. The use of the horse by *E* in its racing business prevents *F* from satisfying the original use requirement of paragraph (b)(3)(ii) of this section. However, *F*'s acquisition of the horse satisfies the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Assuming all other requirements are met, *F*'s purchase price of the horse qualifies for the additional first year depreciation deduction for *F* under this section.

(D) *Example 4*. In the ordinary course of its business, *G* sells fractional interests in its aircraft to unrelated parties. *G* holds out for sale eight equal fractional interests in an aircraft. On October 1, 2017, *G* sells five of the eight fractional interests in the aircraft to *H* and *H* begins to use its proportionate share of the aircraft immediately upon purchase. On February 1, 2018, *G* sells to *I* the remaining unsold $\frac{3}{8}$ fractional interests in the aircraft. *H* is considered the original user as to its $\frac{5}{8}$ fractional interest in the aircraft and *I* is considered the original user as to its $\frac{3}{8}$ fractional interest in the aircraft. Thus, assuming all other requirements are met, *H*'s purchase price for its $\frac{5}{8}$ fractional interest in the aircraft qualifies for the additional first year depreciation deduction under this section and *I*'s purchase price for its $\frac{3}{8}$ fractional interest in the aircraft qualifies for the additional first year depreciation deduction under this section.

(E) *Example 5*. On September 1, 2017, *J*, an equipment dealer, buys new tractors that are held by *J* primarily for sale to customers in the ordinary course of its business. On October 15, 2017, *J* withdraws the tractors from inventory and begins to use the tractors primarily for producing rental income. The holding of the tractors by *J* as inventory does not constitute a ''use'' for purposes of the original use requirement and, therefore, the original use of the tractors commences with *J* on October 15, 2017, for purposes of paragraph (b)(3)(ii) of this section. However, the tractors are not eligible for the additional first year depreciation deduction under this section because *J* acquired the tractors before September 28, 2017.

(F) *Example 6*. *K* is in the trade or business of leasing equipment to others. During 2016, *K* buys a new machine (Machine #1) and then leases it to *L* for use in *L*'s trade or business. The lease between *K* and *L* for Machine #1 is a true lease for Federal income tax purposes. During 2018, *L* enters into a written binding contract with *K* to buy Machine #1 at its fair market value on May 15, 2018. *L* did not have any depreciable interest in Machine #1 before *L* acquired it on May 15, 2018. As a result, *L*'s acquisition of Machine #1 satisfies the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Assuming all other requirements are met, *L*'s purchase price of Machine #1 qualifies for the additional first year depreciation deduction for *L* under this section.

(G) *Example 7.* The facts are the same as in *Example 6* of paragraph (b)(3)(vii)(F) of this section, except that *K* and *L* are related parties within the meaning of section 179(d)(2)(A) or (B) and §1.179–4(c). As a result, *L*'s acquisition of Machine #1 does not satisfy the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Thus, Machine #1 is not eligible for the additional first year depreciation deduction for *L*.

(H) *Example 8.* The facts are the same as in *Example 6* of paragraph (b)(3)(vii)(F) of this section, except *L* incurred capital expenditures of $5,000 to improve Machine #1 on September 5, 2017, and has a depreciable interest in such improvements. *L*'s purchase price of $5,000 for the improvements to Machine #1 satisfies the original use requirement of §1.168(k)–1(b)(3)(i) and, assuming all other requirements are met, qualifies for the 50-percent additional first year depreciation deduction. Because *L* had a depreciable interest only in the improvements to Machine #1, *L*'s acquisition of Machine #1, excluding *L*'s improvements to such machine, satisfies the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Assuming all other requirements are met, *L*'s unadjusted depreciable basis of Machine #1, excluding the amount of such unadjusted depreciable basis attributable to *L*'s improvements to Machine #1, qualifies for the additional first year depreciation deduction for *L* under this section.

(I) *Example 9.* During 2016, *M* and *N* purchased used equipment for use in their trades or businesses and each own a 50 percent interest in such equipment. Prior to this acquisition, *M* and *N* did not have any depreciable interest in the equipment. Assume this ownership arrangement is not a partnership. During 2018, *N* enters into a written binding contract with *M* to buy *M*'s interest in the equipment. Pursuant to paragraph (b)(3)(iii)(B)(*2*) of this section, *N* is not treated as using *M*'s interest in the equipment prior to *N*'s acquisition of *M*'s interest. As a result, *N*'s acquisition of *M*'s interest in the equipment satisfies the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Assuming all other requirements are met, *N*'s purchase price of *M*'s interest in the equipment qualifies for the additional first year depreciation deduction for *N* under this section.

(J) *Example 10.* The facts are the same as in *Example 9* of paragraph (b)(3)(vii)(I) of this section, except *N* had a 100-percent depreciable interest in the equipment during 2011 through 2015, and *M* purchased from *N* a 50-percent interest in the equipment during 2016. Pursuant to paragraph (b)(3)(iii)(B)(*1*) of this section, the lookback period is 2013 through 2017 to determine if *N* had a depreciable interest in *M*'s 50-percent interest in the equipment *N* acquired from *M* in 2018. Because *N* had a 100-percent depreciable interest in the equipment during 2013 through 2015, *N* had a depreciable interest in *M*'s 50-percent interest in the equipment during the lookback period. As a result, *N*'s acquisition of *M*'s interest in the equipment during 2018 does not satisfy the used property acquisition requirements of paragraphs (b)(3)(iii)(A)(*1*) and (b)(3)(iii)(B)(*1*) of this section. Paragraph (b)(3)(iii)(B)(*2*) of this section does not apply because *N* initially acquired a 100-percent depreciable interest in the equipment. Accordingly, *N*'s purchase price of *M*'s interest in the equipment during 2018 does not qualify for the additional first year depreciation deduction for *N*.

(K) *Example 11.* The facts are the same as in *Example 9* of paragraph (b)(3)(vii)(I) of this section, except *N* had a 100-percent depreciable interest in the equipment only during 2011, and *M* purchased from *N* a 50-percent interest in the equipment during 2012. Pursuant to paragraph (b)(3)(iii)(B)(*1*) of this section, the lookback period is 2013 through 2017 to determine if *N* had a depreciable interest in *M*'s 50-percent interest in the equipment *N* acquired from *M* in 2018. Because *N* had a depreciable interest in only its 50-percent interest in the equipment during this lookback period, *N*'s acquisition of *M*'s interest in the equipment during 2018 satisfies the used property acquisition requirements of paragraphs (b)(3)(iii)(A)(*1*) and (b)(3)(iii)(B)(*1*) of this section. Assuming all other requirements are met, *N*'s purchase price of *M*'s interest in the equipment during 2018 qualifies for the additional first year depreciation deduction for *N* under this section.

(L) *Example 12*. The facts are the same as in *Example 9* of paragraph (b)(3)(vii)(I) of this section, except during 2018, *M* also enters into a written binding contract with *N* to buy *N*'s interest in the equipment. Pursuant to paragraph (b)(3)(iii)(B)(*2*) of this section, both *M* and *N* are treated as previously having a depreciable interest in a 50-percent portion of the equipment. Accordingly, the acquisition by *M* of *N*'s 50-percent interest and the acquisition by *N* of *M*'s 50-percent interest in the equipment during 2018 do not qualify for the additional first year depreciation deduction.

(M) *Example 13*. *O* and *P* form an equal partnership, *OP*, in 2018. *O* contributes cash to *OP*, and *P* contributes equipment to *OP*. *OP*'s basis in the equipment contributed by *P* is determined under section 723. Because *OP*'s basis in such equipment is determined in whole or in part by reference to *P*'s adjusted basis in such equipment, *OP*'s acquisition of such equipment does not satisfy section 179(d)(2)(C) and §1.179–4(c)(1)(iv) and, thus, does not satisfy the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Accordingly, *OP*'s acquisition of such equipment is not eligible for the additional first year depreciation deduction.

(N) *Example 14*. *Q*, *R*, and *S* form an equal partnership, *QRS*, in 2019. Each partner contributes $100, which *QRS* uses to purchase a retail motor fuels outlet for $300. Assume this retail motor fuels outlet is *QRS*' only property and is qualified property under section 168(k)(2)(A)(i). *QRS* makes an election not to deduct the additional first year depreciation for all qualified property placed in service during 2019. *QRS* has a section 754 election in effect. *QRS* claimed depreciation of $15 for the retail motor fuels outlet for 2019. During 2020, when the retail motor fuels outlet's fair market value is $600, *Q* sells all of its partnership interest to *T* in a fully taxable transaction for $200. *T* never previously had a depreciable interest in the retail motor fuels outlet. *T* takes an outside basis of $200 in the partnership interest previously owned by *Q*. *T*'s share of the partnership's previously taxed capital is $95. Accordingly, *T*'s section 743(b) adjustment is $105 and is allocated entirely to the retail motor fuels outlet under section 755. Assuming all other requirements are met, *T*'s section 743(b) adjustment qualifies for the additional first year depreciation deduction under this section.

(O) *Example 15*. The facts are the same as in *Example 14* of paragraph (b)(3)(vii)(N) of this section, except that *Q* sells his partnership interest to *U*, a related person within the meaning of section 179(d)(2)(A) or (B) and §1.179–4(c). *U*'s section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

(P) *Example 16*. The facts are the same as in *Example 14* of paragraph (b)(3)(vii)(N) of this section, except that *Q* dies and his partnership interest is transferred to *V*. *V* takes a basis in *Q*'s partnership interest under section 1014. As a result, section 179(d)(2)(C)(ii) and §1.179–4(c)(1)(iv) are not satisfied, and *V*'s section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

(Q) *Example 17*. The facts are the same as in *Example 14* of paragraph (b)(3)(vii)(N) of this section, except that *QRS* purchased the retail motor fuels outlet from *T* prior to *T* purchasing *Q*'s partnership interest in *QRS*. *T* had a depreciable interest in such retail motor fuels outlet. Because *T* had a depreciable interest in the retail motor fuels outlet before *T* acquired its interest in *QRS*, *T*'s section 743(b) adjustment does not qualify for the additional first year depreciation deduction.

(R) *Example 18*. (*1*) *W*, a freight transportation company, acquires and places in service a used aircraft during 2019 (Airplane #1). Prior to this acquisition, *W* never had a depreciable interest in this aircraft. During September 2020, *W* enters into a written binding contract with a third party to renovate Airplane #1. The third party begins to renovate Airplane #1 in October 2020 and delivers the renovated aircraft (Airplane #2) to *W* in February 2021. To renovate Airplane #1, the third party used mostly new parts but also used parts from Airplane #1. The cost of the used parts is not more than 20 percent of the total cost of the renovated airplane, Airplane #2. *W* uses Airplane #2 in its trade or business.

(*2*) Although Airplane #2 contains used parts, the cost of the used parts is not more than 20 percent of the total cost of Airplane #2. As a result, Airplane #2 is not treated as reconditioned or rebuilt property, and *W* is considered the original user of Airplane #2, pursuant to paragraph (b)(3)(ii)(A) of this section. Accordingly, assuming all other requirements are met, the amount paid or incurred by *W* for Airplane #2 qualifies for the additional first year depreciation deduction for *W* under this section.

(S) *Example 19*. (*1*) *X*, a freight transportation company, acquires and places in service a new aircraft in 2019 (Airplane #1). During 2022, *X* sells Airplane #1 to *AB* and *AB* uses Airplane #1 in its trade or business. Prior to this acquisition, *AB* never had a depreciable interest in Airplane #1. During January 2023, *AB* enters into a written binding contract with a third party to renovate Airplane #1. The third party begins to renovate Airplane #1 in February 2023 and delivers the renovated aircraft (Airplane #2) to *AB* in June 2023. To renovate Airplane #1, the third party used mostly new parts but also used parts from Airplane #1. The cost of the used parts is not more than 20 percent of the total cost of the renovated airplane, Airplane #2. *AB* uses Airplane #2 in its trade or business. During 2025, *AB* sells Airplane #2 to *X* and *X* uses Airplane #2 in its trade or business.

(*2*) With respect to *X*'s purchase of Airplane #1 in 2019, *X* is the original user of this airplane pursuant to paragraph (b)(3)(ii)(A) of this section. Accordingly, assuming all other requirements are met, *X*'s purchase price for Airplane #1 qualifies for the additional first year depreciation deduction for *X* under this section.

(*3*) Because *AB* never had a depreciable interest in Airplane #1 prior to its acquisition in 2022, the requirements of paragraphs (b)(3)(iii)(A)(*1*) and (b)(3)(ii)(B)(*1*) of this section are satisfied. Accordingly, assuming all other requirements are met, *AB*'s purchase price for Airplane #1 qualifies for the additional first year depreciation deduction for *AB* under this section.

(*4*) Although Airplane #2 contains used parts, the cost of the used parts is not more than 20 percent of the total cost of Airplane #2. As a result, Airplane #2 is not treated as reconditioned or rebuilt property, and *AB* is considered the original user of Airplane #2, pursuant to paragraph (b)(3)(ii)(A) of this section. Accordingly, assuming all other requirements are met, the amount paid or incurred by *AB* for Airplane #2 qualifies for the additional first year depreciation deduction for *AB* under this section.

(*5*) With respect to *X*'s purchase of Airplane #2 in 2025, Airplane #2 is substantially renovated property pursuant to paragraph (b)(3)(iii)(B)(*3*) of this section. Also, pursuant to paragraph (b)(3)(iii)(B)(*3*) of this section, *X*'s depreciable interest in Airplane #1 is not taken into account for determining if *X* previously had a depreciable interest in Airplane #2 prior to its acquisition during 2025. As a result, Airplane #2 is not treated as used by *X* at any time before its acquisition of Airplane #2 in 2025 pursuant to paragraph (b)(3)(iii)(B)(*3*) of this section. Accordingly, assuming all other requirements are met, *X*'s purchase price of Airplane #2 qualifies for the additional first year depreciation deduction for *X* under this section.

(T) *Example 20*. In November 2017, AA Corporation purchases a used drill press costing $10,000 and is granted a trade-in allowance of $2,000 on its old drill press. The used drill press is qualified property under section 168(k)(2)(A)(i). The old drill press had a basis of $1,200. Under sections 1012 and 1031(d), the basis of the used drill press is $9,200 ($1,200 basis of old drill press plus cash expended of $8,000). Only $8,000 of the basis of the used drill press satisfies the requirements of section

179(d)(3) and §1.179–4(d) and, thus, satisfies the used property acquisition requirement of paragraph (b)(3)(iii) of this section. The remaining $1,200 of the basis of the used drill press does not satisfy the requirements of section 179(d)(3) and §1.179–4(d) because it is determined by reference to the old drill press. Accordingly, assuming all other requirements are met, only $8,000 of the basis of the used drill press is eligible for the additional first year depreciation deduction under this section.

(U) *Example 21*. (*1*) M Corporation acquires and places in service a used airplane on March 26, 2018. Prior to this acquisition, M Corporation never had a depreciable interest in this airplane. On March 26, 2018, M Corporation also leases the used airplane to N Corporation, an airline company. On May 27, 2018, M Corporation sells to O Corporation the used airplane subject to the lease with N Corporation. M Corporation and O Corporation are related parties within the meaning of section 179(d)(2)(A) or (B) and §1.179–4(c). As of May 27, 2018, N Corporation is still the lessee of the used airplane. Prior to this acquisition, O Corporation never had a depreciable interest in the used airplane. O Corporation is a calendar-year taxpayer.

(*2*) The sale transaction of May 27, 2018, satisfies the requirements of a syndication transaction described in paragraph (b)(3)(vi) of this section. As a result, O Corporation is considered the taxpayer that acquired the used airplane for purposes of applying the used property acquisition requirements in paragraph (b)(3)(iii) of this section. In applying these rules, the fact that M Corporation and O Corporation are related parties is not taken into account because O Corporation, not M Corporation, is treated as acquiring the used airplane. Also, O Corporation, not M Corporation, is treated as having the depreciable interest in the used airplane. Further, pursuant to paragraph (b)(4)(iv) of this section, the used airplane is treated as originally placed in service by O Corporation on May 27, 2018. Because O Corporation never had a depreciable interest in the used airplane and assuming all other requirements are met, O Corporation's purchase price of the used airplane qualifies for the additional first year depreciation deduction for O Corporation under this section.

(V) *Example 22*. (*1*) The facts are the same as in *Example 21* of paragraph (b)(3)(vii)(U)(*1*) of this section. Additionally, on September 5, 2018, O Corporation sells to P Corporation the used airplane subject to the lease with N Corporation. Prior to this acquisition, P Corporation never had a depreciable interest in the used airplane.

(*2*) Because O Corporation, a calendar-year taxpayer, placed in service and disposed of the used airplane during 2018, the used airplane is not eligible for the additional first year depreciation deduction for O Corporation pursuant to paragraph (g)(1)(i) of this section.

(*3*) Because P Corporation never had a depreciable interest in the used airplane and assuming all other requirements are met, P Corporation's purchase price of the used airplane qualifies for the additional first year depreciation deduction for P Corporation under this section.

(W) *Example 23*. (*1*) The facts are the same as in *Example 21* of paragraph (b)(3)(vii)(U)(*1*) of this section, except M Corporation and O Corporation are not related parties within the meaning of section 179(d)(2)(A) or (B) and §1.179–4(c). Additionally, on March 26, 2020, O Corporation sells to M Corporation the used airplane subject to the lease with N Corporation.

(*2*) The sale transaction of May 27, 2018, satisfies the requirements of a syndication transaction described in paragraph (b)(3)(vi) of this section. As a result, O Corporation is considered the taxpayer that acquired the used airplane for purposes of applying the used property acquisition requirements in paragraph (b)(3)(iii) of this section. Also, O Corporation, not M Corporation, is treated as having the depreciable interest in the used airplane. Further, pursuant to paragraph (b)(4)(iv) of this section, the used airplane is treated as originally placed in service by O Corporation on May 27, 2018. Because O Corporation never had a depreciable interest in the used airplane before its acquisition in 2018 and assuming all other requirements are met, O Corporation's purchase price of the used airplane qualifies for the additional first year depreciation deduction for O Corporation under this section.

(*3*) Prior to its acquisition of the used airplane on March 26, 2020, M Corporation never had a depreciable interest in the used airplane pursuant to paragraph (b)(3)(vi) of this section. Assuming all other requirements are met, M Corporation's purchase price of the used airplane on March 26, 2020, qualifies for the additional first year depreciation deduction for M Corporation under this section.

(X) *Example 24*. (*1*) J, K, and L are corporations that are unrelated parties within the meaning of section 179(d)(2)(A) or (B) and §1.179–4(c). None of J, K, or L is a member of a consolidated group. J has a depreciable interest in Equipment #5. During 2018, J sells Equipment #5 to K. During 2020, J merges into L in a transaction described in section 368(a)(1)(A). In 2021, L acquires Equipment #5 from K.

(*2*) Because J is the predecessor of L, and because J previously had a depreciable interest in Equipment #5, L's acquisition of Equipment #5 does not satisfy paragraphs (b)(3)(iii)(A)(*1*) and (b)(3)(iii)(B)(*1*) of this section. Thus, L's acquisition of Equipment #5 does not satisfy the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Accordingly, L's acquisition of Equipment #5 is not eligible for the additional first year depreciation deduction.

(Y) *Example 25*. (*1*) *JL* is a fiscal year taxpayer with a taxable year ending June 30. On April 22, 2020, *JL* acquires and places in service a new machine for use in its trade or business. On May 1, 2022, *JL* sells this machine to *JM*, an unrelated party, for use in *JM*'s trade or business. *JM* is a fiscal year taxpayer with a taxable year ending March 31. On February 1, 2023, *JL* buys the machine from *JM* and places the machine in service. *JL* uses the machine in its trade or business for the remainder of its taxable year ending June 30, 2023.

(*2*) *JL*'s acquisition of the machine on April 22, 2020, satisfies the original use requirement in paragraph (b)(3)(ii) of this section. Assuming all other requirements are met, *JL*'s purchase price of the machine qualifies for the additional first year depreciation deduction for *JL* for the taxable year ending June 30, 2020, under this section.

(*3*) *JM* placed in service the machine on May 1, 2022, and disposed of it on February 1, 2023. As a result, *JM* placed in service and disposed of the machine during the same taxable year (*JM*'s taxable year beginning April 1, 2022, and ending March 31, 2023). Accordingly, *JM*'s acquisition of the machine on May 1, 2022, does not qualify for the additional first year depreciation deduction pursuant to paragraph (g)(1)(i) of this section.

(*4*) Pursuant to paragraph (b)(3)(iii)(B)(*1*) of this section, the lookback period is calendar years 2018 through 2022 and January 1, 2023, through January 31, 2023, to determine if *JL* had a depreciable interest in the machine when *JL* reacquired it on February 1, 2023. As a result, *JL*'s depreciable interest in the machine during the period April 22, 2020, to April 30, 2022, is taken into account for determining whether the machine was used by *JL* or a predecessor at any time prior to its reacquisition by *JL* on February 1, 2023. Accordingly, the reacquisition of the machine by *JL* on February 1, 2023, does not qualify for the additional first year depreciation deduction.

(Z) *Example 26*. (*1*) *EF* has owned and had a depreciable interest in Property since 2012. On January 1, 2016, *EF* contributes assets (not including Property) to existing *Partnership T* in a transaction described in section 721, in exchange for a partnership interest in *Partnership T*, and *Partnership T* placed in service these assets for use in its trade or business. On July 1, 2016, *EF* sells Property to *EG*, a party unrelated to either *EF* or *Partnership T*. On April 1, 2018, *Partnership T* buys Property from *EG* and places it in service for use in its trade or business.

(*2*) *EF* is not *Partnership T*'s predecessor with respect to Property within the meaning of paragraph (a)(2)(iv)(B) of this section. Pursuant to paragraph (b)(3)(iii)(B)(*1*) of this section, the lookback period is 2013–2017, plus January through March 2018, to determine if *Partnership T* had a depreciable interest in Property that *Partnership T* acquired on April 1, 2018. *EF* need not be examined in the lookback period to see if *EF* had a depreciable interest in Property, because *EF* is not *Partnership T*'s predecessor. Because *Partnership T* did not have a depreciable interest in Property in the lookback period prior to its acquisition of Property on April 1, 2018, *Partnership T*'s acquisition of Property on April 1, 2018, satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(B)(*1*) of this section. Assuming all other requirements of this section are satisfied, *Partnership T*'s purchase price of Property qualifies for the additional first year depreciation deduction under this section.

(AA) *Example 27*. (*1*) The facts are the same as in *Example 26* of paragraph (b)(3)(vii)(Z)(*1*) of this section, except that on January 1, 2016, *EF*'s contribution of assets to *Partnership T* includes Property. On July 1, 2016, *Partnership T* sells Property to *EG*.

(*2*) *Partnership T*'s acquisition of Property on January 1, 2016, does not satisfy the original use requirement of §1.168(k)–1(b)(3) and is not eligible for the additional first year depreciation deduction under section 168(k) as in effect prior to the enactment of the Act.

(*3*) With respect to *Partnership T*'s acquisition of Property on April 1, 2018, *EF* is *Partnership T*'s predecessor with respect to Property within the meaning of paragraph (a)(2)(iv)(B) of this section. Pursuant to paragraph (b)(3)(iii)(B)(*1*) of this section, the lookback period is 2013–2017, plus January through March 2018, to determine if *EF* or *Partnership T* had a depreciable interest in Property that *Partnership T* acquired on April 1, 2018. Because *EF* had a depreciable interest in Property from 2013 to 2015 and *Partnership T* had a depreciable interest in Property from January through June 2016, *Partnership T*'s acquisition of Property on April 1, 2018, does not satisfy the used property acquisition requirement of paragraph (b)(3)(iii)(B)(*1*) of this section and is not eligible for the additional first year depreciation deduction.

(BB) *Example 28*. (*1*) X Corporation has owned and had a depreciable interest in Property since 2012. On January 1, 2015, X Corporation sold Property to *Q*, an unrelated party. Y Corporation is formed July 1, 2015. On January 1, 2016, Y Corporation merges into X Corporation in a transaction described in section 368(a)(1)(A). On April 1, 2018, X Corporation buys Property from *Q* and places it in service for use in its trade or business.

(*2*) Pursuant to paragraph (a)(2)(iv)(A) of this section, Y Corporation is X Corporation's predecessor. Pursuant to paragraph (b)(3)(iii)(B)(*1*) of this section, the lookback period is 2013–2017, plus January through March 2018, to determine if Y Corporation or X Corporation had a depreciable interest in Property that X Corporation acquired on April 1, 2018. Y Corporation did not have a depreciable interest in Property at any time during the lookback period. Because X Corporation had a depreciable interest in Property from 2013 through 2014, X Corporation's acquisition of Property on April 1, 2018, does not satisfy the used property acquisition requirement of paragraph (b)(3)(iii)(B)(*1*) of this section and is not eligible for the additional first year depreciation deduction.

(CC) *Example 29*. (*1*) Y Corporation has owned and had a depreciable interest in Property since 2012. On January 1, 2015, Y Corporation sells Property to *Q*, an unrelated party. X Corporation is formed on July 1, 2015. On January 1, 2016, Y Corporation merges into X Corporation in a transaction described in section 368(a)(1)(A). On April 1, 2018, X Corporation buys Property from *Q* and places it in service for use in its trade or business.

(*2*) Pursuant to paragraph (a)(2)(iv)(A) of this section, Y Corporation is X Corporation's predecessor. Pursuant to paragraph (b)(3)(iii)(B)(*1*) of this section, the lookback period is 2013–2017, plus January through March 2018, to determine if X Corporation or Y Corporation had a depreciable interest in Property that X Corporation acquired on April 1, 2018. Because Y Corporation had a depreciable interest in Property from 2013 through 2014, X Corporation's acquisition of Property on April 1, 2018, does not satisfy the used property acquisition requirement of paragraph (b)(3)(iii)(B)(*1*) of this section and is not eligible for the additional first year depreciation deduction.

(DD) *Example 30*. (*1*) On September 5, 2017, *Y*, a calendar-year taxpayer, acquires and places in service a new machine (Machine #1), and begins using Machine #1 in its manufacturing trade or business. On November 1, 2017, *Y* sells Machine #1 to *Z*, then *Z* leases Machine #1 back to *Y* for 4 years, and *Y* continues to use Machine #1 in its manufacturing trade or business. The lease agreement contains a purchase option provision allowing *Y* to buy Machine #1 at the end of the lease term. On November 1, 2021, *Y* exercises the purchase option in the lease agreement and buys Machine #1 from *Z*. The lease between *Y* and *Z* for Machine #1 is a true lease for Federal tax purposes.

(*2*) Because *Y*, a calendar-year taxpayer, placed in service and disposed of Machine #1 during 2017, Machine #1 is not eligible for the additional first year depreciation deduction for *Y* pursuant to § 1.168(k)–1(f)(1)(i).

(*3*) The use of Machine #1 by *Y* prevents *Z* from satisfying the original use requirement of paragraph (b)(3)(ii) of this section. However, *Z*'s acquisition of Machine #1 satisfies the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Assuming all other requirements are met, *Z*'s purchase price of Machine #1 qualifies for the additional first year depreciation deduction for *Z* under this section.

(*4*) During 2017, *Y* sold Machine #1 within 90 calendar days of placing Machine #1 in service originally on September 5, 2017. Pursuant to paragraph (b)(3)(iii)(B)(*4*) of this section, *Y*'s depreciable interest in Machine #1 during that 90-day period is not taken into account for determining whether Machine #1 was used by *Y* or a predecessor at any time prior to its reacquisition by *Y* on November 1, 2021. Accordingly, assuming all other requirements are met, *Y*'s purchase price of Machine #1 on November 1, 2021, qualifies for the additional first year depreciation deduction for *Y* under this section.

(EE) *Example 31*. (*1*) On October 15, 2019, *FA*, a calendar-year taxpayer, buys and places in service a new machine for use in its trade or business. On January 10, 2020, *FA* sells this machine to *FB* for use in *FB*'s trade or business. *FB* is a calendar-year taxpayer and is not related to *FA*. On March 30, 2020, *FA* buys the machine from *FB* and places the machine in service. *FA* uses the machine in its trade or business for the remainder of 2020.

(*2*) *FA*'s acquisition of the machine on October 15, 2019, satisfies the original use requirement in paragraph (b)(3)(ii) of this section. Assuming all other requirements are met, *FA*'s purchase price of the machine qualifies for the additional first year depreciation deduction for *FA* for the 2019 taxable year under this section.

(*3*) Because *FB* placed in service the machine on January 10, 2020, and disposed of it on March 30, 2020, *FB*'s acquisition of the machine on January 10, 2020, does not qualify for the additional first year depreciation deduction pursuant to § 1.168(k)–2(g)(1)(i).

(*4*) *FA* sold the machine to *FB* in 2020 and within 90 calendar days of placing the machine in service originally on October 15, 2019. Pursuant to paragraph (b)(3)(iii)(B)(*4*) of this section, *FA*'s depreciable interest in the machine during that 90-day period is not taken into account for determining whether the machine was used by *FA* or a predecessor at any time prior to its reacquisition by *FA* on March 30, 2020. Accordingly, assuming all other requirements are met, *FA*'s purchase price of the machine on March 30, 2020, qualifies for the additional first year depreciation deduction for *FA* for the 2020 taxable year under this section.

(FF) *Example 32*. (*1*) The facts are the same as in *Example 31* of paragraph (b)(3)(vii)(EE)(*1*) of this section, except that on November 1, 2020, *FB* buys the machine from *FA* and places the machine in service. *FB* uses the machine in its trade or business for the remainder of 2020.

(*2*) Because *FA* placed in service the machine on March 30, 2020, and disposed of it on November 1, 2020, *FA*'s reacquisition of the machine on March 30, 2020, does not qualify for the additional first year depreciation deduction pursuant to paragraph (g)(1)(i) of this section.

(*3*) During 2020, *FB* sold the machine to *FA* within 90 calendar days of placing the machine in service originally on January 10, 2020. After *FB* reacquired the machine on November 1, 2020, *FB* did not dispose of the property during the remainder of 2020. Pursuant to paragraph (b)(3)(iii)(B)(*4*) of this section, *FB*'s depreciable interest in the machine during that 90-day period is not taken into account for determining whether the machine was used by *FB* or a predecessor at any time prior to its reacquisition by *FB* on November 1, 2020. Accordingly, assuming all other requirements are met, *FB*'s purchase price of the machine on November 1, 2020, qualifies for the additional first year depreciation deduction for *FB* under this section.

(GG) *Example 33*. (*1*) The facts are the same as in *Example 32* of paragraph (b)(3)(vii)(FF)(*1*) of this section, except *FB* sells the machine to *FC*, an unrelated party, on December 31, 2020.

(*2*) Because *FB* placed in service the machine on November 1, 2020, and disposed of it on December 31, 2020, *FB*'s reacquisition of the machine on November 1, 2020, does not qualify for the additional first year depreciation deduction pursuant to paragraph (g)(1)(i) of this section.

(*3*) *FC*'s acquisition of the machine on December 31, 2020, satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming all other requirements of this section are satisfied, *FC*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(HH) *Example 34*. (*1*) In August 2017, *FD*, a calendar-year taxpayer, entered into a written binding contract with *X* for *X* to manufacture a machine for *FD* for use in its trade or business. Before September 28, 2017, *FD* incurred more than 10 percent of the total cost of the machine. On February 8, 2020, *X* delivered the machine to *FD* and *FD* placed in service the machine. The machine is property described in section 168(k)(2)(B) as in effect on the day before the date of the enactment of the Act. *FD*'s entire unadjusted depreciable basis of the machine is attributable to the machine's manufacture before January 1, 2020. *FD* uses the safe harbor test in §1.168(k)–1(b)(4)(iii)(B)(*2*) to determine when manufacturing of the machine began. On March 26, 2020, *FD* sells the machine to *FE* for use in *FE*'s trade or business. *FE* is a calendar-year taxpayer and is not related to *FD*. On November 7, 2020, *FD* buys the machine from *FE* and places in service the machine. *FD* uses the machine in its trade or business for the remainder of 2020.

(*2*) Because *FD* incurred more than 10 percent of the cost of the machine before September 28, 2017, and *FD* uses the safe harbor test in §1.168(k)–1(b)(4)(iii)(B)(*2*) to determine when the manufacturing of the machine began, *FD* acquired the machine before September 28, 2017. If *FD* had not disposed of the machine on March 26, 2020, the cost of the machine would have qualified for the 30-percent additional first year depreciation deduction pursuant to section 168(k)(8), assuming all requirements are met under section 168(k)(2) as in effect on the day before the date of the enactment of the Act. However, because *FD* placed in service the machine on February 8, 2020, and disposed of it on March 26, 2020, FD's acquisition of the machine on February 8, 2020, does not qualify for the additional first year depreciation deduction pursuant to §1.168(k)–1(f)(1)(i).

(*3*) Because *FE* placed in service the machine on March 26, 2020, and disposed of it on November 7, 2020, *FE*'s acquisition of the machine on March 26, 2020, does not qualify for the additional first year depreciation deduction pursuant to paragraph (g)(1)(i) of this section.

(*4*) During 2020, *FD* sold the machine to *FE* within 90 calendar days of placing the machine in service originally on February 8, 2020. After *FD* reacquired the machine on November 7, 2020, *FD* did not dispose of the machine during the remainder of 2020. *FD* originally acquired this machine before September 28, 2017. As a result, paragraph (b)(3)(iii)(B)(*4*) of this section does not apply. Pursuant to paragraph (b)(3)(iii)(B)(*1*) of this section, the lookback period is 2015 through 2019 and January 1, 2020, through November 6, 2020, to determine if *FD* had a depreciable interest in the machine when *FD* reacquired it on November 7, 2020. As a result, *FD*'s depreciable interest in the machine during the period February 8, 2020, to March 26, 2020, is taken into account for determining whether the machine was used by *FD* or a predecessor at any time prior to its reacquisition by *FD* on November 7, 2020. Accordingly, the reacquisition of the machine by *FD* on November 7, 2020, does not qualify for the additional first year depreciation deduction.

(II) *Example 35*. (*1*) In a series of related transactions, a father sells a machine to an unrelated individual on December 15, 2019, who sells the machine to the father's daughter on January 2, 2020, for use in the daughter's trade or business. Pursuant to paragraph (b)(3)(iii)(C)(*1*) of this section, a transferee tests its relationship with the transferor from which the transferee directly acquires the depreciable property, and with the original transferor of the depreciable property in the series. The relationship is tested when the transferee acquires, and immediately before the first transfer of, the depreciable property in the series. As a result, the following relationships are tested under section 179(d)(2)(A): The unrelated individual tests its relationship to the father as of December 15, 2019; and the daughter tests her relationship to the unrelated individual as of January 2, 2020, and December 15, 2019, and to the father as of January 2, 2020, and December 15, 2019.

(*2*) Because the individual is not related to the father within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) as of December 15, 2019, the individual's acquisition of the machine satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming the unrelated individual placed the machine in service for use in its trade or business in 2019 and all other requirements of this section are satisfied, the unrelated individual's purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(*3*) The individual and the daughter are not related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) as of January 2, 2020, or December 15, 2019. However, the father and his daughter are related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) as of January 2, 2020, or December 15, 2019. Accordingly, the daughter's acquisition of the machine does not satisfy the used property acquisition requirements of paragraph (b)(3)(iii) of this section and is not eligible for the additional first year depreciation deduction.

(JJ) *Example 36*. (*1*) The facts are the same as in *Example 35* of paragraph (b)(3)(vii)(II)(*1*) of this section, except that instead of selling to an unrelated individual, the father sells the machine to his son on December 15, 2019, who sells the machine to his sister (the father's daughter) on January 2, 2020. Pursuant to paragraph (b)(3)(iii)(C)(*1*) of this section, a transferee tests its relationship with the transferor from which the transferee directly acquires the depreciable property, and with the original transferor of the depreciable property in the series. The relationship is tested when the transferee acquires, and immediately before the first transfer of, the depreciable property in the series. As a result, the following relationships are tested under section 179(d)(2)(A): The son tests his relationship to the father as of December 15, 2019; and the daughter tests her relationship to her brother as of January 2, 2020, and December 15, 2019, and to the father as of January 2, 2020, and December 15, 2019.

(*2*) Because the father and his son are related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) as of December 15, 2019, the son's acquisition of the machine does not satisfy the used property acquisition requirements of paragraph (b)(3)(iii) of this section. Accordingly, the son's acquisition of the machine is not eligible for the additional first year depreciation deduction.

(*3*) The son and his sister are not related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) as of January 2, 2020, or December 15, 2019. However, the father and his daughter are related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) as of January 2, 2020, or December 15, 2019. Accordingly, the daughter's acquisition of the machine does not satisfy the used property acquisition requirements of paragraph (b)(3)(iii) of this section and is not eligible for the additional first year depreciation deduction.

(KK) *Example 37.* (*1*) In June 2018, *BA*, an individual, bought and placed in service a new machine from an unrelated party for use in its trade or business. In a series of related transactions, *BA* sells the machine to *BB* and *BB* places it in service on October 1, 2019, *BB* sells the machine to *BC* and *BC* places it in service on December 1, 2019, and *BC* sells the machine to *BD* and *BD* places it in service on January 2, 2020. *BA* and *BB* are related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii). *BB* and *BC* are related parties within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii). *BC* and *BD* are not related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii), or section 179(d)(2)(B) and §1.179–4(c)(1)(iii). *BA* is not related to *BC* or to *BD* within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii). All parties are calendar-year taxpayers.

(*2*) *BA*'s purchase of the machine in June 2018 satisfies the original use requirement of paragraph (b)(3)(ii) of this section and, assuming all other requirements of this section are met, *BA*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(*3*) Pursuant to paragraph (b)(3)(iii)(C)(*1*) of this section, a transferee tests its relationship with the transferor from which the transferee directly acquires the depreciable property, and with the original transferor of the depreciable property in the series. The relationship is tested when the transferee acquires, and immediately before the first transfer of, the depreciable property in the series. However, because *BB* placed in service and disposed of the machine in the same taxable year, *BB* is disregarded pursuant to paragraph (b)(3)(iii)(C)(*2*)(*i*) of this section. As a result, the following relationships are tested under section 179(d)(2)(A) and (B): *BC* tests its relationship to *BA* as of December 1, 2019, and October 1, 2019; and *BD* tests its relationship to *BC* as of January 2, 2020, and October 1, 2019, and to *BA* as of January 2, 2020, and October 1, 2020.

(*4*) Because *BA* is not related to *BC* within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) as of December 1, 2019, or October 1, 2019, *BC*'s acquisition of the machine satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming all other requirements of this section are satisfied, *BC*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(*5*) Because *BC* is not related to *BD* and *BA* is not related to *BD* within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii), or section 179(d)(2)(B) and §1.179–4(c)(1)(iii) as of January 2, 2020, or October 1, 2019, *BD*'s acquisition of the machine satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming all other requirements of this section are satisfied, *BD*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(LL) *Example 38.* (*1*) In June 2018, *CA*, an individual, bought and placed in service a new machine from an unrelated party for use in his trade or business. In a series of related transactions, *CA* sells the machine to *CB* and *CB* places it in service on September 1, 2019, *CB* transfers the machine to *CC* in a transaction described in paragraph (g)(1)(iii) of this section and *CC* places it in service on November 1, 2019, and *CC* sells the machine to *CD* and *CD* places it in service on January 2, 2020. *CA* and *CB* are not related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii). *CB* and *CC* are related parties within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii). *CB* and *CD* are related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii), or section 179(d)(2)(B) and §1.179–4(c)(1)(iii). *CC* and *CD* are not related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii), or section 179(d)(2)(B) and §1.179–4(c)(1)(iii). *CA* is not related to *CC* or to *CD* within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii). All parties are calendar-year taxpayers.

(*2*) *CA*'s purchase of the machine in June 2018 satisfies the original use requirement of paragraph (b)(3)(ii) of this section and, assuming all other requirements of this section are met, *CA*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(*3*) Pursuant to paragraph (b)(3)(iii)(C)(*1*) of this section, a transferee tests its relationship with the transferor from which the transferee directly acquires the depreciable property, and with the original transferor of the depreciable property in the series. The relationship is tested when the transferee acquires, and immediately before the first transfer of, the depreciable property in the series. However, because *CB* placed in service and transferred the machine in the same taxable year in a transaction described in paragraph (g)(1)(iii) of this section, the section 168(i)(7) transaction between *CB* and *CC* is disregarded pursuant to paragraph (b)(3)(iii)(C)(*2*)(*iii*) of this section. As a result, the following relationships are tested under section 179(d)(2)(A) and (B): *CB* tests its relationship to *CA* as of September 1, 2019; and *CD* tests its relationship to *CB*, *CC*, and *CA* as of January 2, 2020, and September 1, 2019.

(*4*) Because *CA* is not related to *CB* within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) as of September 1, 2019, *CB*'s acquisition of the machine satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming all other requirements of this section are satisfied, *CB*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section. Pursuant to paragraph (g)(1)(iii) of this section, *CB* is allocated 2/12 of its 100-percent additional first year depreciation deduction for the machine, and *CC* is allocated the remaining portion of *CB*'s 100-percent additional first year depreciation deduction for the machine.

(*5*) *CC* is not related to *CD* and *CA* is not related to *CD* within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii), or section 179(d)(2)(B) and §1.179–4(c)(1)(iii) as of January 2, 2020, or September 1, 2019. However, *CB* and *CD* are related parties within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii), or section 179(d)(2)(B) and §1.179–4(c)(1)(iii) as of January 2, 2020, or September 1, 2019. Accordingly, *CD*'s acquisition of the machine does not satisfy the used property acquisition requirements of paragraph (b)(3)(iii) of this section and is not eligible for the additional first year depreciation deduction.

(MM) *Example 39*. (*1*) In a series of related transactions, on January 2, 2018, *DA*, a corporation, bought and placed in service a new machine from an unrelated party for use in its trade or business. As part of the same series, *DB* purchases 100 percent of the stock of *DA* on January 2, 2019, and such stock acquisition meets the requirements of section 1504(a)(2). *DB* and *DA* were not related prior to the acquisition within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) or section 179(d)(2)(B) and §1.179–4(c)(1)(iii). Immediately after acquiring the *DA* stock, and *DB* liquidates *DA* under section 331. In the liquidating distribution, *DB* receives the machine that was acquired by *DA* on January 2, 2018. As part of the same series, on March 1, 2020, *DB* sells the machine to *DC* and *DC* places it in service. Throughout the series, *DC* is not related to *DB* or *DA* within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) or section 179(d)(2)(B) and §1.179–4(c)(1)(iii).

(*2*) *DA*'s purchase of the machine on January 2, 2018, satisfies the original use requirement of paragraph (b)(3)(ii) of this section and, assuming all other requirements of this section are met, *DA*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(*3*) Pursuant to paragraph (b)(3)(iii)(C)(*1*) of this section, a transferee tests its relationship with the transferor from which the transferee directly acquires the depreciable property, and with the original transferor of the depreciable property in the series. The relationship is tested when the transferee acquires, and immediately before the first transfer of, the depreciable property in the series. Although *DA* is no longer in existence as of the date *DC* acquires the machine, pursuant to paragraph (b)(3)(iii)(C)(*2*)(*vi*) of this section, *DA* is deemed to be in existence at the time of each transfer for purposes of testing relationships under paragraph (b)(3)(iii)(C)(*1*). As a result, the following relationships are tested under section 179(d)(2)(A) and (B): *DB* tests its relationship to *DA* as of January 2, 2019, and January 2, 2018; and *DC* tests its relationship to *DB* and *DA* as of March 1, 2020, and January 2, 2018.

(*4*) Because *DB* acquired the machine in a series of related transactions in which *DB* acquired stock, meeting the requirements of section 1504(a)(2), of *DA* followed by a liquidation of *DA* under section 331, the relationship of *DB* and *DA* created thereof is disregarded for purposes of testing the relationship pursuant to paragraph (b)(3)(iii)(C)(*2*)(*v*) of this section. Therefore, *DA* is not related to *DB* within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) or section 179(d)(2)(B) and §1.179–4(c)(1)(iii) as of January 2, 2019, or January 2, 2018, and *DB*'s acquisition of the machine satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming all other requirements of this section are satisfied, *DB*'s depreciable basis of the machine as a result of the liquidation of *DA* qualifies for the additional first year depreciation deduction under this section.

(*5*) Because *DC* is not related to *DB* or *DA* within the meaning of section 179(d)(2)(A) and §1.179–4(c)(1)(ii) or section 179(d)(2)(B) and §1.179–4(c)(1)(iii) as of March 1, 2020, or January 2, 2018, *DC*'s acquisition of the machine satisfies the used property acquisition requirements of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming all other requirements of this section are satisfied, *DC*'s purchase price of the machine qualifies for the additional first year depreciation deduction.

(NN) *Example 40*. (*1*) Pursuant to a series of related transactions, on January 2, 2018, *EA* bought and placed in service a new machine from an unrelated party for use in its trade or business. As part of the same series, *EA* sells the machine to *EB* and *EB* places it in service on January 2, 2019. As part of the same series, *EB* sells the machine to *EC* and *EC* places it in service on January 2, 2020. Throughout the series, *EA* is not related to *EB* or *EC* within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii). *EB* and *EC* were related parties within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii) until July 1, 2019, at which time, they ceased to be related.

(*2*) *EA*'s purchase of the machine on January 2, 2018, satisfies the original use requirement of paragraph (b)(3)(ii) of this section and, assuming all other requirements of this section are met, *EA*'s purchase price of the machines qualifies for the additional first year depreciation deduction under this section.

(*3*) Pursuant to paragraph (b)(3)(iii)(C)(*1*) of this section, a transferee tests its relationship with the transferor from which the transferee directly acquires the depreciable property, and with the original transferor of the depreciable property in the series. The relationship is tested when the transferee acquires, and immediately before the first transfer of, the depreciable property in the series. As a result, the following relationships are tested under section 179(d)(2)(A) and (B): *EB* tests its relationship to *EA* as of January 2, 2019, and January 2, 2018; and *EC* tests its relationship to *EA* and *EB* as of January 2, 2020, and January 2, 2018.

(*4*) Because *EA* is not related to *EB* within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii) as of January 2, 2019, or January 2, 2018, *EB*'s acquisition of the machine satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming all other requirements of this section are satisfied, *EB*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(*5*) *EC* and *EA* are not related parties within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii) as of January 2, 2020, or January 2, 2018. Within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii), *EC* is not related to *EB* as of January 2, 2020; however, *EC* is related to *EB* as of January 2, 2018. Accordingly, *EC*'s acquisition of the machine does not satisfy the used property acquisition requirement of paragraph (b)(3)(iii) of this section and is not eligible for the additional first year depreciation deduction.

(OO) *Example 41*. (*1*) The facts are the same as in *Example 40* of paragraph (b)(3)(vii)(NN)(*1*) of this section, except that instead of selling to *EC*, *EB* sells the machine to *EE*, and *EE* places in service on January 2, 2020, and *EE* sells the machine to *EC* and *EC* places in service on January 2, 2021. *EE* was not in existence until July 2019 and is not related to *EA* or *EB*.

(*2*) *EA*'s purchase of the machine on January 2, 2018, satisfies the original use requirement of paragraph (b)(3)(ii) of this section and, assuming all other requirements of this section are met, *EA*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(*3*) Pursuant to paragraph (b)(3)(iii)(C)(*1*) of this section, a transferee tests its relationship with the transferor from which the transferee directly acquires the depreciable property, and with the original transferor of the depreciable property in the series. The relationship is tested when the transferee acquires, and immediately before the first transfer of, the depreciable property in the series. However, because *EE* was not in existence immediately prior to the first transfer of the depreciable property in the series, *EC* tests its relationship with *EB* and *EA* pursuant to paragraph (b)(3)(iii)(C)(*2*)(*vii*) of this section. As a result, the following relationships are tested under section 179(d)(2)(A) and (B): *EB* tests its relationship to *EA* as of January 2, 2019, and January 2, 2018; *EE* tests its relationship to *EA* and *EB* as of January 2, 2020, and January 2, 2018; and *EC* tests its relationship to *EA* and *EB* as of January 2, 2021, and January 2, 2018.

(*4*) Because *EA* is not related to *EB* within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii) as of January 2, 2019, or January 2, 2018, *EB*'s acquisition of the machine satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming all other requirements of this section are satisfied, *EB*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(*5*) Because *EE* is not related to *EA* or *EB* within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii) as of January 2, 2020, or January 2, 2018, *EE*'s acquisition of the machine satisfies the used property acquisition requirement of paragraph (b)(3)(iii)(A)(*2*) of this section. Accordingly, assuming all other requirements of this section are satisfied, *EE*'s purchase price of the machine qualifies for the additional first year depreciation deduction under this section.

(*6*) Within the meaning of section 179(d)(2)(B) and §1.179–4(c)(1)(iii), *EC* is not related to *EA* as of January 2, 2021, or January 2, 2018; however, *EC* is related to *EB* as of January 2, 2018. Accordingly, *EC*'s acquisition of the machine does not satisfy the used property acquisition requirement of paragraph (b)(3)(iii) of this section and is not eligible for the additional first year depreciation deduction.

(4) *Placed-in-service date*—(i) *In general*. Depreciable property will meet the requirements of this paragraph (b)(4) if the property is placed in service by the taxpayer for use in its trade or business or for production of income after September 27, 2017; and, except as provided in paragraphs (b)(2)(i)(A) and (D) of this section, before January 1, 2027, or, in the case of property described in section 168(k)(2)(B) or (C), before January 1, 2028.

(ii) *Specified plant*. If the taxpayer has properly made an election to apply section 168(k)(5) for a specified plant, the requirements of this paragraph (b)(4) are satisfied only if the specified plant is planted before January 1, 2027, or is grafted before January 1, 2027, to a plant that has already been planted, by the taxpayer in the ordinary course of the taxpayer's farming business, as defined in section 263A(e)(4).

(iii) *Qualified film, television, or live theatrical production*—(A) *Qualified film or television production*. For purposes of this paragraph (b)(4), a qualified film or television production is treated as placed in service at the time of initial release or broadcast as defined under §1.181–1(a)(7). The taxpayer that places in service a qualified film or television production must be the owner, as defined in §1.181–1(a)(2), of the qualified film or television production.

(B) *Qualified live theatrical production.* For purposes of this paragraph (b)(4), a qualified live theatrical production is treated as placed in service at the time of the initial live staged performance. The taxpayer that places in service a qualified live theatrical production must be the owner, as defined in paragraph (b)(2)(i)(F) of this section and in §1.181–1(a)(2), of the qualified live theatrical production.

(iv) *Syndication transaction.* If new property is acquired and placed in service by a lessor, or if used property is acquired and placed in service by a lessor and the lessor and any predecessor did not previously have a depreciable interest in the used property, and the property is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor (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), and the user of the property after the last sale during this three-month period remains the same as when the property was originally placed in service by the lessor, the property is treated as originally placed in service by the purchaser of the property in the last sale during the three-month period but not earlier than the date of the last sale for purposes of sections 167 and 168, and §§1.46–3(d) and 1.167(a)–11(e)(1).

(v) *Technical termination of a partnership.* For purposes of this paragraph (b)(4), in the case of a technical termination of a partnership under section 708(b)(1)(B) occurring in a taxable year beginning before January 1, 2018, qualified property placed in service by the terminated partnership during the taxable year of termination is treated as originally placed in service by the new partnership on the date the qualified property is contributed by the terminated partnership to the new partnership.

(vi) *Section 168(i)(7) transactions.* For purposes of this paragraph (b)(4), if qualified property is transferred in a transaction described in section 168(i)(7) in the same taxable year that the qualified property is placed in service by the transferor, the transferred property is treated as originally placed in service on the date the transferor placed in service the qualified property. In the case of multiple transfers of qualified property in multiple transactions described in section 168(i)(7) in the same taxable year, the placed-in-service date of the transferred property is deemed to be the date on which the first transferor placed in service the qualified property.

(5) *Acquisition of property*—(i) *In general.* This paragraph (b)(5) provides rules for the acquisition requirements in section 13201(h) of the Act. These rules apply to all property, including self-constructed property or property described in section 168(k)(2)(B) or (C).

(ii) *Acquisition date*—(A) *In general.* Except as provided in paragraph (b)(5)(vi) of this section, depreciable property will meet the requirements of this paragraph (b)(5) if the property is acquired by the taxpayer after September 27, 2017, or is acquired by the taxpayer pursuant to a written binding contract entered into by the taxpayer after September 27, 2017. Property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or for its production of income is not acquired pursuant to a written binding contract but is considered to be self-constructed property under this paragraph (b)(5). For determination of acquisition date, see paragraph (b)(5)(ii)(B) of this section for property acquired pursuant to a written binding contract, paragraph (b)(5)(iv) of this section for self-constructed property, and paragraph (b)(5)(v) of this section for property not acquired pursuant to a written binding contract.

(B) *Determination of acquisition date for property acquired pursuant to a written binding contract.* Except as provided in paragraphs (b)(5)(vi) and (vii) of this section, the acquisition date of property that the taxpayer acquired pursuant to a written binding contract is the later of—

(*1*) The date on which the contract was entered into;

(*2*) The date on which the contract is enforceable under State law;

(*3*) If the contract has one or more cancellation periods, the date on which all cancellation periods end. For purposes of this paragraph (b)(5)(ii)(B)(*3*), a cancellation period is the number of days stated in the contract for any party to cancel the contract without penalty; or

(*4*) If the contract has one or more contingency clauses, the date on which all conditions subject to such clauses are satisfied. For purposes of this paragraph (b)(5)(ii)(B)(*4*), a contingency clause is one that provides for a condition (or conditions) or action (or actions) that is within the control of any party or a predecessor.

(iii) *Definition of binding contract*—(A) *In general.* Except as provided in paragraph (b)(5)(iii)(G) of this section, a contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). For this purpose, any contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. If a contract has multiple provisions that limit damages, only the provision with the highest damages is taken into account in determining whether the contract limits damages. Also, in determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account. For example, if a taxpayer entered into an irrevocable written contract to purchase an asset for $100 and the contract did not contain a provision for liquidated damages, the contract is considered binding notwithstanding the fact that the asset had a fair market value of $99 and under local law the seller would only recover the difference in the event the purchaser failed to perform. If the contract provided for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation, the contract is not considered binding.

(B) *Conditions.* Except as provided in paragraph (b)(5)(iii)(G) of this section, a contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions or if any term is to be determined by a standard beyond the control of either party. A contract that imposes significant obligations on the taxpayer or a predecessor will be treated as binding notwithstanding the fact that certain terms remain to be negotiated by the parties to the contract.

(C) *Options.* An option to either acquire or sell property is not a binding contract.

(D) *Letter of intent.* A letter of intent for an acquisition is not a binding contract.

(E) *Supply agreements.* A binding contract does not include a supply or similar agreement if the amount and design specifications of the property to be purchased have not been specified. The contract will not be a binding contract for the property to be purchased until both the amount and the design specifications are specified. For example, if the provisions of a supply or similar agreement state the design specifications of the property to be purchased, a purchase order under the agreement for a specific number of assets is treated as a binding contract.

(F) *Components.* A binding contract to acquire one or more components of a larger property will not be treated as a binding contract to acquire the larger property. If a binding contract to acquire the component does not satisfy the requirements of this paragraph (b)(5), the component does not qualify for the additional first year depreciation deduction under this section.

(G) *Acquisition of a trade or business or an entity.* A contract to acquire all or substantially all of the assets of a trade or business or to acquire an entity (for example, a corporation, a partnership, or a limited liability company) is binding if it is enforceable under State law against the parties to the contract. The presence of a condition outside the control of the parties, including, for example, regulatory agency approval, will not prevent the contract from being a binding contract. Further, the fact that insubstantial terms remain to be negotiated by the parties to the contract, or that customary conditions remain to be satisfied, does not prevent the contract from being a binding contract. This paragraph (b)(5)(iii)(G) also applies to a contract for the sale of the stock of a corporation that is treated as an asset sale as a result of an election under section 338 or under section 336(e) made for a disposition described in §1.336–2(b)(1).

(iv) *Self-constructed property*—(A) *In general*. If a taxpayer manufactures, constructs, or produces property for use by the taxpayer in its trade or business or for its production of income, the acquisition rules in paragraph (b)(5)(ii) of this section are treated as met for the property if the taxpayer begins manufacturing, constructing, or producing the property after September 27, 2017. Property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract, as defined in paragraph (b)(5)(iii) of this section, that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or for its production of income is considered to be manufactured, constructed, or produced by the taxpayer. If a taxpayer enters into a written binding contract, as defined in paragraph (b)(5)(iii) of this section, before September 28, 2017, with another person to manufacture, construct, or produce property and the manufacture, construction, or production of this property begins after September 27, 2017, the acquisition rules in paragraph (b)(5)(ii) of this section are met.

(B) *When does manufacture, construction, or production begin*—(*1*) *In general*. For purposes of paragraph (b)(5)(iv)(A) of this section, 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 retail motor fuels outlet is to be constructed on-site, construction begins when physical work of a significant nature commences at the site; that is, when work begins on the excavation for footings, pouring the pads for the outlet, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings) does not constitute the beginning of construction. However, if a retail motor fuels outlet is to be assembled on-site from modular units manufactured off-site and delivered to the site where the outlet will be used, manufacturing begins when physical work of a significant nature commences at the off-site location.

(*2*) *Safe harbor*. For purposes of paragraph (b)(5)(iv)(B)(*1*) of this section, a taxpayer may choose to determine when physical work of a significant nature begins in accordance with this paragraph (b)(5)(iv)(B)(*2*). Physical work of a significant nature will be considered to begin at the time the taxpayer incurs (in the case of an accrual basis taxpayer) or pays (in the case of a cash basis taxpayer) 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. When property is manufactured, constructed, or produced for the taxpayer by another person, this safe harbor test must be satisfied by the taxpayer. For example, if a retail motor fuels outlet or other facility is to be constructed for an accrual basis taxpayer by another person for the total cost of $200,000, excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching, construction is deemed to begin for purposes of this paragraph (b)(5)(iv)(B)(*2*) when the taxpayer has incurred more than 10 percent (more than $20,000) of the total cost of the property. A taxpayer chooses to apply this paragraph (b)(5)(iv)(B)(*2*) by filing a Federal income tax return for the placed-in-service year of the property that determines when physical work of a significant nature begins consistent with this paragraph (b)(5)(iv)(B)(*2*).

(C) *Components of self-constructed property*—(*1*) *Acquired components.* If a binding contract, as defined in paragraph (b)(5)(iii) of this section, to acquire a component does not satisfy the requirements of paragraph (b)(5)(ii) of this section, the component does not qualify for the additional first year depreciation deduction under this section. A binding contract described in the preceding sentence to acquire one or more components of a larger self-constructed property will not preclude the larger self-constructed property from satisfying the acquisition rules in paragraph (b)(5)(iv)(A) of this section. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the additional first year depreciation deduction under this section, assuming all other requirements are met, must not include the unadjusted depreciable basis of any component that does not satisfy the requirements of paragraph (b)(5)(ii) of this section. If the manufacture, construction, or production of the larger self-constructed property begins before September 28, 2017, the larger self-constructed property and any acquired components related to the larger self-constructed property do not qualify for the additional first year depreciation deduction under this section, except as provided in paragraph (c) of this section. If a binding contract to acquire the component is entered into after September 27, 2017, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2027, the component qualifies for the additional first year depreciation deduction under this section, assuming all other requirements are met, but the larger self-constructed property does not.

(*2*) *Self-constructed components.* If the manufacture, construction, or production of a component does not satisfy the requirements of this paragraph (b)(5)(iv), the component does not qualify for the additional first year depreciation deduction under this section. However, if the manufacture, construction, or production of a component does not satisfy the requirements of this paragraph (b)(5)(iv), but the manufacture, construction, or production of the larger self-constructed property satisfies the requirements of this paragraph (b)(5)(iv), the larger self-constructed property qualifies for the additional first year depreciation deduction under this section, assuming all other requirements are met, even though the component does not qualify for the additional first year depreciation deduction under this section. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the additional first year depreciation deduction under this section, assuming all other requirements are met, must not include the unadjusted depreciable basis of any component that does not qualify for the additional first year depreciation deduction under this section. If the manufacture, construction, or production of the larger self-constructed property began before September 28, 2017, the larger self-constructed property and any self-constructed components related to the larger self-constructed property do not qualify for the additional first year depreciation deduction under this section, except as provided in paragraph (c) of this section. If the manufacture, construction, or production of a component begins after September 27, 2017, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2027, the component qualifies for the additional first year depreciation deduction under this section, assuming all other requirements are met, but the larger self-constructed property does not.

(v) *Determination of acquisition date for property not acquired pursuant to a written binding contract.* Except as provided in paragraphs (b)(5)(iv), (vi), and (vii) of this section, the acquisition date of property that the taxpayer acquires pursuant to a contract that does not meet the definition of a written binding contract in paragraph (b)(5)(iii) of this section, is the date on which the taxpayer paid, in the case of a cash basis taxpayer, or incurred, in the case of an accrual basis taxpayer, more than 10 percent of the total cost of the property, excluding the cost of any land and preliminary activities such as planning and designing, securing financing, exploring, or researching. The preceding sentence also applies to property that is manufactured, constructed, or produced for the taxpayer by another person under a written contract that does not meet the definition of a binding contract in paragraph (b)(5)(iii) of this section, and that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or for its production of income. This paragraph (b)(5)(v) does not apply to an acquisition described in paragraph (b)(5)(iii)(G) of this section.

(vi) *Qualified film, television, or live theatrical production*—(A) *Qualified film or television production.* For purposes of section 13201(h)(1)(A) of the Act, a qualified film or television production is treated as acquired on the date principal photography commences.

(B) *Qualified live theatrical production.* For purposes of section 13201(h)(1)(A) of the Act, a qualified live theatrical production is treated as acquired on the date when all of the necessary elements for producing the live theatrical production are secured. These elements may include a script, financing, actors, set, scenic and costume designs, advertising agents, music, and lighting.

(vii) *Specified plant.* If the taxpayer has properly made an election to apply section 168(k)(5) for a specified plant, the requirements of this paragraph (b)(5) are satisfied if the specified plant is planted after September 27, 2017, or is grafted after September 27, 2017, to a plant that has already been planted, by the taxpayer in the ordinary course of the taxpayer's farming business, as defined in section 263A(e)(4).

(viii) *Examples.* The application of this paragraph (b)(5) is illustrated by the following examples. Unless the facts specifically indicate otherwise, assume that the parties are not related within the meaning of section 179(d)(2)(A) or (B) and §1.179–4(c), paragraph (c) of this section does not apply, and the parties do not have predecessors:

(A) *Example 1.* On September 1, 2017, *BB*, a corporation, entered into a written agreement with *CC*, a manufacturer, to purchase 20 new lamps for $100 each within the next two years. Although the agreement specifies the number of lamps to be purchased, the agreement does not specify the design of the lamps to be purchased. Accordingly, the agreement is not a binding contract pursuant to paragraph (b)(5)(iii)(E) of this section.

(B) *Example 2.* The facts are the same as in *Example 1* of paragraph (b)(5)(viii)(A) of this section. On December 1, 2017, *BB* placed a purchase order with *CC* to purchase 20 new model XPC5 lamps for $100 each for a total amount of $2,000. Because the agreement specifies the number of lamps to be purchased and the purchase order specifies the design of the lamps to be purchased, the purchase order placed by *BB* with *CC* on December 1, 2017, is a binding contract pursuant to paragraph (b)(5)(iii)(E) of this section. Accordingly, assuming all other requirements are met, the cost of the 20 lamps qualifies for the 100-percent additional first year depreciation deduction.

(C) *Example 3.* The facts are the same as in *Example 1* of paragraph (b)(5)(viii)(A) of this section, except that the written agreement between *BB* and *CC* is to purchase 100 model XPC5 lamps for $100 each within the next two years. Because this agreement specifies the amount and design of the lamps to be purchased, the agreement is a binding contract pursuant to paragraph (b)(5)(iii)(E) of this section. However, because the agreement was entered into before September 28, 2017, no lamp acquired by *BB* under this contract qualifies for the 100-percent additional first year depreciation deduction.

(D) *Example 4.* On September 1, 2017, *DD* began constructing a retail motor fuels outlet for its own use. On November 1, 2018, *DD* ceases construction of the retail motor fuels outlet prior to its completion. Between September 1, 2017, and November 1, 2018, *DD* incurred $3,000,000 of expenditures for the construction of the retail motor fuels outlet. On May 1, 2019, *DD* resumed construction of the retail motor fuels outlet and completed its construction on August 31, 2019. Between May 1, 2019, and August 31, 2019, *DD* incurred another $1,600,000 of expenditures to complete the construction of the retail motor fuels outlet and, on September 1, 2019, *DD* placed the retail motor fuels outlet in service. None of *DD*'s total expenditures of $4,600,000 qualify for the 100-percent additional first year depreciation deduction because, pursuant to paragraph (b)(5)(iv)(A) of this section, *DD* began constructing the retail motor fuels outlet before September 28, 2017.

(E) *Example 5*. The facts are the same as in *Example 4* of paragraph (b)(5)(viii)(D) of this section except that *DD* began constructing the retail motor fuels outlet for its own use on October 1, 2017, and *DD* incurred the $3,000,000 between October 1, 2017, and November 1, 2018. *DD*'s total expenditures of $4,600,000 qualify for the 100-percent additional first year depreciation deduction because, pursuant to paragraph (b)(5)(iv)(A) of this section, *DD* began constructing the retail motor fuels outlet after September 27, 2017, and *DD* placed the retail motor fuels outlet in service on September 1, 2019. Accordingly, assuming all other requirements are met, the additional first year depreciation deduction for the retail motor fuels outlet will be $4,600,000, computed as $4,600,000 multiplied by 100 percent.

(F) *Example 6*. On August 15, 2017, *EE*, an accrual basis taxpayer, entered into a written binding contract with *FF* to manufacture an aircraft described in section 168(k)(2)(C) for use in *EE*'s trade or business. *FF* begins to manufacture the aircraft on October 1, 2017. The completed aircraft is delivered to *EE* on February 15, 2018, at which time *EE* incurred the total cost of the aircraft. *EE* places the aircraft in service on March 1, 2018. Pursuant to paragraphs (b)(5)(ii)(A) and (b)(5)(iv)(A) of this section, the aircraft is considered to be manufactured by *EE*. Because *EE* began manufacturing the aircraft after September 27, 2017, the aircraft qualifies for the 100-percent additional first year depreciation deduction, assuming all other requirements are met.

(G) *Example 7*. On June 1, 2017, *HH* entered into a written binding contract with GG to acquire a new component part of property that is being constructed by *HH* for its own use in its trade or business. *HH* commenced construction of the property in November 2017, and placed the property in service in November 2018. Because *HH* entered into a written binding contract to acquire a component part prior to September 28, 2017, pursuant to paragraphs (b)(5)(ii) and (b)(5)(iv)(C)(*1*) of this section, the component part does not qualify for the 100-percent additional first year depreciation deduction. However, pursuant to paragraphs (b)(5)(iv)(A) and (b)(5)(iv)(C)(*1*) of this section, the property constructed by *HH* will qualify for the 100-percent additional first year depreciation deduction, because construction of the property began after September 27, 2017, assuming all other requirements are met. Accordingly, the unadjusted depreciable basis of the property that is eligible for the 100-percent additional first year depreciation deduction must not include the unadjusted depreciable basis of the component part.

(H) *Example 8*. The facts are the same as in *Example 7* of paragraph (b)(5)(viii)(G) of this section except that *HH* entered into the written binding contract with GG to acquire the new component part on September 30, 2017, and *HH* commenced construction of the property on August 1, 2017. Pursuant to paragraphs (b)(5)(iv)(A) and (C) of this section, neither the property constructed by *HH* nor the component part will qualify for the 100-percent additional first year depreciation deduction, because *HH* began construction of the property prior to September 28, 2017.

(I) *Example 9*. On September 1, 2017, *II* acquired and placed in service equipment. On January 15, 2018, *II* sells the equipment to *JJ* and leases the property back from *JJ* in a sale-leaseback transaction. Pursuant to paragraph (b)(5)(ii) of this section, *II*'s cost of the equipment does not qualify for the 100-

percent additional first year depreciation deduction because *II* acquired the equipment prior to September 28, 2017. However, *JJ* acquired used equipment from an unrelated party after September 27, 2017, and, assuming all other requirements are met, *JJ*'s cost of the used equipment qualifies for the 100-percent additional first year depreciation deduction for *JJ*.

(J) *Example 10*. On July 1, 2017, *KK* began constructing property for its own use in its trade or business. *KK* placed this property in service on September 15, 2017. On January 15, 2018, *KK* sells the property to *LL* and leases the property back from *LL* in a sale-leaseback transaction. Pursuant to paragraph (b)(5)(iv) of this section, *KK*'s cost of the property does not qualify for the 100-percent additional first year depreciation deduction because *KK* began construction of the property prior to September 28, 2017. However, *LL* acquired used property from an unrelated party after September 27, 2017, and, assuming all other requirements are met, *LL*'s cost of the used property qualifies for the 100-percent additional first year depreciation deduction for *LL*.

(K) *Example 11*. *MM*, a calendar year taxpayer, is engaged in a trade or business described in section 163(j)(7)(A)(iv). In December 2018, *MM* began constructing a new electric generation power plant for its own use. *MM* placed in service this new power plant, including all component parts, in 2020. Even though *MM* began constructing the power plant after September 27, 2017, none of *MM*'s total expenditures of the power plant qualify for the additional first year depreciation deduction under this section because, pursuant to paragraph (b)(2)(ii)(F) of this section, the power plant is property that is primarily used in a trade or business described in section 163(j)(7)(A)(iv) and the power plant was placed in service in *MM*'s taxable year beginning after 2017.

(c) *Election for components of larger self-constructed property for which the manufacture, construction, or production begins before September 28, 2017*—(1) *In general*. A taxpayer may elect to treat any acquired or self-constructed component, as described in paragraph (c)(3) of this section, of the larger self-constructed property, as described in paragraph (c)(2) of this section, as being eligible for the additional first year depreciation deduction under this section, assuming all requirements of section 168(k) and this section are met. The taxpayer may make this election for one or more such components.

(2) *Eligible larger self-constructed property*—(i) *In general*. Solely for purposes of this paragraph (c), a larger self-constructed property is property that is manufactured, constructed, or produced by the taxpayer for its own use in its trade or business or production of income. Solely for purposes of this paragraph (c), property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract, as defined in paragraph (b)(5)(iii) of this section, or under a written contract that does not meet the definition of a binding contract in paragraph (b)(5)(iii) of this section, that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or production of income is considered to be manufactured, constructed, or produced by the taxpayer. Except as provided in paragraph (c)(2)(iv) of this section, such larger self-constructed property must be property—

(A) That is described in paragraph (b)(2)(i)(A), (B), (C), or (D) of this section. Solely for purposes of the preceding sentence, the requirement that property has to be acquired after September 27, 2017, is disregarded;

(B) That meets the requirements under paragraph (b) of this section, determined without regard to the acquisition date requirement in paragraph (b)(5) of this section; and

(C) For which the taxpayer begins the manufacture, construction, or production before September 28, 2017.

(ii) *Residential rental property or nonresidential real property*. If the taxpayer constructs, manufactures, or produces residential rental property or nonresidential real property, as defined in section 168(e)(2), or an improvement to such property, for use in its trade or business or production of income, all property that is constructed, manufactured, or produced as part of such residential rental property, nonresidential real property, or improvement, as applicable, and that is described in paragraph (c)(2)(i)(A) of this section is the larger self-constructed property for purposes of applying the rules in this paragraph (c).

(iii) *Beginning of manufacturing, construction, or production.* Solely for purposes of paragraph (c)(2)(i)(C) of this section, the determination of when manufacture, construction, or production of the larger self-constructed property begins is made in accordance with the rules in paragraph (b)(5)(iv)(B) of this section if the larger self-constructed property is manufactured, constructed, or produced by the taxpayer for its own use in its trade or business or production of income, or is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract, as defined in paragraph (b)(5)(iii) of this section, that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or production of income. If the larger self-constructed property is manufactured, constructed, or produced for the taxpayer by another person under a written contract that does not meet the definition of a binding contract in paragraph (b)(5)(iii) of this section, that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or production of income, the determination of when manufacture, construction, or production of the larger self-constructed property begins is made in accordance with the rules in paragraph (b)(5)(v) of this section. If the taxpayer enters into a written binding contract, as defined in paragraph (b)(5)(iii) of this section, before September 28, 2017, with another person to manufacture, construct, or produce the larger self-constructed property and the manufacture, construction, or production of this property begins after September 27, 2017, as determined under paragraph (b)(5)(iv)(B) of this section, this paragraph (c) does not apply. If the taxpayer enters into a written contract that does not meet the definition of a binding contract in paragraph (b)(5)(iii) of this section before September 28, 2017, with another person to manufacture, construct, or produce the larger self-constructed property and the manufacture, construction, or production of this property begins after September 27, 2017, as determined under paragraph (b)(5)(v) of this section, this paragraph (c) does not apply.

(iv) *Exception.* This paragraph (c) does not apply to any larger self-constructed property that is included in a class of property for which the taxpayer made an election under section 168(k)(7) (formerly section 168(k)(2)(D)(iii)) not to deduct the additional first year depreciation deduction.

(3) *Eligible components*—(i) *In general.* Solely for purposes of this paragraph (c), a component of the larger self-constructed property, as described in paragraph (c)(2) of this section, must be qualified property under section 168(k)(2) and paragraph (b) of this section. Solely for purposes of the preceding sentence, a component will satisfy the acquisition date requirement in paragraph (b)(5) of this section if it satisfies the requirements in paragraph (c)(3)(ii) or (iii) of this section, as applicable.

(ii) *Acquired components.* If a component of the larger self-constructed property is acquired pursuant to a written binding contract, as defined in paragraph (b)(5)(iii) of this section, the component must be acquired by the taxpayer after September 27, 2017, as determined under the rules in paragraph (b)(5)(ii)(B) of this section. If a component of the larger self-constructed property is acquired pursuant to a written contract that does not meet the definition of a binding contract in paragraph (b)(5)(iii) of this section, the component must be acquired by the taxpayer after September 27, 2017, as determined under the rules in paragraph (b)(5)(v) of this section.

(iii) *Self-constructed components.* The manufacture, construction, or production of a component of a larger self-constructed property must begin after September 27, 2017. The determination of when manufacture, construction, or production of the component begins is made in accordance with the rules in—

(A) Paragraph (b)(5)(iv)(B) of this section if the component is manufactured, constructed, or produced by the taxpayer for its own use in its trade or business or for its production of income, or is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract, as defined in paragraph (b)(5)(iii) of this section, that is entered into prior to the manufacture, construction, or production of the component for use by the taxpayer in its trade or business or for its production of income; or

(B) Paragraph (b)(5)(v) of this section if the component is manufactured, constructed, or produced for the taxpayer by another person under a written contract that does not meet the definition of a binding contract in paragraph (b)(5)(iii) of this section, that is entered into prior to the manufacture, construction, or production of the component for use by the taxpayer in its trade or business or for its production of income.

(4) *Special rules*—(i) *Installation costs.* If the taxpayer pays, in the case of a cash basis taxpayer, or incurs, in the case of an accrual basis taxpayer, costs, including labor costs, to install a component of the larger self-constructed property, as described in paragraph (c)(2) of this section, such costs are eligible for the additional first year depreciation under this section, assuming all requirements are met, only if the component being installed meets the requirements in paragraph (c)(3) of this section.

(ii) *Property described in section 168(k)(2)(B).* The rules in paragraph (e)(1)(iii) of this section apply for determining the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3), of larger self-constructed property described in paragraph (c)(2) of this section and in section 168(k)(2)(B).

(5) *Computation of additional first year depreciation deduction*—(i) *Election is made.* Before determining the allowable additional first year depreciation deduction for the larger self-constructed property, as described in paragraph (c)(2) of this section, for which the taxpayer makes the election specified in this paragraph (c) for one or more components of such property, the taxpayer must determine the portion of the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3), of the larger self-constructed property, including all components, attributable to the component that meets the requirements of paragraphs (c)(3) and (c)(4)(i) of this section (component basis). The additional first year depreciation deduction for the component basis is determined by multiplying such component basis by the applicable percentage for the placed-in-service year of the larger self-constructed property. The additional first year depreciation deduction, if any, for the remaining unadjusted depreciable basis of the larger self-constructed property, as described in paragraph (c)(2) of this section, is determined under section 168(k), as in effect on the day before the date of the enactment of the Act, and section 168(k)(8). For purposes of this paragraph (c), the remaining unadjusted depreciable basis of the larger self-constructed property is equal to the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3), of the larger self-constructed property, including all components, reduced by the sum of the component basis of the components for which the taxpayer makes the election specified in this paragraph (c).

(ii) *Election is not made.* If the taxpayer does not make the election specified in this paragraph (c), the additional first year depreciation deduction, if any, for the larger self-constructed property, including all components, is determined under section 168(k), as in effect on the day before the date of the enactment of the Act, and section 168(k)(8).

(6) *Time and manner for making election*—(i) *Time for making election.* The election specified in this paragraph (c) must be made by the due date, including extensions, of the Federal tax return for the taxable year in which the taxpayer placed in service the larger self-constructed property.

(ii) *Manner of making election.* The election specified in this paragraph (c) must be made by attaching a statement to such return indicating that the taxpayer is making the election provided in this paragraph (c) and whether the taxpayer is making the election for all or some of the components described in paragraph (c)(3) of this section. The election is made separately by each person owning qualified property (for example, for each member of a consolidated group by the agent for the group (within the meaning of § 1.1502–77(a) and (c)), by the partnership (including a lower-tier partnership), or by the S corporation).

(7) *Revocation of election*—(i) *In general*. Except as provided in paragraph (c)(7)(ii) of this section, the election specified in this paragraph (c), once made, may be revoked only by filing a request for a private letter ruling and obtaining the Commissioner of Internal Revenue's written consent to revoke the election. The Commissioner may grant a request to revoke the election if the taxpayer acted reasonably and in good faith, and the revocation will not prejudice the interests of the Government. See generally § 301.9100–3 of this chapter. The election specified in this paragraph (c) may not be revoked through a request under section 446(e) to change the taxpayer's method of accounting.

(ii) *Automatic 6-month extension*. If a taxpayer made the election specified in this paragraph (c), 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 larger self-constructed property is granted to revoke that election, provided the taxpayer timely filed the taxpayer's Federal tax return for that placed-in-service year and, within this 6-month extension period, the taxpayer, and all taxpayers whose tax liability would be affected by the election, file an amended Federal tax return for the placed-in-service year in a manner that is consistent with the revocation of the election.

(8) *Additional procedural guidance*. The IRS may publish procedural guidance in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) that provides alternative procedures for complying with paragraph (c)(6) or (c)(7)(i) of this section.

(9) *Examples*. The application of this paragraph (c) is illustrated by the following examples. Unless the facts specifically indicate otherwise, assume that the larger self-constructed property is described in paragraph (c)(2) of this section, the components that are acquired or self-constructed after September 27, 2017, are described in paragraph (c)(3) of this section, the taxpayer is an accrual basis taxpayer, and none of the costs paid or incurred after September 27, 2017, are for the installation of components that do not meet the requirements of paragraph (c)(3) of this section.

(i) *Example 1*. (A) *BC*, a calendar year taxpayer, is engaged in a trade or business described in section 163(j)(7)(A)(iv) and §§ 1.163(j)–1(b)(15)(i) and 1.163(j)–10(c)(3)(iii)(C)(*3*). In December 2015, *BC* decided to construct an electric generation power plant for its own use. This plant is property described in section 168(k)(2)(B) as in effect on the day before the date of the enactment of the Act. However, the turbine for the plant had to be manufactured by another person for *BC*. In January 2016, *BC* entered into a written binding contract with *CD* to acquire the turbine. *BC* received the completed turbine in August 2017 at which time *BC* incurred the cost of the turbine. The cost of the turbine is 11 percent of the total cost of the electric generation power plant to be constructed by *BC*. *BC* began constructing the electric generation power plant in October 2017 and placed in service this new power plant, including all component parts, in 2020.

(B) The larger self-constructed property is the electric generation power plant to be constructed by *BC*. For determining if the construction of this power plant begins before September 28, 2017, paragraph (b)(5)(iv)(B) of this section provides that manufacture, construction, or production of property begins when physical work of a significant nature begins. *BC* uses the safe harbor test in paragraph (b)(5)(iv)(B)(*2*) of this section to determine when physical work of a significant nature begins for the electric generation power plant. Because the turbine that was manufactured by *CD* for *BC* is more than 10 percent of the total cost of the electric generation power plant, physical work of a significant nature for this plant began before September 28, 2017.

(C) The power plant is described in section 168(k)(9)(A) and paragraph (b)(2)(ii)(F) of this section and, therefore, is not larger self-constructed property eligible for the election pursuant to paragraph (c)(2)(i)(B) of this section. Accordingly, none of *BC*'s expenditures for components of the power plant that are acquired or self-constructed after September 27, 2017, are eligible for the election specified in this paragraph (c). Assuming all requirements are met under section 168(k)(2) as in effect on the day before the date of the enactment of the Act, the unadjusted depreciable basis of the power plant, including all components, attributable to its construction before January 1, 2020, is eligible for the 30-percent additional first year depreciation deduction pursuant to section 168(k)(8).

(ii) *Example 2*. (A) In August 2017, *BD*, a calendar-year taxpayer, entered into a written binding contract with *CE* for *CE* to manufacture a locomotive for *BD* for use in its trade or business. Before September 28, 2017, *BD* acquired or self-constructed components of the locomotive. These components cost $500,000, which is more than 10 percent of the total cost of the locomotive, and *BD* incurred such costs before September 28, 2017. After September 27, 2017, *BD* acquired or self-constructed components of the locomotive and these components cost $4,000,000. In February 2019, *CE* delivered the locomotive to *BD* and *BD* placed in service the locomotive. The total cost of the locomotive is $4,500,000. The locomotive is property described in section 168(k)(2)(B) as in effect on the day before the date of the enactment of the Act. On its timely filed Federal income tax return for 2019, *BD* made the election specified in this paragraph (c).

(B) The larger self-constructed property is the locomotive being manufactured by *CE* for *BD*. For determining if the manufacturing of this locomotive begins before September 28, 2017, paragraph (b)(5)(iv)(B) of this section provides that manufacture, construction, or production of property begins when physical work of a significant nature begins. *BD* uses the safe harbor test in paragraph (b)(5)(iv)(B)(*2*) of this section to determine when physical work of a significant nature begins for the locomotive. Because *BD* had incurred more than 10 percent of the total cost of the locomotive before September 28, 2017, physical work of a significant nature for this locomotive began before September 28, 2017.

(C) Because *BD* made the election specified in this paragraph (c), the cost of $4,000,000 for the locomotive's components acquired or self-constructed after September 27, 2017, qualifies for the 100-percent additional first year depreciation deduction under this section, assuming all other requirements are met. The remaining cost of the locomotive is $500,000 and such amount qualifies for the 40-percent additional first year depreciation deduction pursuant to section 168(k)(8), assuming all other requirements in section 168(k) as in effect on the day before the date of the enactment of the Act are met.

(iii) *Example 3*. (A) In February 2016, *BF*, a calendar-year taxpayer, entered into a written binding contract with *CG* for *CG* to manufacture a vessel for *BF* for use in its trade or business. Before September 28, 2017, *BF* acquired or self-constructed components for the vessel. These components cost $30,000,000, which is more than 10 percent of the total cost of the vessel, and *BF* incurred such costs before September 28, 2017. After September 27, 2017, *BF* acquired or self-constructed components for the vessel and these components cost $15,000,000. In February 2021, *CG* delivered the vessel to *BF* and *BF* placed in service the vessel. The vessel is property described in section 168(k)(2)(B) as in effect on the day before the date of the enactment of the Act. The total cost of the vessel is $45,000,000. On its timely filed Federal income tax return for 2021, *BF* made the election specified in this paragraph (c).

(B) The larger self-constructed property is the vessel being manufactured by *CG* for *BF*. For determining if the manufacturing of this vessel begins before September 28, 2017, paragraph (b)(5)(iv)(B) of this section provides that manufacture, construction, or production of property begins when physical work of a significant nature begins. *BF* uses the safe harbor test in paragraph (b)(5)(iv)(B)(*2*) of this section to determine when physical work of a significant nature begins for the vessel. Because *BF* had incurred more than 10 percent of the total cost of the vessel before September 28, 2017, physical work of a significant nature for this vessel began before September 28, 2017.

(C) Because *BF* made the election specified in this paragraph (c), the cost of $15,000,000 for the vessel's components acquired or self-constructed after September 27, 2017, qualifies for the 100-percent additional first year depreciation deduction under this section, assuming all other requirements are met. Pursuant to section 168(k)(8) and because *BF* placed in service the vessel after 2020, none of the remaining cost of the vessel is eligible for any additional first year depreciation deduction under section 168(k) and this section nor under section 168(k) as in effect on the day before the date of the enactment of the Act.

(iv) *Example 4*. (A) In March 2017, *BG*, a calendar year taxpayer, entered into a written contract with *CH* for *CH* to construct a building for *BG* to use in its retail business. This written contract does not meet the definition of a binding contract in paragraph (b)(5)(iii) of this section. In September 2019, the construction of the building was completed and placed in service by *BG*. The total cost is $10,000,000. Of this amount, $3,000,000 is the total cost for all section 1245 properties constructed as part of the building, and $7,000,000 is for the building. Under section 168(e), section 1245 properties in the total amount of $2,400,000 are 5-year property and in the total amount of $600,000 are 7-year property. The building is nonresidential real property under section 168(e). Before September 28, 2017, *BG* acquired or self-constructed certain components and the total cost of these components is $500,000 for the section 1245 properties and $3,000,000 for the building. *BG* incurred these costs before September 28, 2017. After September 27, 2017, *BG* acquired or self-constructed the remaining components of the section 1245 properties and these components cost $2,500,000. *BG* incurred these costs of $2,500,000 after September 27, 2017. On its timely filed Federal income tax return for 2019, *BG* made the election specified in this paragraph (c).

(B) All section 1245 properties are constructed as part of the construction of the building and are described in paragraph (b)(2)(i)(A) of this section. The building is not described in paragraph (b)(2)(i)(A), (B), (C), or (D) of this section. As a result, under paragraph (c)(2)(ii) of this section, the larger self-constructed property is all section 1245 properties with a total cost of $3,000,000. For determining if the construction of these section 1245 properties begins before September 28, 2017, paragraph (b)(5)(v) of this section provides that manufacture, construction, or production of property begins when the taxpayer incurs more than 10 percent of the total cost of the property. Because *BG* incurred more than 10 percent of the total cost of the section 1245 properties before September 28, 2017, construction of the section 1245 properties began before September 28, 2017.

(C) Because *BG* made the election specified in this paragraph (c), the cost of $2,500,000 for the section 1245 components acquired or self-constructed by *BG* after September 27, 2017, qualifies for the 100-percent additional first year depreciation deduction under this section, assuming all other requirements are met. The remaining cost of the section 1245 components is $500,000 and such amount qualifies for the 30-percent additional first year depreciation deduction pursuant to section 168(k)(8), assuming all other requirements in section 168(k), as in effect on the day before the date of the enactment of the Act, are met. Because the building is not qualified property under section 168(k), as in effect on the day before the date of the enactment of the Act, none of the cost of $7,000,000 for the building is eligible for any additional first year depreciation deduction under section 168(k) and this section or under section 168(k), as in effect on the day before the date of the enactment of the Act.

(d) *Property described in section 168(k)(2)(B) or (C)*—(1) *In general*. Property described in section 168(k)(2)(B) or (C) will meet the acquisition requirements of section 168(k)(2)(B)(i)(III) or (k)(2)(C)(i) if the property is acquired by the taxpayer before January 1, 2027, or acquired by the taxpayer pursuant to a written binding contract that is entered into before January 1, 2027. Property described in section 168(k)(2)(B) or (C), including its components, also must meet the acquisition requirement in section 13201(h)(1)(A) of the Act (for further guidance, see paragraph (b)(5) of this section).

(2) *Definition of binding contract.* For purposes of this paragraph (d), the rules in paragraph (b)(5)(iii) of this section for a binding contract apply.

(3) *Self-constructed property*—(i) *In general.* If a taxpayer manufactures, constructs, or produces property for use by the taxpayer in its trade or business or for its production of income, the acquisition rules in paragraph (d)(1) of this section are treated as met for the property if the taxpayer begins manufacturing, constructing, or producing the property before January 1, 2027. Property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract, as defined in paragraph (b)(5)(iii) of this section, that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or for its production of income is considered to be manufactured, constructed, or produced by the taxpayer. If a taxpayer enters into a written binding contract, as defined in paragraph (b)(5)(iii) of this section, before January 1, 2027, with another person to manufacture, construct, or produce property described in section 168(k)(2)(B) or (C) and the manufacture, construction, or production of this property begins after December 31, 2026, the acquisition rule in paragraph (d)(1) of this section is met.

(ii) *When does manufacture, construction, or production begin*—(A) *In general.* For purposes of this paragraph (d)(3), 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 retail motor fuels outlet is to be constructed on-site, construction begins when physical work of a significant nature commences at the site; that is, when work begins on the excavation for footings, pouring the pads for the outlet, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings) does not constitute the beginning of construction. However, if a retail motor fuels outlet is to be assembled on-site from modular units manufactured off-site and delivered to the site where the outlet will be used, manufacturing begins when physical work of a significant nature commences at the off-site location.

(B) *Safe harbor.* For purposes of paragraph (d)(3)(ii)(A) of this section, a taxpayer may choose to determine when physical work of a significant nature begins in accordance with this paragraph (d)(3)(ii)(B). Physical work of a significant nature will be considered to begin at the time the taxpayer incurs (in the case of an accrual basis taxpayer) or pays (in the case of a cash basis taxpayer) 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. When property is manufactured, constructed, or produced for the taxpayer by another person, this safe harbor test must be satisfied by the taxpayer. For example, if a retail motor fuels outlet is to be constructed for an accrual basis taxpayer by another person for the total cost of $200,000, excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching, construction is deemed to begin for purposes of this paragraph (d)(3)(ii)(B) when the taxpayer has incurred more than 10 percent (more than $20,000) of the total cost of the property. A taxpayer chooses to apply this paragraph (d)(3)(ii)(B) by filing a Federal income tax return for the placed-in-service year of the property that determines when physical work of a significant nature begins consistent with this paragraph (d)(3)(ii)(B).

(iii) *Components of self-constructed property*—(A) *Acquired components.* If a binding contract, as defined in paragraph (b)(5)(iii) of this section, to acquire a component does not satisfy the requirements of paragraph (d)(1) of this section, the component does not qualify for the additional first year depreciation deduction under this section. A binding contract described in the preceding sentence to acquire one or more components of a larger self-constructed property will not preclude the larger self-constructed property from satisfying the acquisition rules in paragraph (d)(3)(i) of this section. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the additional first year depreciation deduction under this section, assuming all other requirements are met, must not include the unadjusted depreciable basis of any component that does not satisfy the requirements of paragraph (d)(1) of this section. If a binding contract to acquire the component is entered into before January 1, 2027, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2027, the component qualifies for the additional first year depreciation deduction under this section, assuming all other requirements are met, but the larger self-constructed property does not.

(B) *Self-constructed components.* If the manufacture, construction, or production of a component by the taxpayer does not satisfy the requirements of paragraph (d)(3)(i) of this section, the component does not qualify for the additional first year depreciation deduction under this section. However, if the manufacture, construction, or production of a component does not satisfy the requirements of paragraph (d)(3)(i) of this section, but the manufacture, construction, or production of the larger self-constructed property satisfies the requirements of paragraph (d)(3)(i) of this section, the larger self-constructed property qualifies for the additional first year depreciation deduction under this section, assuming all other requirements are met, even though the component does not qualify for the additional first year depreciation deduction under this section. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the additional first year depreciation deduction under this section, assuming all other requirements are met, must not include the unadjusted depreciable basis of any component that does not qualify for the additional first year depreciation deduction under this section. If the manufacture, construction, or production of a component begins before January 1, 2027, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2027, the component qualifies for the additional first year depreciation deduction under this section, assuming all other requirements are met, but the larger self-constructed property does not.

(iv) *Determination of acquisition date for property not acquired pursuant to a written binding contract.* For purposes of the acquisition rules in paragraph (d)(1) of this section, the following property is acquired by the taxpayer before January 1, 2027, if the taxpayer paid, in the case of a cash basis taxpayer, or incurred, in the case of an accrual basis taxpayer, more than 10 percent of the total cost of the property before January 1, 2027, excluding the cost of any land and preliminary activities such as planning and designing, securing financing, exploring, or researching:

(A) Property that the taxpayer acquires pursuant to a contract that does not meet the definition of a written binding contract in paragraph (b)(5)(iii) of this section; or

(B) Property that is manufactured, constructed, or produced for the taxpayer by another person under a written contract that does not meet the definition of a binding contract in paragraph (b)(5)(iii) of this section, and that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business or production of income.

(4) *Examples.* The application of this paragraph (d) is illustrated by the following examples:

(A) *Example 1.* (*1*) On June 1, 2016, *NN* decided to construct property described in section 168(k)(2)(B) for its own use.

However, one of the component parts of the property had to be manufactured by another person for *NN*. On August 15, 2016, *NN* entered into a written binding contract with *OO* to acquire this component part of the property for $100,000. *OO* began manufacturing the component part on November 1, 2016, and delivered the completed component part to *NN* on September 1, 2017, at which time *NN* incurred $100,000 for the cost of the component. The cost of this component part is 9 percent of the total cost of the property to be constructed by *NN*. *NN* did not incur any other cost of the property to be constructed before *NN* began construction. *NN* began constructing the property described in section 168(k)(2)(B) on October 15, 2017, and placed in service this property, including all component parts, on November 1, 2020. *NN* uses the safe harbor test in paragraph (d)(3)(ii)(B) of this section to determine when physical work of a significant nature begins for the property described in section 168(k)(2)(B).

(*2*) Because the component part of $100,000 that was manufactured by *OO* for *NN* is not more than 10 percent of the total cost of the property described in section 168(k)(2)(B), physical work of a significant nature for the property described in section 168(k)(2)(B) did not begin before September 28, 2017.

(*3*) Pursuant to paragraphs (b)(5)(iv)(C)(*2*) and (d)(1) of this section, the self-constructed component part of $100,000 manufactured by *OO* for *NN* is not eligible for the 100-percent additional first year depreciation deduction because the manufacturing of such component part began before September 28, 2017. However, pursuant to paragraph (d)(3)(i) of this section, the cost of the property described in section 168(k)(2)(B), excluding the cost of the component part of $100,000 manufactured by *OO* for *NN*, is eligible for the 100-percent additional first year depreciation deduction, assuming all other requirements are met, because construction of the property began after September 27, 2017, and before January 1, 2027, and the property described in section 168(k)(2)(B) was placed in service by *NN* during 2020.

(B) *Example 2*. (*1*) On June 1, 2026, *PP* decided to construct property described in section 168(k)(2)(B) for its own use. However, one of the component parts of the property had to be manufactured by another person for *PP*. On August 15, 2026, *PP* entered into a written binding contract with *XP* to acquire this component part of the property for $100,000. *XP* began manufacturing the component part on September 1, 2026, and delivered the completed component part to *PP* on February 1, 2027, at which time *PP* incurred $100,000 for the cost of the component. The cost of this component part is 9 percent of the total cost of the property to be constructed by *PP*. *PP* did not incur any other cost of the property to be constructed before *PP* began construction. *PP* began constructing the property described in section 168(k)(2)(B) on January 15, 2027, and placed this property, including all component parts, in service on November 1, 2027.

(*2*) Pursuant to paragraph (d)(3)(iii)(B) of this section, the self-constructed component part of $100,000 manufactured by *XP* for *PP* is eligible for the additional first year depreciation deduction under this section, assuming all other requirements are met, because the manufacturing of the component part began before January 1, 2027, and the property described in section 168(k)(2)(B), the larger self-constructed property, was placed in service by *PP* before January 1, 2028. However, pursuant to paragraph (d)(3)(i) of this section, the cost of the property described in section 168(k)(2)(B), excluding the cost of the self-constructed component part of $100,000 manufactured by *XP* for *PP*, is not eligible for the additional first year depreciation deduction under this section because construction of the property began after December 31, 2026.

(C) *Example 3*. On December 1, 2026, *QQ* entered into a written binding contract, as defined in paragraph (b)(5)(iii) of this section, with *RR* to manufacture an aircraft described in section 168(k)(2)(C) for use in *QQ*'s trade or business. *RR* begins to manufacture the aircraft on February 1, 2027. *QQ* places the aircraft in service on August 1, 2027. Pursuant to paragraph (d)(3)(i) of this section, the aircraft meets the requirements of paragraph (d)(1) of this section because the aircraft was acquired by *QQ* pursuant to a written binding contract entered into before January 1, 2027. Further, the aircraft was placed in service by *QQ* before January 1, 2028. Thus, assuming all other requirements are met, *QQ*'s cost of the aircraft is eligible for the additional first year depreciation deduction under this section.

(e) *Computation of depreciation deduction for qualified property*—(1) *Additional first year depreciation deduction*—(i) *Allowable taxable year*. The additional first year depreciation deduction is allowable—

(A) Except as provided in paragraph (e)(1)(i)(B) or (g) of this section, in the taxable year in which the qualified property is placed in service by the taxpayer for use in its trade or business or for the production of income; or

(B) In the taxable year in which the specified plant is planted, or grafted to a plant that has already been planted, by the taxpayer in the ordinary course of the taxpayer's farming business, as defined in section 263A(e)(4), if the taxpayer properly made the election to apply section 168(k)(5) (for further guidance, see paragraph (f) of this section).

(ii) *Computation*. Except as provided in paragraph (g)(5) of this section, the allowable additional first year depreciation deduction for qualified property is determined by multiplying the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3), of the qualified property by the applicable percentage. Except as provided in paragraph (g)(1) of this section, the additional first year depreciation deduction is not affected by a taxable year of less than 12 months. See paragraph (g)(1) of this section for qualified property placed in service or planted or grafted, as applicable, and disposed of during the same taxable year. See paragraph (g)(5) of this section for qualified property acquired in a like-kind exchange or as a result of an involuntary conversion.

(iii) *Property described in section 168(k)(2)(B)*. For purposes of paragraph (e)(1)(ii) of this section, the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3), of qualified property described in section 168(k)(2)(B) is limited to the property's unadjusted depreciable basis attributable to the property's manufacture, construction, or production before January 1, 2027. The amounts of unadjusted depreciable basis attributable to the property's manufacture, construction, or production before January 1, 2027, are referred to as "progress expenditures." Rules similar to the rules in section 4.02(1)(b) of Notice 2007–36 (2007–17 I.R.B. 1000) (see § 601.601(d)(2)(ii)(*b*) of this chapter) apply for determining progress expenditures, regardless of whether the property is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract, as defined in paragraph (b)(5)(iii) of this section, or under a written contract that does not meet the definition of a binding contract in paragraph (b)(5)(iii) of this section. The IRS may publish procedural guidance in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter) that provides alternative procedures for complying with this paragraph (e)(1)(iii).

(iv) *Alternative minimum tax*—(A) *In general*. The additional first year depreciation deduction is allowable for alternative minimum tax purposes—

(*1*) Except as provided in paragraph (e)(1)(iv)(A)(*2*) of this section, in the taxable year in which the qualified property is placed in service by the taxpayer; or

(*2*) In the taxable year in which a specified plant is planted by the taxpayer, or grafted by the taxpayer to a plant that was previously planted, if the taxpayer properly made the election to apply section 168(k)(5) (for further guidance, see paragraph (f) of this section).

(B) *Special rules*. In general, the additional first year depreciation deduction for alternative minimum tax purposes is based on the unadjusted depreciable basis of the property for alternative minimum tax purposes. However, see paragraph (g)(5)(iii)(E) of this section for qualified property acquired in a like-kind exchange or as a result of an involuntary conversion.

(2) *Otherwise allowable depreciation deduction*—(i) *In general*. Before determining the amount otherwise allowable as a depreciation deduction for the qualified property for the placed-in-

service year and any subsequent taxable year, the taxpayer must determine the remaining adjusted depreciable basis of the qualified property. This remaining adjusted depreciable basis is equal to the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3), of the qualified property reduced by the amount of the additional first year depreciation allowed or allowable, whichever is greater. The remaining adjusted depreciable basis of the qualified property is then depreciated using the applicable depreciation provisions under the Internal Revenue Code for the qualified property. The remaining adjusted depreciable basis of the qualified property that is MACRS property is also the basis to which the annual depreciation rates in the optional depreciation tables apply (for further guidance, see section 8 of Rev. Proc. 87–57 (1987–2 C.B. 687) and §601.601(d)(2)(ii)(*b*) of this chapter). The depreciation deduction allowable for the remaining adjusted depreciable basis of the qualified property is affected by a taxable year of less than 12 months.

(ii) *Alternative minimum tax.* For alternative minimum tax purposes, the depreciation deduction allowable for the remaining adjusted depreciable basis of the qualified property is based on the remaining adjusted depreciable basis for alternative minimum tax purposes. The remaining adjusted depreciable basis of the qualified property for alternative minimum tax purposes is depreciated using the same depreciation method, recovery period (or useful life in the case of computer software), and convention that apply to the qualified property for regular tax purposes.

(3) *Examples.* This paragraph (e) is illustrated by the following examples:

(i) *Example 1.* On March 1, 2023, *SS*, a calendar-year taxpayer, purchased and placed in service qualified property that costs $1 million and is 5-year property under section 168(e). *SS* depreciates its 5-year property placed in service in 2023 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. For 2023, *SS* is allowed an 80-percent additional first year depreciation deduction of $800,000 (the unadjusted depreciable basis of $1 million multiplied by 0.80). Next, *SS* must reduce the unadjusted depreciable basis of $1 million by the additional first year depreciation deduction of $800,000 to determine the remaining adjusted depreciable basis of $200,000. Then, *SS'* depreciation deduction allowable in 2023 for the remaining adjusted depreciable basis of $200,000 is $40,000 (the remaining adjusted depreciable basis of $200,000 multiplied by the annual depreciation rate of 0.20 for recovery year 1).

(ii) *Example 2.* On June 1, 2023, *TT*, a calendar-year taxpayer, purchased and placed in service qualified property that costs $1,500,000. The property qualifies for the expensing election under section 179 and is 5-year property under section 168(e). *TT* did not purchase any other section 179 property in 2023. *TT* makes the election under section 179 for the property and depreciates its 5-year property placed in service in 2023 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. Assume the maximum section 179 deduction for 2023 is $1,000,000. For 2023, *TT* is first allowed a $1,000,000 deduction under section 179. Next, *TT* must reduce the cost of $1,500,000 by the section 179 deduction of $1,000,000 to determine the unadjusted depreciable basis of $500,000. Then, for 2023, *TT* is allowed an 80-percent additional first year depreciation deduction of $400,000 (the unadjusted depreciable basis of $500,000 multiplied by 0.80). Next, *TT* must reduce the unadjusted depreciable basis of $500,000 by the additional first year depreciation deduction of $400,000 to determine the remaining adjusted depreciable basis of $100,000. Then, *TT*'s depreciation deduction allowable in 2023 for the remaining adjusted depreciable basis of $100,000 is $20,000 (the remaining adjusted depreciable basis of $100,000 multiplied by the annual depreciation rate of 0.20 for recovery year 1).

(f) *Elections under section 168(k)*—(1) *Election not to deduct additional first year depreciation*—(i) *In general.* A taxpayer may make an election not to deduct the additional first year depreciation for any class of property that is qualified property placed in service during the taxable year. If this election is made, the election applies to all qualified 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 property placed in service during the taxable year in the class of property, except as provided in § 1.743–1(j)(4)(i)(B)(*1*).

(ii) *Definition of class of property.* For purposes of this paragraph (f)(1), the term *class of property* means:

(A) Except for the property described in paragraphs (f)(1)(ii)(B) and (D), and (f)(2) of this section, each class of property described in section 168(e) (for example, 5-year property);

(B) Water utility property as defined in section 168(e)(5) and depreciated under section 168;

(C) Computer software as defined in, and depreciated under, section 167(f)(1) and § 1.167(a)–14(b);

(D) Qualified improvement property as defined in § 1.168(b)–1(a)(5)(i)(C) and (a)(5)(ii) (acquired by the taxpayer after September 27, 2017, and placed in service by the taxpayer after September 27, 2017, and before January 1, 2018), and depreciated under section 168;

(E) Each separate production, as defined in § 1.181–3(b), of a qualified film or television production;

(F) Each separate production, as defined in section 181(e)(2), of a qualified live theatrical production; or

(G) Each partner's basis adjustment in partnership assets under section 743(b) for each class of property described in paragraphs (f)(1)(ii)(A) through (F), and (f)(2) of this section (for further guidance, see § 1.743–1(j)(4)(i)(B)(*1*)).

(iii) *Time and manner for making election*—(A) *Time for making election.* Except as provided in paragraph (f)(6) of this section, any election specified in paragraph (f)(1)(i) 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 property is placed in service by the taxpayer.

(B) *Manner of making election.* Except as provided in paragraph (f)(6) of this section, any election specified in paragraph (f)(1)(i) 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 property (for example, for each member of a consolidated group by the common parent of the group, by the partnership (including a lower-tier partnership; also including basis adjustments in the partnership assets under section 743(b)), 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.

(iv) *Failure to make election.* If a taxpayer does not make the election specified in paragraph (f)(1)(i) of this section within the time and in the manner prescribed in paragraph (f)(1)(iii) of this section, the amount of depreciation allowable for that property under section 167 or 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, any election specified in paragraph (f)(1)(i) 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).

(2) *Election to apply section 168(k)(5) for specified plants*—(i) *In general.* A taxpayer may make an election to apply section 168(k)(5) to one or more specified plants that are planted, or grafted to a plant that has already been planted, by the taxpayer in the ordinary course of the taxpayer's farming business, as defined in section 263A(e)(4). If this election is made for a specified plant, such plant is not treated as qualified property under section 168(k) and this section in its placed-in-service year.

(ii) *Time and manner for making election*—(A) *Time for making election.* Except as provided in paragraph (f)(6) of this section, any election specified in paragraph (f)(2)(i) of this section must be made by the due date, including extensions, of the Federal tax return for the taxable year in which the taxpayer planted or grafted the specified plant to which the election applies.

(B) *Manner of making election.* Except as provided in paragraph (f)(6) of this section, any election specified in paragraph (f)(2)(i) 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 specified plants (for example, for each member of a consolidated group by the common parent of the group, by the partnership (including a lower-tier 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.

(iii) *Failure to make election.* If a taxpayer does not make the election specified in paragraph (f)(2)(i) of this section for a specified plant within the time and in the manner prescribed in paragraph (f)(2)(ii) of this section, the specified plant is treated as qualified property under section 168(k), assuming all requirements are met, in the taxable year in which such plant is placed in service by the taxpayer. Thus, any election specified in paragraph (f)(2)(i) 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).

(3) *Election for qualified property placed in service during the 2017 taxable year*—(i) *In general.* A taxpayer may make an election to deduct 50 percent, instead of 100 percent, additional first year depreciation for all qualified property acquired after September 27, 2017, by the taxpayer and placed in service by the taxpayer during its taxable year that includes September 28, 2017. If a taxpayer makes an election to apply section 168(k)(5) for its taxable year that includes September 28, 2017, the taxpayer also may make an election to deduct 50 percent, instead of 100 percent, additional first year depreciation for all specified plants that are planted, or grafted to a plant that has already been planted, after September 27, 2017, by the taxpayer in the ordinary course of the taxpayer's farming business during such taxable year.

(ii) *Time and manner for making election*—(A) *Time for making election.* Except as provided in paragraph (f)(6) of this section, any election specified in paragraph (f)(3)(i) of this section must be made by the due date, including extensions, of the Federal tax return for the taxpayer's taxable year that includes September 28, 2017.

(B) *Manner of making election.* Except as provided in paragraph (f)(6) of this section, any election specified in paragraph (f)(3)(i) of this section must be made in the manner prescribed on the 2017 Form 4562, ''Depreciation and Amortization,'' and its instructions. The election is made separately by each person owning qualified property (for example, for each member of a consolidated group by the common parent of the group, by the partnership (including a lower-tier partnership), or by the S corporation).

(iii) *Failure to make election.* If a taxpayer does not make the election specified in paragraph (f)(3)(i) of this section within the time and in the manner prescribed in paragraph (f)(3)(ii) of this section, the amount of depreciation allowable for qualified property under section 167 or 168, as applicable, acquired and placed in service, or planted or grafted, as applicable, by the taxpayer after September 27, 2017, must be determined for the taxable year that includes September 28, 2017, and for all subsequent taxable years by taking into account the 100-percent additional first year depreciation deduction, unless the taxpayer makes the election specified in paragraph (f)(1)(i) of this section within the time and in the manner prescribed in paragraph (f)(1)(iii) of this section for the class of property in which the qualified property is included. Thus, any election specified in paragraph (f)(3)(i) 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).

(4) *Alternative minimum tax.* If a taxpayer makes an election specified in paragraph (f)(1) of this section for a class of property or in paragraph (f)(2)

of this section for a specified plant, the depreciation adjustments under section 56 and the regulations in this part under section 56 do not apply to the property or specified plant, as applicable, to which that election applies for purposes of computing the taxpayer's alternative minimum taxable income. If a taxpayer makes an election specified in paragraph (f)(3) of this section for all qualified property, see paragraphs (e)(1)(iv) and (e)(2)(ii) of this section.

(5) *Revocation of election*–(i) *In general.* Except as provided in paragraphs (f)(5)(ii) and (f)(6) of this section, an election specified in this paragraph (f), once made, may be revoked only by filing a request for a private letter ruling and obtaining the Commissioner of Internal Revenue's written consent to revoke the election. The Commissioner may grant a request to revoke the election if the taxpayer acted reasonably and in good faith, and the revocation will not prejudice the interests of the Government. See generally § 301.9100–3 of this chapter. An election specified in this paragraph (f) may not be revoked through a request under section 446(e) to change the taxpayer's method of accounting.

(ii) *Automatic 6-month extension.* If a taxpayer made an election specified in this paragraph (f), 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 or the taxable year in which the specified plant is planted or grafted, as applicable, is granted to revoke that election, provided the taxpayer timely filed the taxpayer's Federal tax return for the placed-in-service year or the taxable year in which the specified plant is planted or grafted, as applicable, and, within this 6-month extension period, the taxpayer, and all taxpayers whose tax liability would be affected by the election, file an amended Federal tax return for the placed-in-service year or the taxable year in which the specified plant is planted or grafted, as applicable, in a manner that is consistent with the revocation of the election.

(6) *Special rules for 2016 and 2017 returns.* For an election specified in this paragraph (f) for qualified property placed in service, or for a specified plant that is planted, or grafted to a plant that has already been planted, by the taxpayer during its taxable year that included September 28, 2017, the taxpayer should refer to Rev. Proc. 2019–33 (2019–34 I.R.B. 662) (see § 601.601(d)(2)(ii)(*b*) of this chapter) for the time and manner of making the election on the 2016 or 2017 Federal tax return.

(7) *Additional procedural guidance.* The IRS may publish procedural guidance in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) that provides alternative procedures for complying with paragraph (f)(1)(iii), (f)(1)(iv), (f)(2)(ii), (f)(2)(iii), (f)(3)(ii), (f)(3)(iii), or (f)(5)(i) of this section.

(g) *Special rules*—(1) *Property placed in service and disposed of in the same taxable year*—(i) *In general.* Except as provided in paragraphs (g)(1)(ii) and (iii) of this section and by the application of paragraph (b)(3)(iii)(B)(*4*) of this section, the additional first year depreciation deduction is not allowed for qualified property placed in service or planted or grafted, as applicable, and disposed of during the same taxable year. If a partnership interest is acquired and disposed of during the same taxable year, the additional first year depreciation deduction is not allowed for any section 743(b) adjustment arising from the initial acquisition. Also, if qualified property is placed in service and disposed of during the same taxable year and then reacquired and again placed in service in a subsequent taxable year, the additional first year depreciation deduction is not allowable for the property in the subsequent taxable year, except as otherwise provided by the application of paragraph (b)(3)(iii)(B) of this section.

(ii) *Technical termination of a partnership.* In the case of a technical termination of a partnership under section 708(b)(1)(B) in a taxable year beginning before January 1, 2018, the additional first year depreciation deduction is allowable for any qualified property placed in service or planted or grafted, as applicable, by the terminated partnership during the taxable year of termination and contributed by the terminated partnership to the new partnership. The allowable additional first year depreciation deduction for the qualified property shall not be claimed by the terminated partnership but instead shall be claimed by the new partnership for the new partnership's taxable year in which the qualified property was contributed by the terminated partnership to the new partnership. However, if qualified property is both placed in service or planted or grafted, as applicable, and contributed to a new partnership in a transaction described in section 708(b)(1)(B) by the terminated partnership during the taxable year of termination, and if such property is disposed of by the new partnership in the same taxable year the new partnership received such property from the terminated partnership, then no additional first year depreciation deduction is allowable to either partnership.

(iii) *Section 168(i)(7) transactions.* If any qualified property is transferred in a transaction described in section 168(i)(7) in the same taxable year that the qualified property is placed in service or planted or grafted, as applicable, by the transferor, the additional first year depreciation deduction is allowable for the qualified property. If a partnership interest is purchased and transferred in a transaction described in section 168(i)(7) in the same taxable year, the additional first year depreciation deduction is allowable for any section 743(b) adjustment that arises from the initial acquisition with respect to qualified property held by the partnership, provided the requirements of paragraph (b)(3)(iv)(D) of this section and all other requirements of section 168(k) and this section are satisfied. The allowable additional first year depreciation deduction for the qualified property for the transferor's taxable year in which the property is placed in service or planted or grafted, as applicable, is allocated between the transferor and the transferee on a monthly basis. The allowable additional first year depreciation deduction for a section 743(b) adjustment with respect to qualified property held by the partnership is allocated between the transferor and the transferee on a monthly basis notwithstanding that under §1.743–1(f) a transferee's section 743(b) adjustment is determined without regard to a transferors section 743(b) adjustment. These allocations shall be made in accordance with the rules in §1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee. However, solely for purposes of this section, if the qualified property is transferred in a section 721(a) transaction to a partnership that has as a partner a person, other than the transferor, who previously had a depreciable interest in the qualified property, in the same taxable year that the qualified property is acquired or planted or grafted, as applicable, by the transferor, the qualified property is deemed to be placed in service or planted or grafted, as applicable, by the transferor during that taxable year, and the allowable additional first year depreciation deduction is allocated entirely to the transferor and not to the partnership. Additionally, if qualified property is both placed in service or planted or grafted, as applicable, and transferred in a transaction described in section 168(i)(7) by the transferor during the same taxable year, and if such property is disposed of by the transferee, other than by a transaction described in section 168(i)(7), during the same taxable year the transferee received such property from the transferor, then no additional first year depreciation deduction is allowable to either party.

(iv) *Examples.* The application of this paragraph (g)(1) is illustrated by the following examples:

(A) *Example 1. UU* and *VV* are equal partners in *Partnership JL*, a general partnership. *Partnership JL* is a calendar-year taxpayer. On October 1, 2017, *Partnership JL* purchased and placed in service qualified property at a cost of $30,000. On November 1, 2017, *UU* sells its entire 50 percent interest to *WW* in a transfer that terminates the partnership under section 708(b)(1)(B). As a result, terminated *Partnership JL* is deemed to have contributed the qualified property to new *Partnership JL*. Pursuant to paragraph (g)(1)(ii) of this section, new *Partnership JL*, not terminated *Partnership JL*, is eligible to claim the 100-percent additional first year depreciation deduction allowable for the qualified property for the taxable year 2017, assuming all other requirements are met.

(B) *Example 2.* On January 5, 2018, *XX* purchased and placed in service qualified property for a total amount of $9,000. On August 20, 2018, *XX* transferred this qualified property to *Partnership BC* in a transaction described in section 721(a). No other partner of *Partnership BC* has ever had a depreciable interest in the qualified property. *XX* and *Partnership BC* are calendar-year taxpayers. Because the transaction between *XX* and *Partnership BC* is a transaction described in section 168(i)(7), pursuant to paragraph (g)(1)(iii) of this section, the 100-percent additional first year depreciation deduction allowable for the qualified property is allocated between *XX* and *Partnership BC* in accordance with the rules in §1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee. Accordingly, the 100-percent additional first year depreciation deduction allowable of $9,000 for the qualified property for 2018 is allocated between *XX* and *Partnership BC* based on the number of months that *XX* and *Partnership BC* held the qualified property in service during 2018. Thus, because the qualified property was held in service by *XX* for 7 of 12 months, which includes the month in which *XX* placed the qualified property in service but does not include the month in which the qualified property was transferred, *XX* is allocated $5,250 ($\frac{7}{12} \times$ $9,000 additional first year depreciation deduction). *Partnership BC* is allocated $3,750, the remaining $\frac{5}{12}$ of the $9,000 additional first year depreciation deduction allowable for the qualified property.

(2) *Redetermination of basis.* If the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3), of qualified property is redetermined (for example, due to contingent purchase price or discharge of indebtedness) before January 1, 2027, or in the case of property described in section 168(k)(2)(B) or (C), is redetermined before January 1, 2028, the additional first year depreciation deduction allowable for the qualified property is redetermined as follows:

(i) *Increase in basis.* For the taxable year in which an increase in basis of qualified property occurs, the taxpayer shall claim an additional first year depreciation deduction for qualified property by multiplying the amount of the increase in basis for this property by the applicable percentage for the taxable year in which the underlying property was placed in service by the taxpayer. For purposes of this paragraph (g)(2)(i), the additional first year depreciation deduction applies to the increase in basis only if the underlying property is qualified property. To determine the amount otherwise allowable as a depreciation deduction for the increase in basis of qualified property, the amount of the increase in basis of the qualified property must be reduced by the additional first year depreciation deduction allowed or allowable, whichever is greater, for the increase in basis and the remaining increase in basis of—

(A) Qualified property, except for computer software described in paragraph (b)(2)(i)(B) of this section, a qualified film or television production described in paragraph (b)(2)(i)(E) of this section, or a qualified live theatrical production described in paragraph (b)(2)(i)(F) of this section, is depreciated over the recovery period of the qualified property remaining as of the beginning of the taxable year in which the increase in basis occurs, and using the same depreciation method and convention applicable to the qualified property that applies for the taxable year in which the increase in basis occurs; and

(B) Computer software, as defined in paragraph (b)(2)(i)(B) of this section, that is qualified property is depreciated ratably over the remainder of the 36-month period, the useful life under section 167(f)(1), as of the beginning of the first day of the month in which the increase in basis occurs.

(ii) *Decrease in basis.* For the taxable year in which a decrease in basis of qualified property occurs, the taxpayer shall reduce the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property by the excess additional first year depreciation deduction previously claimed for the qualified property. If, for such taxable year, the excess additional first year depreciation deduction exceeds the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property, the taxpayer shall take into account a negative depreciation deduction in computing taxable income. The excess additional first year depreciation deduction for qualified property is determined by multiplying the amount of the decrease in basis for this property by the applicable percentage for the taxable year in which the underlying property was placed in service by the taxpayer. For purposes of this paragraph (g)(2)(ii), the additional first year depreciation deduction applies to the decrease in basis only if the underlying property is qualified property. Also, if the taxpayer establishes by adequate records or other sufficient evidence that the taxpayer claimed less than the additional first year depreciation deduction allowable for the qualified property before the decrease in basis, or if the taxpayer claimed more than the additional first year depreciation deduction allowable for the qualified property before the decrease in basis, the excess additional first year depreciation deduction is determined by multiplying the amount of the decrease in basis by the additional first year depreciation deduction percentage actually claimed by the taxpayer for the qualified property before the decrease in basis. To determine the amount to reduce the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property for the excess depreciation previously claimed, other than the additional first year depreciation deduction, resulting from the decrease in basis of the qualified property, the amount of the decrease in basis of the qualified property must be adjusted by the excess additional first year depreciation deduction that reduced the total amount otherwise allowable as a depreciation deduction, as determined under this paragraph (g)(2)(ii), and the remaining decrease in basis of—

(A) Qualified property, except for computer software described in paragraph (b)(2)(i)(B) of this section, a qualified film or television production described in paragraph (b)(2)(i)(E) of this section, or a qualified live theatrical production described in paragraph (b)(2)(i)(F) of this section, reduces the amount otherwise allowable as a depreciation deduction over the recovery period of the qualified property remaining as of the beginning of the taxable year in which the decrease in basis occurs, and using the same depreciation method and convention of the qualified property that applies in the taxable year in which the decrease in basis occurs. If, for any taxable year, the reduction to the amount otherwise allowable as a depreciation deduction, as determined under this paragraph (g)(2)(ii)(A), exceeds the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property, the taxpayer shall take into account a negative depreciation deduction in computing taxable income; and

(B) Computer software, as defined in paragraph (b)(2)(i)(B) of this section, that is qualified property reduces the amount otherwise allowable as a depreciation deduction over the remainder of the 36-month period, the useful life under section 167(f)(1), as of the beginning of the first day of the month in which the decrease in basis occurs. If, for any taxable year, the reduction to the amount otherwise allowable as a depreciation deduction, as determined under this paragraph (g)(2)(ii)(B), exceeds the total amount otherwise allowable as a depreciation deduction for all of the taxpayer's depreciable property, the taxpayer shall take into account a negative depreciation deduction in computing taxable income.

(iii) *Definitions.* Except as otherwise expressly provided by the Internal Revenue Code (for example, section 1017(a)), the regulations under the Internal Revenue Code, or other guidance published in the Internal Revenue Bulletin for purposes of this paragraph (g)(2)—

(A) An increase in basis occurs in the taxable year an amount is taken into account under section 461; and

(B) A decrease in basis occurs in the taxable year an amount would be taken into account under section 451.

(iv) *Examples.* The application of this paragraph (g)(2) is illustrated by the following examples:

(A) *Example 1.* (*1*) On May 15, 2023, *YY*, a cash-basis taxpayer, purchased and placed in service qualified property that is 5-year property at a cost of $200,000. In addition to the $200,000, *YY* agrees to pay the seller 25 percent of the gross profits from the operation of the property in 2023. On May 15, 2024, *YY* paid to the seller an additional $10,000. *YY* depreciates the 5-year property placed in service in 2023 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention.

(*2*) For 2023, *YY* is allowed an 80-percent additional first year depreciation deduction of $160,000 (the unadjusted depreciable basis of $200,000 multiplied by 0.80). In addition, *YY*'s depreciation deduction for 2023 for the remaining adjusted depreciable basis of $40,000 (the unadjusted depreciable basis of $200,000 reduced by the additional first year depreciation deduction of $160,000) is $8,000 (the remaining adjusted depreciable basis of $40,000 multiplied by the annual depreciation rate of 0.20 for recovery year 1).

(*3*) For 2024, *YY*'s depreciation deduction for the remaining adjusted depreciable basis of $40,000 is $12,800 (the remaining adjusted depreciable basis of $40,000 multiplied by the annual depreciation rate of 0.32 for recovery year 2). In addition, pursuant to paragraph (g)(2)(i) of this section, *YY* is allowed an additional first year depreciation deduction for 2024 for the $10,000 increase in basis of the qualified property. Consequently, *YY* is allowed an additional first year depreciation deduction of $8,000 (the increase in basis of $10,000 multiplied by 0.80, the applicable percentage for 2023). Also, *YY* is allowed a depreciation deduction for 2024 attributable to the remaining increase in basis of $2,000 (the increase in basis of $10,000 reduced by the additional first year depreciation deduction of $8,000). The depreciation deduction allowable for 2024 attributable to the remaining increase in basis of $2,000 is $889 (the remaining increase in basis of $2,000 multiplied by 0.4444, which is equal to 1/remaining recovery period of 4.5 years at January 1, 2024, multiplied by 2). Accordingly, for 2024, *YY*'s total depreciation deduction allowable for the qualified property is $21,689 ($12,800 plus $8,000 plus $889).

(B) *Example 2.* (*1*) On May 15, 2023, *ZZ*, a calendar-year taxpayer, purchased and placed in service qualified property that is 5-year property at a cost of $400,000. To purchase the property, *ZZ* borrowed $250,000 from Bank1. On May 15, 2024, Bank1 forgives $50,000 of the indebtedness. *ZZ* makes the election provided in section 108(b)(5) to apply any portion of the reduction under section 1017 to the basis of the depreciable property of the taxpayer. *ZZ* depreciates the 5-year property placed in service in 2023 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention.

(*2*) For 2023, *ZZ* is allowed an 80-percent additional first year depreciation deduction of $320,000 (the unadjusted depreciable basis of $400,000 multiplied by 0.80). In addition, *ZZ*'s depreciation deduction allowable for 2023 for the remaining adjusted depreciable basis of $80,000 (the unadjusted depreciable basis of $400,000 reduced by the additional first year depreciation deduction of $320,000) is $16,000 (the remaining adjusted depreciable basis of $80,000 multiplied by the annual depreciation rate of 0.20 for recovery year 1).

(*3*) For 2024, *ZZ*'s deduction for the remaining adjusted depreciable basis of $80,000 is $25,600 (the remaining adjusted depreciable basis of $80,000 multiplied by the annual depreciation rate 0.32 for recovery year 2). Although Bank1 forgave the indebtedness in 2024, the basis of the property is reduced on January 1, 2025, pursuant to sections 108(b)(5) and 1017(a) under which basis is reduced at the beginning of the taxable year following the taxable year in which the discharge of indebtedness occurs.

(*4*) For 2025, *ZZ*'s deduction for the remaining adjusted depreciable basis of $80,000 is $15,360 (the remaining adjusted depreciable basis of $80,000 multiplied by the annual depreciation rate 0.192 for recovery year 3). However, pursuant to paragraph (g)(2)(ii) of this section, *ZZ* must reduce the amount otherwise allowable as a depreciation deduction for 2025 by the excess depreciation previously claimed for the $50,000 decrease in basis of the qualified property. Consequently, *ZZ* must reduce the amount of depreciation otherwise allowable for 2025 by the excess additional first year depreciation of $40,000 (the decrease in basis of $50,000 multiplied by 0.80, the applicable percentage for 2023). Also, *ZZ* must reduce the amount of depreciation otherwise allowable for 2025 by the excess depreciation attributable to the remaining decrease in basis of $10,000 (the decrease in basis of $50,000 reduced by the excess additional first year depreciation of $40,000). The reduction in the amount of depreciation otherwise allowable for 2025 for the remaining decrease in basis of $10,000 is $5,714 (the remaining decrease in basis of $10,000 multiplied by 0.5714, which is equal to (1/remaining recovery period of 3.5 years at January 1, 2025, multiplied by 2). Accordingly, assuming the qualified property is the only depreciable property owned by *ZZ*, for 2025, *ZZ* has a negative depreciation deduction for the qualified property of $30,354 ($15,360 minus $40,000 minus $5,714).

(3) *Sections 1245 and 1250 depreciation recapture*. For purposes of section 1245 and §§ 1.1245–1 through –6, the additional first year depreciation deduction is an amount allowed or allowable for depreciation. Further, for purposes of section 1250(b) and § 1.1250–2, the additional first year depreciation deduction is not a straight line method.

(4) *Coordination with section 169*. The additional first year depreciation deduction is allowable in the placed-in-service year of a certified pollution control facility, as defined in § 1.169–2(a), that is qualified property even if the taxpayer makes the election to amortize the certified pollution control facility under section 169 and §§ 1.169–1 through –4 in the certified pollution control facility's placed-in-service year.

(5) *Like-kind exchanges and involuntary conversions*—(i) *Scope*. The rules of this paragraph (g)(5) apply to replacement MACRS property or replacement computer software that is qualified property at the time of replacement provided the time of replacement is after September 27, 2017, and before January 1, 2027; or, in the case of replacement MACRS property or replacement computer software that is qualified property described in section 168(k)(2)(B) or (C), the time of replacement is after September 27, 2017, and before January 1, 2028.

(ii) *Definitions*. For purposes of this paragraph (g)(5), the following definitions apply:

(A) *Replacement MACRS property* has the same meaning as that term is defined in § 1.168(i)–6(b)(1).

(B) *Relinquished MACRS property* has the same meaning as that term is defined in § 1.168(i)–6(b)(2).

(C) *Replacement computer software* is computer software, as defined in paragraph (b)(2)(i)(B) of this section, in the hands of the acquiring taxpayer that is acquired for other computer software in a like-kind exchange or in an involuntary conversion.

(D) *Relinquished computer software* is computer software that is transferred by the taxpayer in a like-kind exchange or in an involuntary conversion.

(E) *Time of disposition* has the same meaning as that term is defined in § 1.168(i)–6(b)(3) for relinquished MACRS property. For relinquished computer software, *time of disposition* is when the disposition of the relinquished computer software takes place under the convention determined under § 1.167(a)–14(b).

(F) Except as provided in paragraph (g)(5)(iv) of this section, the *time of replacement* has the same meaning as that term is defined in § 1.168(i)–6(b)(4) for replacement MACRS property. For replacement computer software, the *time of replacement* is, except as provided in paragraph (g)(5)(iv) of this section, the later of—

(*1*) When the replacement computer software is placed in service under the convention determined under § 1.167(a)–14(b); or

(*2*) The time of disposition of the relinquished property.

(G) *Exchanged basis* has the same meaning as that term is defined in § 1.168(i)–6(b)(7) for MACRS property, as defined in §1.168(b)–1(a)(2). For computer software, the *exchanged basis* is determined after the amortization deductions for the year of disposition are determined under §1.167(a)–14(b) and is the lesser of—

(*1*) The basis in the replacement computer software, as determined under section 1031(d) and §1.1031(d)–1, 1.1031(d)–2, 1.1031(j)–1, or 1.1031(k)–1; or section 1033(b) and §1.1033(b)–1; or

(*2*) The adjusted depreciable basis of the relinquished computer software.

(H) *Excess basis* has the same meaning as that term is defined in §1.168(i)–6(b)(8) for replacement MACRS property. For replacement computer software, the *excess basis* is any excess of the basis in the replacement computer software, as determined under section 1031(d) and §1.1031(d)–1, 1.1031(d)–2, 1.1031(j)–1, or 1.1031(k)–1; or section 1033(b) and §1.1033(b)–1, over the exchanged basis as determined under paragraph (g)(5)(ii)(G) of this section.

(I) *Remaining exchanged basis* is the exchanged basis as determined under paragraph (g)(5)(ii)(G) of this section reduced by—

(*1*) The percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business or for the production of income; and

(*2*) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code (including section 1016(a)(2) and (3)) for periods prior to the disposition of the relinquished property.

(J) *Remaining excess basis* is the excess basis as determined under paragraph (g)(5)(ii)(H) of this section reduced by—

(*1*) The percentage of such basis attributable to the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business or for the production of income;

(*2*) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179 or 179C; and

(*3*) Any adjustments to basis provided by other provisions of the Code and the regulations under the Code.

(K) *Year of disposition* has the same meaning as that term is defined in §1.168(i)–6(b)(5).

(L) *Year of replacement* has the same meaning as that term is defined in §1.168(i)–6(b)(6).

(M) *Like-kind exchange* has the same meaning as that term is defined in §1.168(i)–6(b)(11).

(N) *Involuntary conversion* has the same meaning as that term is defined in §1.168(i)–6(b)(12).

(iii) *Computation*—(A) *In general.* If the replacement MACRS property or the replacement computer software, as applicable, meets the original use requirement in paragraph (b)(3)(ii) of this section and all other requirements of section 168(k) and this section, the remaining exchanged basis for the year of replacement and the remaining excess basis, if any, for the year of replacement for the replacement MACRS property or the replacement computer software, as applicable, are eligible for the additional first year depreciation deduction under this section. If the replacement MACRS property or the replacement computer software, as applicable, meets the used property acquisition requirements in paragraph (b)(3)(iii) of this section and all other requirements of section 168(k) and this section, only the remaining excess basis for the year of replacement for the replacement MACRS property or the replacement computer software, as applicable, is eligible for the additional first year depreciation deduction under this section. See paragraph (b)(3)(iii)(A)(*3*) of this section. The additional first year depreciation deduction applies to the remaining exchanged basis and any remaining excess basis, as applicable, of the replacement MACRS property or the replacement computer software, as applicable, if the time of replacement is after September 27, 2017, and before January 1, 2027; or, in the case of replacement MACRS property or replacement computer software, as applicable, described in section 168(k)(2)(B) or (C), the time of replacement is after September 27, 2017, and before January 1, 2028. The additional first year depreciation deduction is computed separately for the remaining exchanged basis and any remaining excess basis, as applicable.

(B) *Year of disposition and year of replacement.* The additional first year depreciation deduction is allowable for the replacement MACRS property or replacement computer software in the year of replacement. However, the additional first year depreciation deduction is not allowable for the relinquished MACRS property or the relinquished computer software, as applicable, if the relinquished MACRS property or the relinquished computer software, as applicable, is placed in service and disposed of in a like-kind exchange or in an involuntary conversion in the same taxable year.

(C) *Property described in section 168(k)(2)(B).* For purposes of paragraph (g)(5)(iii)(A) of this section, the total of the remaining exchanged basis and the remaining excess basis, if any, of the replacement MACRS property that is qualified property described in section 168(k)(2)(B) and meets the original use requirement in paragraph (b)(3)(ii) of this section is limited to the total of the property's remaining exchanged basis and remaining excess basis, if any, attributable to the property's manufacture, construction, or production after September 27, 2017, and before January 1, 2027. For purposes of paragraph (g)(5)(iii)(A) of this section, the remaining excess basis, if any, of the replacement MACRS property that is qualified property described in section 168(k)(2)(B) and meets the used property acquisition requirements in paragraph (b)(3)(iii) of this section is limited to the property's remaining excess basis, if any, attributable to the property's manufacture, construction, or production after September 27, 2017, and before January 1, 2027.

(D) *Effect of §1.168(i)–6(i)(1) election.* If a taxpayer properly makes the election under §1.168(i)–6(i)(1) not to apply §1.168(i)–6 for any MACRS property, as defined in §1.168(b)–1(a)(2), involved in a like-kind exchange or involuntary conversion, then:

(*1*) If the replacement MACRS property meets the original use requirement in paragraph (b)(3)(ii) of this section and all other requirements of section 168(k) and this section, the total of the exchanged basis, as defined in §1.168(i)–6(b)(7), and the excess basis, as defined in §1.168(i)–6(b)(8), if any, in the replacement MACRS property is eligible for the additional first year depreciation deduction under this section; or

(*2*) If the replacement MACRS property meets the used property acquisition requirements in paragraph (b)(3)(iii) of this section and all other requirements of section 168(k) and this section, only the excess basis, as defined in §1.168(i)–6(b)(8), if any, in the replacement MACRS property is eligible for the additional first year depreciation deduction under this section.

(E) *Alternative minimum tax.* The additional first year depreciation deduction is allowed for alternative minimum tax purposes for the year of replacement of replacement MACRS property or replacement computer software, as applicable, that is qualified property. If the replacement MACRS property or the replacement computer software, as applicable, meets the original use requirement in paragraph (b)(3)(ii) of this section and all other requirements of section 168(k) and this section, the additional first year depreciation deduction for alternative minimum tax purposes is based on the remaining exchanged basis and the remaining excess basis, if any, of the replacement MACRS property or the replacement computer software, as applicable, for alternative minimum tax purposes. If the replacement MACRS property or the replacement computer software, as applicable, meets the used property acquisition requirements in paragraph (b)(3)(iii) of this section and all other requirements of section 168(k) and this section, the additional first year depreciation deduction for alternative minimum tax purposes is based on the remaining excess basis, if any, of the replacement MACRS property or the replacement computer software, as applicable, for alternative minimum tax purposes.

(iv) *Replacement MACRS property or replacement computer software that is acquired and placed in service before disposition of relinquished MACRS property or relinquished computer software.* If, in an involuntary conversion, a taxpayer acquires and places in service the replacement MACRS property or the replacement computer software, as applicable, before the time of disposition of the involuntarily converted MACRS property or the involuntarily converted computer software, as applicable; and the time of disposition of the involuntarily converted MACRS property or the involuntarily converted computer software, as applicable, is after December 31, 2026, or, in the case of property described in service 168(k)(2)(B) or (C), after December 31, 2027, then—

(A) The time of replacement for purposes of this paragraph (g)(5) is when the replacement MACRS property or replacement computer software, as applicable, is placed in service by the taxpayer, provided the threat or imminence of requisition or condemnation of the involuntarily converted MACRS property or involuntarily converted computer software, as applicable, existed before January 1, 2027, or, in the case of property described in section 168(k)(2)(B) or (C), existed before January 1, 2028; and

(B) The taxpayer depreciates the replacement MACRS property or replacement computer software, as applicable, in accordance with paragraph (e) of this section. However, at the time of disposition of the involuntarily converted MACRS property, the taxpayer determines the exchanged basis, as defined in §1.168(i)–6(b)(7), and the excess basis, as defined in §1.168(i)–6(b)(8), of the replacement MACRS property and begins to depreciate the depreciable exchanged basis, as defined in §1.168(i)–6(b)(9), of the replacement MACRS property in accordance with §1.168(i)–6(c). The depreciable excess basis, as defined in §1.168(i)–6(b)(10), of the replacement MACRS property continues to be depreciated by the taxpayer in accordance with the first sentence of this paragraph (g)(5)(iv)(B). Further, in the year of disposition of the involuntarily converted MACRS property, the taxpayer must include in taxable income the excess of the depreciation deductions allowable, including the additional first year depreciation deduction allowable, on the unadjusted depreciable basis of the replacement MACRS property over the additional first year depreciation deduction that would have been allowable to the taxpayer on the remaining exchanged basis of the replacement MACRS property at the time of replacement, as defined in paragraph (g)(5)(iv)(A) of this section, plus the depreciation deductions that would have been allowable, including the additional first year depreciation deduction allowable, to the taxpayer on the depreciable excess basis of the replacement MACRS property from the date the replacement MACRS property was placed in service by the taxpayer, taking into account the applicable convention, to the time of disposition of the involuntarily converted MACRS property. Similar rules apply to replacement computer software.

(v) *Examples.* The application of this paragraph (g)(5) is illustrated by the following examples:

(A) *Example 1.* (*1*) In April 2016, *CSK*, a calendar-year corporation, acquired for $200,000 and placed in service Canopy V1, a gas station canopy. Canopy V1 is qualified property under section 168(k)(2), as in effect on the day before amendment by the Act, and is 5-year property under section 168(e). *CSK* depreciated Canopy V1 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *CSK* elected to use the optional depreciation tables to compute the depreciation allowance for Canopy V1. In November 2017, Canopy V1 was destroyed in a fire and was no longer usable in *CSK*'s business. In December 2017, in an involuntary conversion, *CSK* acquired and placed in service Canopy W1 with all of the $160,000 of insurance proceeds *CSK* received due to the loss of Canopy V1. Canopy W1 is qualified property under section 168(k)(2) and this section, and is 5-year property under section 168(e). Canopy W1 also meets the original use requirement in paragraph (b)(3)(ii) of this section. *CSK* did not make the election under §1.168(i)–6(i)(1).

(*2*) For 2016, *CSK* is allowed a 50-percent additional first year depreciation deduction of $100,000 for Canopy V1 (the unadjusted depreciable basis of $200,000 multiplied by 0.50), and a regular MACRS depreciation deduction of $20,000 for Canopy V1 (the remaining adjusted depreciable basis of $100,000 multiplied by the annual depreciation rate of 0.20 for recovery year 1).

(*3*) For 2017, *CSK* is allowed a regular MACRS depreciation deduction of $16,000 for Canopy V1 (the remaining adjusted depreciable basis of $100,000 multiplied by the annual depreciation rate of 0.32 for recovery year 2 × ½ year).

(*4*) Pursuant to paragraph (g)(5)(iii)(A) of this section, the additional first year depreciation deduction allowable for Canopy W1 for 2017 equals $64,000 (100 percent of Canopy W1's remaining exchanged basis at the time of replacement of $64,000 (Canopy V1's remaining adjusted depreciable basis of $100,000 minus 2016 regular MACRS depreciation deduction of $20,000 minus 2017 regular MACRS depreciation deduction of $16,000)).

(B) *Example 2*. (*1*) The facts are the same as in *Example 1* of paragraph (g)(5)(v)(A)(*1*) of this section, except *CSK* elected not to deduct the additional first year depreciation for 5-year property placed in service in 2016. *CSK* deducted the additional first year depreciation for 5-year property placed in service in 2017.

(*2*) For 2016, *CSK* is allowed a regular MACRS depreciation deduction of $40,000 for Canopy V1 (the unadjusted depreciable basis of $200,000 multiplied by the annual depreciation rate of 0.20 for recovery year 1).

(*3*) For 2017, *CSK* is allowed a regular MACRS depreciation deduction of $32,000 for Canopy V1 (the unadjusted depreciable basis of $200,000 multiplied by the annual depreciation rate of 0.32 for recovery year 2 × ½ year).

(*4*) Pursuant to paragraph (g)(5)(iii)(A) of this section, the additional first year depreciation deduction allowable for Canopy W1 for 2017 equals $128,000 (100 percent of Canopy W1's remaining exchanged basis at the time of replacement of $128,000 (Canopy V1's unadjusted depreciable basis of $200,000 minus 2016 regular MACRS depreciation deduction of $40,000 minus 2017 regular MACRS depreciation deduction of $32,000)).

(C) *Example 3*. The facts are the same as in *Example 1* of paragraph (g)(5)(v)(A)(*1*) of this section, except Canopy W1 meets the used property acquisition requirements in paragraph (b)(3)(iii) of this section. Because the remaining excess basis of Canopy W1 is zero, *CSK* is not allowed any additional first year depreciation for Canopy W1 pursuant to paragraph (g)(5)(iii)(A) of this section.

(D) *Example 4*. (*1*) In December 2016, *AB*, a calendar-year corporation, acquired for $10,000 and placed in service Computer X2. Computer X2 is qualified property under section 168(k)(2), as in effect on the day before amendment by the Act, and is 5-year property under section 168(e). *AB* depreciated Computer X2 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *AB* elected to use the optional depreciation tables to compute the depreciation allowance for Computer X2. In November 2017, *AB* acquired Computer Y2 by exchanging Computer X2 and $1,000 cash in a like-kind exchange. Computer Y2 is qualified property under section 168(k)(2) and this section, and is 5-year property under section 168(e). Computer Y2 also meets the original use requirement in paragraph (b)(3)(ii) of this section. *AB* did not make the election under § 1.168(i)–6(i)(1).

(*2*) For 2016, *AB* is allowed a 50-percent additional first year depreciation deduction of $5,000 for Computer X2 (unadjusted basis of $10,000 multiplied by 0.50), and a regular MACRS depreciation deduction of $1,000 for Computer X2 (the remaining adjusted depreciable basis of $5,000 multiplied by the annual depreciation rate of 0.20 for recovery year 1).

(*3*) For 2017, *AB* is allowed a regular MACRS depreciation deduction of $800 for Computer X2 (the remaining adjusted depreciable basis of $5,000 multiplied by the annual depreciation rate of 0.32 for recovery year 2 × ½ year).

(*4*) Pursuant to paragraph (g)(5)(iii)(A) of this section, the 100-percent additional first year depreciation deduction for Computer Y2 for 2017 is allowable for the remaining exchanged basis at the time of replacement of $3,200 (Computer X2's unadjusted depreciable basis of $10,000 minus additional first year depreciation deduction allowable of $5,000 minus the 2016 regular MACRS depreciation deduction of $1,000 minus the 2017 regular MACRS depreciation deduction of $800) and for the remaining excess basis at the time of replacement of $1,000 (cash paid for Computer Y2). Thus, the 100-percent additional first year depreciation deduction allowable for Computer Y2 totals $4,200 for 2017.

(E) *Example 5*. (*1*) In July 2017, *BC*, a calendar-year corporation, acquired for $20,000 and placed in service Equipment X3. Equipment X3 is qualified property under section 168(k)(2), as in effect on the day before amendment by the Act, and is 5-year property under section 168(e). *BC* depreciated Equipment X3 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *BC* elected to use the optional depreciation tables to compute the depreciation allowance for Equipment X3. In December 2017, *BC* acquired Equipment Y3 by exchanging Equipment X3 and $5,000 cash in a like-kind exchange. Equipment Y3 is qualified property under section 168(k)(2) and this section, and is 5-year property under section 168(e). Equipment Y3 also meets the used property acquisition requirements in paragraph (b)(3)(iii) of this section. *BC* did not make the election under § 1.168(i)–6(i)(1).

(*2*) Pursuant to § 1.168(k)–1(f)(5)(iii)(B), no additional first year depreciation deduction is allowable for Equipment X3 and, pursuant to § 1.168(d)–1(b)(3)(ii), no regular depreciation deduction is allowable for Equipment X3, for 2017.

(*3*) Pursuant to paragraph (g)(5)(iii)(A) of this section, no additional first year depreciation deduction is allowable for Equipment Y3's remaining exchanged basis at the time of replacement of $20,000 (Equipment X3's unadjusted depreciable basis of $20,000). However, pursuant to paragraph (g)(5)(iii)(A) of this section, the 100-percent additional first year depreciation deduction is allowable for Equipment Y3's remaining excess basis at the time of replacement of $5,000 (cash paid for Equipment Y3). Thus, the 100-percent additional first year depreciation deduction allowable for Equipment Y3 is $5,000 for 2017.

(F) *Example 6*. (*1*) The facts are the same as in *Example 5* of paragraph (g)(5)(v)(E)(*1*) of this section, except *BC* properly makes the election under § 1.168(i)–6(i)(1) not to apply § 1.168(i)–6 to Equipment X3 and Equipment Y3.

(*2*) Pursuant to § 1.168(k)–1(f)(5)(iii)(B), no additional first year depreciation deduction is allowable for Equipment X3 and, pursuant to § 1.168(d)–1(b)(3)(ii), no regular depreciation deduction is allowable for Equipment X3, for 2017.

(*3*) Pursuant to § 1.168(i)–6(i)(1), *BC* is treated as placing Equipment Y3 in service in December 2017 with a basis of $25,000 (the total of the exchanged basis of $20,000 and the excess basis of $5,000). However, pursuant to paragraph (g)(5)(iii)(D)(*2*) of this section, the 100-percent additional first year depreciation deduction is allowable only for Equipment Y3's excess basis at the time of replacement of $5,000 (cash paid for Equipment Y3). Thus, the 100-percent additional first year depreciation deduction allowable for Equipment Y3 is $5,000 for 2017.

(6) *Change in use*—(i) *Change in use of MACRS property*. The determination of whether the use of MACRS property, as defined in § 1.168(b)–1(a)(2), changes is made in accordance with section 168(i)(5) and § 1.168(i)–4.

(ii) *Conversion to personal use*. If qualified property is converted from business or income-producing use to personal use in the same taxable year in which the property is placed in service by a taxpayer, the additional first year depreciation deduction is not allowable for the property.

(iii) *Conversion to business or income-producing use*—(A) *During the same taxable year*. If, during the same taxable year, property is acquired by a taxpayer for personal use and is converted by the taxpayer from personal use to business or income-producing use, the additional first year depreciation deduction is allowable for the property in the taxable year the property is converted to business or income-producing use, assuming all of the requirements in paragraph (b) of this section are met. See paragraph (b)(3)(ii) of this section relating to the original use rules for a conversion of property to business or income-producing use. See § 1.168(i)–4(b)(1) for determining the depreciable basis of the property at the time of conversion to business or income-producing use.

(B) *Subsequent to the acquisition year*. If property is acquired by a taxpayer for personal use and, during a subsequent taxable year, is converted by the taxpayer from personal use to business or income-producing use, the additional first year depreciation deduction is allowable for the property in the taxable year the property is converted to business or income-producing use, assuming all of the requirements in paragraph (b) of this section are met. For purposes of paragraphs (b)(4) and (5) of this section, the property must be acquired by the taxpayer for personal use after September 27, 2017, and converted by the taxpayer from personal use to business or income-producing use by January 1, 2027. See paragraph (b)(3)(ii) of this section relating to the original use rules for a conversion of property to business or income-producing use. See §1.168(i)–4(b)(1) for determining the depreciable basis of the property at the time of conversion to business or income-producing use.

(iv) *Depreciable property changes use subsequent to the placed-in-service year*. (A) If the use of qualified property changes in the hands of the same taxpayer subsequent to the taxable year the qualified property is placed in service and, as a result of the change in use, the property is no longer qualified property, the additional first year depreciation deduction allowable for the qualified property is not redetermined.

(B) If depreciable property is not qualified property in the taxable year the property is placed in service by the taxpayer, the additional first year depreciation deduction is not allowable for the property even if a change in the use of the property subsequent to the taxable year the property is placed in service results in the property being qualified property in the taxable year of the change in use.

(v) *Examples*. The application of this paragraph (g)(6) is illustrated by the following examples:

(A) *Example 1*. (*1*) On January 1, 2019, *FFF*, a calendar year corporation, purchased and placed in service several new computers at a total cost of $100,000. *FFF* used these computers within the United States for 3 months in 2019 and then moved and used the computers outside the United States for the remainder of 2019. On January 1, 2020, *FFF* permanently returns the computers to the United States for use in its business.

(*2*) For 2019, the computers are considered as used predominantly outside the United States in 2019 pursuant to §1.48–1(g)(1)(i). As a result, the computers are required to be depreciated under the alternative depreciation system of section 168(g). Pursuant to paragraph (b)(2)(ii)(B) of this section, the computers are not qualified property in 2019, the placed-in-service year. Thus, pursuant to paragraph (g)(6)(iv)(B) of this section, no additional first year depreciation deduction is allowed for these computers, regardless of the fact that the computers are permanently returned to the United States in 2020.

(B) *Example 2*. (*1*) On February 8, 2023, *GGG*, a calendar year corporation, purchased and placed in service new equipment at a cost of $1,000,000 for use in its California plant. The equipment is 5-year property under section 168(e) and is qualified property under section 168(k). *GGG* depreciates its 5-year property placed in service in 2023 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. On June 4, 2024, due to changes in *GGG*'s business circumstances, *GGG* permanently moves the equipment to its plant in Mexico.

(*2*) For 2023, *GGG* is allowed an 80-percent additional first year depreciation deduction of $800,000 (the adjusted depreciable basis of $1,000,000 multiplied by 0.80). In addition, *GGG*'s depreciation deduction allowable in 2023 for the remaining adjusted depreciable basis of $200,000 (the unadjusted depreciable basis of $1,000,000 reduced by the additional first year depreciation deduction of $800,000) is $40,000 (the remaining adjusted depreciable basis of $200,000 multiplied by the annual depreciation rate of 0.20 for recovery year 1).

(*3*) For 2024, the equipment is considered as used predominantly outside the United States pursuant to §1.48–1(g)(1)(i). As a result of this change in use, the adjusted depreciable basis of $160,000 for the equipment is required to be depreciated under the alternative depreciation system of section 168(g) beginning in 2024. However, the additional first year depreciation deduction of $800,000 allowed for the equipment in 2023 is not redetermined.

(7) *Earnings and profits.* The additional first year depreciation deduction is not allowable for purposes of computing earnings and profits.

(8) *Limitation of amount of depreciation for certain passenger automobiles.* For a passenger automobile as defined in section 280F(d)(5), the limitation under section 280F(a)(1)(A)(i) is increased by $8,000 for qualified property acquired and placed in service by a taxpayer after September 27, 2017.

(9) *Coordination with section 47*—(i) *In general.* If qualified rehabilitation expenditures, as defined in section 47(c)(2) and §1.48–12(c), incurred by a taxpayer with respect to a qualified rehabilitated building, as defined in section 47(c)(1) and §1.48–12(b), are qualified property, the taxpayer may claim the rehabilitation credit provided by section 47(a), provided the requirements of section 47 are met—

(A) With respect to the portion of the basis of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures if the taxpayer makes the applicable election under paragraph (f)(1)(i) of this section not to deduct any additional first year depreciation for the class of property that includes the qualified rehabilitation expenditures; or

(B) With respect to the portion of the remaining rehabilitated basis of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures if the taxpayer claims the additional first year depreciation deduction on the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3) but before the reduction in basis for the amount of the rehabilitation credit, of the qualified rehabilitation expenditures; and the taxpayer depreciates the remaining adjusted depreciable basis, as defined in paragraph (e)(2)(i) of this section, of such expenditures using straight line cost recovery in accordance with section 47(c)(2)(B)(i) and §1.48–12(c)(7)(i). For purposes of this paragraph (g)(9)(i)(B), the remaining rehabilitated basis is equal to the unadjusted depreciable basis, as defined in §1.168(b)–1(a)(3) but before the reduction in basis for the amount of the rehabilitation credit, of the qualified rehabilitation expenditures that are qualified property reduced by the additional first year depreciation allowed or allowable, whichever is greater.

(ii) *Example.* The application of this paragraph (g)(9) is illustrated by the following example:

(A) Between February 8, 2023, and June 4, 2023, *JM*, a calendar-year taxpayer, incurred qualified rehabilitation expenditures of $200,000 with respect to a qualified rehabilitated building that is nonresidential real property under section 168(e). These qualified rehabilitation expenditures are qualified property and qualify for the 20-percent rehabilitation credit under section 47(a)(1). *JM*'s basis in the qualified rehabilitated building is zero before incurring the qualified rehabilitation expenditures and *JM* placed the qualified rehabilitated building in service in July 2023. *JM* depreciates its nonresidential real property placed in service in 2023 under the general depreciation system of section 168(a) by using the straight line method of depreciation, a 39-year recovery period, and the mid-month convention. *JM* elected to use the optional depreciation tables to compute the depreciation allowance for its depreciable property placed in service in 2023. Further, for 2023, *JM* did not make any election under paragraph (f) of this section.

(B) Because *JM* did not make any election under paragraph (f) of this section, *JM* is allowed an 80-percent additional first year depreciation deduction of $160,000 for the qualified rehabilitation expenditures for 2023 (the unadjusted depreciable basis of $200,000 (before reduction in basis for the rehabilitation credit) multiplied by 0.80). *JM* also is allowed to claim a rehabilitation credit of $8,000 for the remaining rehabilitated basis of $40,000 (the unadjusted depreciable basis (before reduction in basis for the rehabilitation credit) of $200,000 less the additional first year depreciation deduction of $160,000, multiplied by 0.20 to calculate the rehabilitation credit). For 2023, the ratable share of the rehabilitation credit of $8,000 is $1,600. Further, *JM*'s depreciation deduction for 2023 for the remaining adjusted depreciable basis of $32,000 (the unadjusted depreciable basis (before reduction in basis for the rehabilitation credit) of $200,000 less the additional first year depreciation deduction of $160,000 less the rehabilitation credit of $8,000) is $376.64 (the remaining adjusted depreciable basis of $32,000 multiplied by the depreciation rate of 0.01177 for recovery year 1, placed in service in month 7).

(10) *Coordination with section 514(a)(3).* The additional first year depreciation deduction is not allowable for purposes of section 514(a)(3).

(11) *Mid-quarter convention.* In determining whether the mid-quarter convention applies for a taxable year under section 168(d)(3) and §1.168(d)–1, the depreciable basis, as defined in §1.168(d)–1(b)(4), for the taxable year the qualified property is placed in service by the taxpayer is not reduced by the allowed or allowable additional first year depreciation deduction for that taxable year. See §1.168(d)–1(b)(4).

(h) *Applicability dates*—(1) *In general.* Except as provided in paragraphs (h)(2) and (3) of this section, this section applies to—

(i) Depreciable property acquired after September 27, 2017, by the taxpayer and placed in service by the taxpayer during or after the taxpayer's taxable year that begins on or after January 1, 2021;

(ii) A specified plant for which the taxpayer properly made an election to apply section 168(k)(5) and that is planted, or grafted to a plant that was previously planted, by the taxpayer during or after the taxpayer's taxable year that begins on or after January 1, 2021; and

(iii) Components acquired or self-constructed after September 27, 2017, of larger self-constructed property described in paragraph (c)(2) of this section and placed in service by the taxpayer during or after the taxpayer's taxable year that begins on or after January 1, 2021.

(2) *Applicability of this section for prior taxable years.* For taxable years beginning before January 1, 2021, see §1.168(k)-2 as contained in 26 CFR part 1, revised as of April 1, 2020.

(3) *Early application of this section and §1.1502–68*—(i) *In general.* Subject to paragraphs (h)(3)(ii) and (iii) of this section, and provided that all members of a consolidated group consistently apply the same set of rules, a taxpayer may choose to apply both the rules of this section and the rules of §1.1502–68 (to the extent relevant), in their entirety and in a consistent manner, to—

(A) Depreciable property acquired after September 27, 2017, by the taxpayer and placed in service by the taxpayer during a taxable year ending on or after September 28, 2017;

(B) A specified plant for which the taxpayer properly made an election to apply section 168(k)(5) and that is planted, or grafted to a plant that was previously planted, after September 27, 2017, by the taxpayer during a taxable year ending on or after September 28, 2017; and

(C) Components acquired or self-constructed after September 27, 2017, of larger self-constructed property described in paragraph (c)(2) of this section and placed in service by the taxpayer during a taxable year ending on or after September 28, 2017.

(ii) *Early application to certain transactions.* In the case of property described in §1.1502–68(e)(2)(i) that is acquired in a transaction that satisfies the requirements of §1.1502–68(c)(1)(ii) or (c)(2)(ii), the taxpayer may apply the rules of this section and the rules of §1.1502–68 (to the extent relevant), in their entirety and in a consistent manner, to such property only if those rules are applied, in their entirety and in a consistent manner, by all parties to the transaction, including the transferor member, the transferee member, and the target, as applicable, and the consolidated groups of which they are members, for the taxable year(s) in which the transaction occurs and the taxable year(s) that includes the day after the deconsolidation date, as defined in §1.1502–68(a)(2)(iii).

(iii) *Bound by early application.* Once a taxpayer applies the rules of this section and the rules of §1.1502–68 (to the extent relevant), in their entirety, for a taxable year, the taxpayer must continue to apply the rules of this section and the rules of §1.1502–68 (to the extent relevant), in their entirety, for the taxpayer's subsequent taxable years.

[T.D. 9874, 84 FR 50129, Sept. 24, 2019, as amended by T.D. 9916, 85 FR 71753, Nov. 10, 2020]

§ 1.168A–1 Amortization of emergency facilities; general rule.

(a) A person (including an estate or trust (see section 642(f) and §1.642(f)–1) and a partnership (see section 703 and §1.703–1)) is entitled, by election, to a deduction with respect to the amortization of the adjusted basis (for determining gain) of an emergency facility, such amortization to be based on a period of 60 months. As to the adjusted basis of an emergency facility, see §1.168A–5. The taxpayer may elect to begin the 60-month amortization period with (1) the month following the month in which such facility was completed or acquired, or (2) the taxable year succeeding that in which such facility was completed or acquired (see §1.168A–2). The date on which, or the month within which, an emergency facility is completed or acquired is to be determined upon the facts in the particular case. Ordinarily, the taxpayer is in possession of all the facts and, therefore, in a position to ascertain such date. A statement of the date ascertained by the taxpayer, together with a statement of the pertinent facts relied upon, should be filed with the taxpayer's election to take amortization deductions with respect to such facility.

(b) Generally, an amortization deduction will not be allowed with respect to an emergency facility for any taxable year unless such facility has been certified before the date of filing of the taxpayer's income tax return for such taxable year. However, this limitation does not apply in the case of a certificate made after August 22, 1957, for an emergency facility to provide primary processing for uranium ore or uranium concentrate under a program of the Atomic Energy Commission for the development of any sources of uranium ore or uranium concentrate, if application for such certificate was filed either (1) before September 2, 1958, and before the expiration of six months after the beginning of construction, reconstruction, erection, or installation or the date of acquisition of the facility, or (2) after September 1, 1958, and on or before December 2, 1958.

(c) In general, with respect to each month of the 60-month period which falls within the taxable year, the amortization deduction is an amount equal to the adjusted basis of the facility at the end of each month divided by the number of months (including the particular month for which the deduction is computed) remaining in the 60-month period. The adjusted basis at the end of any month shall be computed without regard to the amortization deduction for such month. The total amortization deduction with respect to an emergency facility for a particular taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year. The amortization deduction taken for any month is in lieu of the deduction for depreciation which would otherwise be allowable under section 167. See, however, §1.168A–6, relating to depreciation with respect to any portion of the emergency facility not subject to amortization.

(d) This section may be illustrated by the following examples:

Example 1. On July 1, 1954, the X Corporation, which makes its income tax returns on the calendar year basis, begins the construction of an emergency facility which is completed on September 30, 1954, at a cost of $240,000. The certificate covers the entire construction. The X Corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with October, the month following its completion. The adjusted basis of the facility at the end of October is $240,000. The allowable amortization deduction with respect to such facility for the taxable year 1954 is $12,000, computed as follows:

Monthly amortization deductions:	
October: $240,000 divided by 60	$4,000
November: $236,000 ($240,000 minus $4,000) divided by 59	4,000
December: $232,000 ($236,000 minus $4,000) divided by 58	4,000
Total amortization deduction for 1954	12,000

Example 2. The Y Corporation, which makes its income tax returns on the basis of a fiscal year ending November 30, purchases an emergency facility (No. 1) on July 29, 1955. On June 15, 1955, it begins the construction of an emergency facility (No. 2) which is

completed on August 2, 1955. The entire acquisition and construction of such facilities are covered by the certificate. The Y Corporation elects to take amortization deductions with respect to both facilities and to begin the 60-month amortization period in each case with the month following the month of acquisition or completion. At the end of the first month of the amortization period the adjusted basis of facility No. 1 is $300,000 and the adjusted basis of facility No. 2 is $54,000. In September 1955, facility No. 1 is damaged by fire, as a result of which its adjusted basis is properly reduced by $25,370. The allowable amortization deduction with respect to such facilities for the taxable year ending November 30, 1955, is $21,410, computed as follows:

Facility No. 1

Monthly amortization deductions:	
August: $300,000 divided by 60	$5,000
September: $269,630 ($300,000 minus $5,000 and $25,370) divided by 59	4,570
October: $265,060 ($269,630 minus $4,570) divided by 58	4,570
November: $260,490 ($265,060 minus $4,570) divided by 57	4,570
Amortization deduction for 1955	18,710

Facility No. 2

Monthly amortization deductions:	
September: $54,000 divided by 60	$900
October: $53,100 divided by 59	900
November: $52,200 divided by 58	900
Amortization deduction for 1955	2,700
Total amortization deduction for 1955	21,410

Example 3. On June 15, 1954, the Z Corporation, which makes its income tax returns on the calendar year basis, completes the construction of an emergency facility at a cost of $110,000. In its income tax return for 1954, filed on March 15, 1955, the Z Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1954, the month following its completion. No certificate with respect to such facility is made until April 10, 1955, and therefore no amortization deduction with respect to such facility is allowable for any month in the taxable year 1954. The Z Corporation is entitled, however, to take a deduction for depreciation of such facility for the taxable year 1954, such deduction being assumed, for the purposes of this example, to be $2,000. Accordingly, the adjusted basis of such facility at the end of January 1955 (without regard to the amortization deduction for such month) is $108,000 ($110,000 minus $2,000). For the taxable year 1955, the Z Corporation is, with respect to such facility, entitled to an amortization deduction of $24,000, computed as follows:

Monthly amortization deductions:	
January: $108,000 divided by 54	$2,000
February: $106,000 ($108,000 minus $2,000) divided by 53	2,000
March: $104,000 ($106,000 minus $2,000) divided by 52	2,000
For the remaining nine months (similarly computed)	18,000
Total amortization deduction for 1955	24,000

Since the Z Corporation elected in its return for 1954 to take amortization deductions with respect to such facility and to begin the 60-month amortization period with July 1954, it must compute its amortization deductions for the 12 months in the taxable year 1955 on the basis of the remaining months of the established 60-month amortization period, as indicated in the above computation.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46618, Dec. 24, 1986]

§ 1.168A–2 Election of amortization.

(a) *General rule.* An election by the taxpayer to take amortization deductions with respect to an emergency facility and to begin the 60-month amortization period either with the month following the month in which such facility was completed or acquired, or with the taxable year succeeding the taxable year in which such facility was completed or acquired, shall be made by a statement to that effect in its return for the taxable year in which falls the first month of the 60-month amortization period so elected. However, if the facility is described in section 168(e)(2)(C) and an application for a certificate is filed within the period prescribed by section 9(c) of the Technical Amendments Act of 1958 (72 Stat. 1609) and paragraph (b) of § 1.168A–1, the election may be made by a statement in an amended income tax return for the taxable year in which falls the first month of the 60-month amortization period so elected. The statement and amended return in such case must be filed not later than 90 days after the date the certificate is made or not later than April 4, 1960, whichever is later. Amended income tax returns or claims for credit or refund should also be filed for other taxable years which are within such amortization period and which precede the taxable year in which the election is made. Nothing in this paragraph should be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(b) *Election not made, in prescribed manner.* If the statement of election is not made by the taxpayer as prescribed in paragraph (a) of this section, it may, in the discretion of the Commissioner and for good cause shown, be made in such manner and form and within such time as may be approved by the Commissioner.

(c) *Other requirements and considerations.* No method of making such election other than those prescribed in this section and corresponding sections of prior regulations is permitted. Any statement of election should contain a description clearly identifying each emergency facility for which an amortization deduction is claimed. A taxpayer which does not elect, in the manner prescribed in this section or corresponding sections of prior regulations, to take amortization deductions with respect to an emergency facility shall not be entitled to such deductions.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46618, Dec. 24, 1986]

§ 1.168A–3 Election to discontinue amortization.

(a) If a taxpayer has elected to take amortization deductions with respect to an emergency facility, it may, after such election and prior to the expiration of the 60-month amortization period, discontinue the amortization deductions for the remainder of the 60-month period. An election to discontinue the amortization deductions shall be made by a notice in writing filed with the district director for the internal revenue district in which the return of the taxpayer is required to be filed, specifying the month as of the beginning of which the taxpayer elects to discontinue such deductions. Such notice shall be filed before the beginning of the month specified therein, and shall contain a description clearly identifying the emergency facility with respect to which the taxpayer elects to discontinue the amortization deductions. If the taxpayer so elects to discontinue the amortization deductions, it shall not be entitled to any further amortization deductions with respect to such facility.

(b) A taxpayer which thus elects to discontinue amortization deductions with respect to an emergency facility is entitled, if such facility is depreciable property under section 167 and the regulations thereunder, to a deduction for depreciation with respect to such facility. The deduction for depreciation shall begin with the first month as to which the amortization deduction is not applicable, and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 1011 and the regulations thereunder).

(c) This section may be illustrated by the following example:

Example. On July 1, 1954, the X Corporation, which makes its income tax returns on the calendar year basis, purchases an emergency facility, consisting of land with a building thereon, at a cost of $306,000 of which $60,000 is allocable to the land and $246,000 to the building. The certificate covers the entire acquisition. The corporation elects to take amortization deductions with respect to the facility and to begin the 60-month amortization period with the taxable year 1955. Depreciation of the building in the amount of $6,000 is deducted and allowed for the taxable year 1954. On March 25, 1956, the corporation files notice with the district director of its election to discontinue the amortization deductions beginning with the month of April 1956. The adjusted basis of the facility on January 31, 1955, is $300,000, or the cost of the facility ($306,000) less the depreciation allowed for 1954 ($6,000). The amortization deductions for the taxable year 1955 and the months of January, February, and March 1956, amount to $75,000, or $5,000 per month for 15 months. Since, at the beginning of the amortization period (January 1, 1955), the adjusted basis of the land ($60,000) is one-fifth of the adjusted basis of the entire facility ($300,000) and since there are no adjustments to basis other than on account of amortization during the period, the adjusted basis of the land should be reduced by $15,000, or one-fifth of the entire amortization deduction, and the adjusted basis of the building should be reduced by $60,000, or four-fifths of the entire amortization deduction. Accordingly, the adjusted basis of the facility as of April 1, 1956, is $225,000, of which $180,000 is allocable to the building for the purpose of depreciation deductions under section 167, and $45,000 is allocable to the land.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§ 1.168A–4 Definitions.

As used in the regulations under section 168, the term—

(a) ''Certifying authority'' means the certifying authority designated by the President by Executive order.

(b) ''Emergency facility'' means any facility, land, building, machinery, or equipment, or any part thereof, the acquisition of which occurred after December 31, 1949, or the construction, reconstruction, erection, or installation of which was completed after such date, and with respect to which a certificate under section 168(e) has been made. In the case of an application for a certificate under section 168(e) which is filed after March 23, 1951, only the part of any such facility which is constructed, reconstructed, erected, or installed by any person not earlier than six months prior to the filing of such application, and which is certified in accordance with section 168(e), shall be deemed to be an emergency facility, notwithstanding that the other part of such facility was constructed, reconstructed, erected, or installed earlier than six months prior to the filing of such application. However, if the facility is one described in section 168(e)(2)(C) and the application was filed after September 1, 1958, and on or before December 2, 1958, the preceding sentence shall not apply. The term ''emergency facility,'' as so defined, may include, among other things, improvements of land, such as the construction of roads, bridges, and airstrips, and the dredging of channels.

(c) ''Emergency period'' means the period beginning on January 1, 1950, and ending on the date on which the President proclaims that the utilization of a substantial portion of the certified emergency facilities is no longer required in the interest of national defense.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§ 1.168A–5 Adjusted basis of emergency facility.

(a) *In general.* (1) The adjusted basis of an emergency facility for the purpose of computing the amortization deduction may differ from what would otherwise constitute the adjusted basis of such emergency facility in that it shall be the adjusted basis for determining gain (see Part II (section 1011 and following), Subchapter 0, Chapter 1 of the Code) and in that it may be only a portion of what would otherwise constitute the adjusted basis. It will be only a portion of such other adjusted basis if only a portion of the basis (unadjusted) is attributable to certified construction, reconstruction, erection, installation, or acquisition taking place after December 31, 1949. Also, it will be only a portion of what would otherwise constitute the adjusted basis of the emergency facility if only a portion of the basis (unadjusted) is certified as attributable to defense purposes or, in the case of a certification after August 22, 1957, if only a portion of the basis (unadjusted) is certified as attributable to the national defense program. It is therefore necessary first to determine the unadjusted basis of the emergency facility from which the adjusted basis for amortization purposes is derived.

(2) The unadjusted basis for amortization purposes is the same as the unadjusted basis otherwise determined only when the entire construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1949, and is certified in its entirety by the certifying authority.

(3) In cases in which only a portion of the construction, reconstruction, erection, installation, or acquisition takes place after December 31, 1949, and that portion is certified in its entirety by the certifying authority, the unadjusted basis for the purpose of amortization is so much of the entire unadjusted basis as is attributable to the certified construction, reconstruction, erection, installation, or acquisition which takes place after December 31, 1949. For example, the X Corporation begins the construction of a facility on November 15, 1949, and such facility is completed on April 1, 1952, at a cost of $5,000,000, of which $4,600,000 is attributable to construction after December 31, 1949. The entire construction after December 31, 1949, is certified by the certifying authority. The unadjusted basis of the emergency facility for amortization purposes is therefore $4,600,000. For depreciation of

the remaining portion ($400,000) of the cost see § 1.168A–6.

(4) If the certifying authority certifies only a portion of the construction, reconstruction, erection, installation, or acquisition of property which takes place after December 31, 1949, the unadjusted basis for amortization purposes is limited to such portion so certified. Assuming the same facts as in the example in subparagraph (3) of this paragraph, except that only 50 percent of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, is certified, the unadjusted basis for amortization purposes is 50 percent of $4,600,000, or $2,300,000.

(5) The adjusted basis of an emergency facility for amortization purposes is the unadjusted basis for amortization purposes less the adjustments properly applicable thereto. Such adjustments are those specified in sections 1016 and 1017, except that no adjustments are to be taken into account which increase the adjusted basis. (See paragraph (b) of this section.) If the taxpayer constructs, reconstructs, erects, installs, or acquires an emergency facility pursuant to a cost reimbursement contract with an obligation for reimbursement by the United States of all or a part of the cost of such facility, the unadjusted basis of such facility for amortization purposes shall not include that part of the cost for which the taxpayer is entitled to reimbursement, and the amount received as reimbursement shall be treated as a capital receipt. However, amounts received by a taxpayer which represent in fact compensation by reason of termination of a government contract or payment for articles under such a contract, though denominated reimbursements for all or a part of the cost of an emergency facility, are not to be treated as capital receipts but are to be taken into account in computing income, and are therefore not to be applied in reduction of the basis of such facility.

(6) The following examples will illustrate the computation of the adjusted basis of an emergency facility for amortization purposes:

Example 1. The X Corporation completes an emergency facility on July 1, 1954, the entire unadjusted basis of which is $500,000, and the unadjusted basis of which for the purpose of amortization is $300,000. The X Corporation elects to begin amortization as of January 1, 1955. The only adjustment to basis for the period July 1, 1954, to January 31, 1955, other than depreciation or amortization for January 1955, is $5,000 for depreciation for the last six months of 1954. The adjusted basis for the purpose of amortization is therefore $300,000 less $3,000 (300,000/500,000 × $5,000), or $297,000.

Example 2. On July 31, 1956, the Y Corporation has an emergency facility (a building) which was completed on July 1, 1952, the entire basis of which is $500,000 and the unadjusted basis of which for the purpose of amortization is $300,000. The corporation elected to begin amortization as of January 1, 1953, at which time it was entitled to $5,000 depreciation for the last six months of 1952. On July 1, 1956, the facility was damaged by fire, as the result of which its adjusted basis is properly reduced by $200,000. The adjusted basis of the emergency facility as of July 1956 for the purpose of amortization and depreciation, and the adjusted basis for other purposes, are $23,849.18, $49,250.82, and $73,100.00, respectively, computed as follows:

	For amortization	For depreciation	For other purposes
Unadjusted basis	$300,000.00	$200,000.00	$500,000
Less depreciation to Jan. 1, 1953	3,000.00	2,000.00	5,000
Adjusted basis January 1953	297,000.00	198,000.00	495,000
Less amortization for 42 months	207,900.00		207,900
Less depreciation for 42 months		14,000.00	14,000
Adjusted basis at time of fire	89,100.00	184,000.00	273,100
Less fire loss (apportioned as explained below)	65,250.82	134,749.18	200,000
Adjusted basis after fire loss	23,849.18	49,250.82	73,100

The $200,000 fire loss is applied against the adjusted basis for the purpose of amortization and the adjusted basis for the purpose of depreciation in the proportion that each such adjusted basis at the time of the fire bears to their sum, *i.e.*, 89,100/273,100 × $200,000 or $65,250.82, against the amortization basis, and 184,000/273,100 × $200,000, or $134,749.18 against the depreciation basis.

(b) *Capital additions.* (1) If, after the completion or acquisition of an emergency facility which has been certified by the certifying authority, further expenditures are made for construction, reconstruction, erection, installation, or acquisition attributable to such facility but not covered by such certification, such expenditures shall not be added to the adjusted basis of the emergency facility for amortization purposes under such certification. If such further expenditures are separately certified in accordance with the provisions of section 168(e) (1) or (2) and this section, they are treated as certified expenditures in connection with a new and separate emergency facility and, if proper election is made, will be taken into account in computing the adjusted basis of such new and separate emergency facility for the purpose of amortization.

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

Example. On March 1, 1954, the certifying authority certifies as an emergency facility a heating plant proposed to be constructed by the Z Corporation. Such facility is completed on July 1, 1954. The Z Corporation, on August 1, 1954, begins the installation in the plant of an additional boiler, which is not included in the certification for the plant but is certified as a new and separate emergency facility. For amortization purposes, the adjusted basis of the heating plant is determined without including the cost of the additional boiler. Such cost is taken into account in computing the adjusted basis of the new and separate emergency facility (the boiler), as to which the taxpayer has a separate election for amortization purposes and a separate amortization period.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§ 1.168A–6 Depreciation of portion of emergency facility not subject to amortization.

(a) The rule that an amortization deduction with respect to an emergency facility is in lieu of any deduction for depreciation which would otherwise be allowable under section 167 is subject to the exception provided in section 168(f). Under this exception, if the property constituting such facility is depreciable property under section 167 and the regulations thereunder and if the adjusted basis of such facility as computed under section 1011 for purposes other than the amortization deductions is in excess of the adjusted basis computed for the purpose of the amortization deductions, then the excess shall be charged off over the useful life of the facility and recovered through depreciation deductions. Thus, if the construction of an emergency facility is begun on or before December 31, 1949, and completed after such date, no amortization deductions are allowable with respect to the amount attributable to such construction on or before such date (see §1.168A–5). However, if the property constituting such facility is depreciable property under section 167 and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the amount attributable to such construction on or before December 31, 1949.

(b) Similarly, if only a portion of the construction, reconstruction, erection, installation, or acquisition after December 31, 1949, of an emergency facility has been certified by the certifying authority, and if such facility is depreciable property under section 167 and the regulations thereunder, then the depreciation deduction provided by such section and regulations is allowable with respect to the portion which has not been so certified.

(c) For illustration of the treatment of a depreciable portion of an emergency facility, see example (2) in paragraph (a)(6) of §1.168A–5.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§ 1.168A–7 Payment by United States of unamortized cost of facility.

(a) Section 168(g) contemplates that certain payments may be made by the United States to a taxpayer as compensation for the unamortized cost of an emergency facility. If any such payment is properly includible in gross income and has been certified, as provided in section 168(g), as having been paid under the circumstances described therein, a taxpayer which is recovering the adjusted basis of an emergency facility through amortization rather than depreciation may elect to take an amount equal to such payment as an amortization deduction with respect to such facility for the month in which such payment is so includible. Such amortization deduction shall be in lieu of the amortization deduction otherwise allowable with respect to such facility for such month, but it shall not in any case exceed the adjusted basis of such facility (see § 1.168A–5) as of the end of such month (computed without regard to any amortization deduction for such month). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(b) If a taxpayer is recovering the adjusted basis of an emergency facility through depreciation rather than amortization, the depreciation deduction allowable under section 167 for the month in which the amount of any such payment is includible in gross income shall, at the taxpayer's election, be increased by such amount; but the total deduction with respect to the certified portion of such facility shall not in any case exceed the adjusted basis of such facility (computed as provided in section 168(e) and § 1.168A–5 for amortization purposes) as of the end of such month (computed without regard to any amount allowable for such month under section 167 or 168(g)(2)). The election referred to in this paragraph shall be made in the return for the taxable year in which the amount of such payment is includible in gross income.

(c) This section may be illustrated by the following examples:

Example 1. On January 31, 1954, the X Corporation purchases an emergency facility at a cost of $600,000. The certificate covers the entire acquisition. The X Corporation elects to take amortization deductions with respect to such facility and to begin the 60-month amortization period with February 1954, the month following the month of acquisition. On July 15, 1955, as a result of the cancellation of certain contracts with the X Corporation, the United States makes a payment of $300,000 to the corporation as compensation for the unamortized cost of such facility. The $300,000 payment is includible in the X Corporation's gross income for July 1955. The adjusted basis of such facility for amortization purposes as of the end of July 1955, computed without regard to any amortization deduction for such month, is $430,000. Accordingly, the corporation is entitled to take an amortization deduction of $300,000 for such month, in lieu of the $10,000 amortization deduction which is otherwise allowable.

Example 2. On November 30, 1954, the Y Corporation purchases an emergency facility, consisting of land with a building thereon, at a cost of $500,000, of which $200,000 is allocable to the land and $300,000 to the building. The certificate covers the entire acquisition. The Y Corporation does not elect to take amortization deductions with respect to such facility, but is entitled to a depreciation deduction with respect to the building at the rate of 3 percent per annum, or $750 per month. On August 12, 1956, as a result of cancellation of certain contracts, the United States makes a payment of $400,000 to the corporation as compensation for the unrecovered cost of such facility. The $400,000 is includible in the Y Corporation's gross income for August 1956. The adjusted basis of the facility as of the end of August 1956, computed without regard to depreciation for such month, is $485,000, of which amount $200,000 is allocable to the land and $285,000 to the building. Accordingly, the corporation is entitled to increase the $750 depreciation deduction for August 1956 by the full amount of the $400,000 payment.

[T.D. 6500, 25 FR 11402, Nov. 26, 1960; 25 FR 14021, Dec. 21, 1960. Redesignated and amended by T.D. 8116, 51 FR 46619, Dec. 24, 1986]

§ 1.169–1 Amortization of pollution control facilities.

(a) *Allowance of deduction*—(1) *In general.* Under section 169(a), every person, at his election, shall be entitled to a deduction with respect to the amortization of the amortizable basis (as defined in § 1.169–3) of any certified pollution control facility (as defined in § 1.169–2), based on a period of 60 months. Under section 169(b) and paragraph (a) of § 1.169–4, the taxpayer may further elect to begin such 60-month period either with the month following the month in which the facility is completed or acquired or with the first month of the taxable year succeeding the taxable year in which such facility is completed or acquired. Under section 169(c), a taxpayer who has elected under section 169(b) to take the amortization deduction provided by section 169(a) may, at any time after making such election and prior to the expiration of the 60-month amortization period, elect to discontinue the amortization deduction for the remainder of the

60-month period in the manner prescribed in paragraph (b)(1) of §1.169–4. In addition, if on or before May 18, 1971, an election under section 169(a) has been made, consent is hereby given to revoke such election without the consent of the Commissioner in the manner prescribed in (b)(2) of §1.169–4.

(2) *Amount of deduction.* With respect to each month of such 60-month period which falls within the taxable year, the amortization deduction shall be an amount equal to the amortizable basis of the certified pollution control facility at the end of such month divided by the number of months (including the month for which the deduction is computed) remaining in such 60-month period. The amortizable basis at the end of any month shall be computed without regard to the amortization deduction for such month. The total amortization deduction with respect to a certified pollution control facility for a taxable year is the sum of the amortization deductions allowable for each month of the 60-month period which falls within such taxable year. If a certified pollution control facility is sold or exchanged or otherwise disposed of during 1 month, the amortization deduction (if any) allowable to the original holder in respect of such month shall be that portion of the amount to which such person would be entitled for a full month which the number of days in such month during which the facility was held by such person bears to the total number of days in such month.

(3) *Effect on other deductions.* (i) The amortization deduction provided by section 169 with respect to any month shall be in lieu of the depreciation deduction which would otherwise be allowable under section 167 or a deduction in lieu of depreciation which would otherwise be allowable under paragraph (b) of §1.162–11 for such month.

(ii) If the adjusted basis of such facility as computed under section 1011 for purposes other than the amortization deduction provided by section 169 is in excess of the amortizable basis, as computed under §1.169–3, such excess shall be recovered through depreciation deductions under the rules of section 167. See section 169(g).

(iii) See section 179 and paragraph (e)(1)(ii) of §1.179–1 and paragraph (b)(2) of §1.169–3 for additional first-year depreciation in respect of a certified pollution control facility.

(4) [Reserved]

(5) *Special rules.* (i) In the case of a certified pollution control facility held by one person for life with the remainder to another person, the amortization deduction under section 169(a) shall be computed as if the life tenant were the absolute owner of the property and shall be allowable to the life tenant during his life.

(ii) If the assets of a corporation which has elected to take the amortization deduction under section 169(a) are acquired by another corporation in a transaction to which section 381 (relating to carryovers in certain corporate acquisitions) applies, the acquiring corporation is to be treated as if it were the distributor or transferor corporation for purposes of this section.

(iii) For the right of estates and trusts to amortize pollution control facilities see section 642(f) and §1.642 (f)–1. For the allowance of the amortization deduction in the case of pollution control facilities of partnerships, see section 703 and §1.703–1.

(6) *Depreciation subsequent to discontinuance or in the case of revocation of amortization.* A taxpayer which elects in the manner prescribed under paragraph (b) (1) of §1.169–4 to discontinue amortization deductions or under paragraph (b) (2) of §1.169–4 to revoke an election under section 169(a) with respect to a certified pollution control facility is entitled, if such facility is of a character subject to the allowance for depreciation provided in section 167, to a deduction for depreciation (to the extent allowable) with respect to such facility. In the case of an election to discontinue an amortization deduction, the deduction for depreciation shall begin with the first month as to which such amortization deduction is not applicable and shall be computed on the adjusted basis of the property as of the beginning of such month (see section 1011 and the regulations thereunder). Such depreciation deduction shall be based upon the remaining portion of the period authorized under section 167

for the facility as determined, as of the first day of the first month as of which the amortization deduction is not applicable. If the taxpayer so elects to discontinue the amortization deduction under section 169(a), such taxpayer shall not be entitled to any further amortization deduction under this section and section 169(a) with respect to such pollution control facility. In the case of a revocation of an election under section 169(a), the deduction for depreciation shall begin as of the time such depreciation deduction would have been taken but for the election under section 169(a). See paragraph (b)(2) of §1.169–4 for rules as to filing amended returns for years for which amortization deductions have been taken.

(7) *Definitions.* Except as otherwise provided in §1.169–2, all terms used in section 169 and the regulations thereunder shall have the meaning provided by this section and §§1.169–2 through 1.169–4.

(b) *Examples.* This section may be illustrated by the following examples:

Example 1. On September 30, 1970, the X Corporation, which uses the calendar year as its taxable year, completes the installation of a facility all of which qualifies as a certified pollution control facility within the meaning of paragraph (a) of §1.169–2. The cost of the facility is $120,000 and the period referred to in paragraph (a)(6) of §1.169–2 is 10 years in accordance with the rules set forth in paragraph (a) of §1.169–4, on its income tax return filed for 1970, X elects to take amortization deductions under section 169(a) with respect to the facility and to begin the 60-month amortization period with October 1970, the month following the month in which it was completed. The amortizable basis at the end of October 1970 (determined without regard to the amortization deduction under section 169(a) for that month) is $120,000. The allowable amortization deduction with respect to such facility for the taxable year 1970 is $6,000, computed as follows:

Monthly amortization deductions:	
October: $120,000 divided by 60	$2,000
November: $118,000 (that is, $120,000 minus $2,000) divided by 59	2,000
December: $116,000 (that is, $118,000 minus $2,000) divided by 58	2,000
Total amortization deduction for 1970	6,000

Example 2. Assume the same facts as in example (1). Assume further that on May 20, 1972, X properly files notice of its election to discontinue the amortization deductions with the month of June 1972. The adjusted basis of the facility as of June 1, 1972, is $80,000, computed as follows:

Yearly amortization deductions:	
1970 (as computed in example (1))	$6,000
1971 (computed in accordance with example (1))	24,000
1972 (for the first 5 months of 1972 computed in accordance with example (1))	10,000
Total amortization deductions for 20 months	40,000
Adjusted basis as beginning of amortization period	120,000
Less: Amortization deductions	40,000
Adjusted basis as of June 1, 1972	80,000

Beginning as of June 1, 1972, the deduction for depreciation under section 167 is allowable with respect to the property on its adjusted basis of $80,000.

[T.D. 7116, 36 FR 9012, May 18, 1971; 36 FR 9770, May 28, 1971, as amended by T.D. 7203, 37 FR 17133, Aug. 25, 1972]

§ 1.169–2 Definitions.

(a) *Certified pollution control facility*—(1) *In general.* Under section 169 (d), the term ''certified pollution control facility'' means a facility which—

(i) The Federal certifying authority certifies, in accordance with the rules prescribed in paragraph (c) of this section, is a ''treatment facility'' described in subparagraph (2) of this paragraph, and

(ii) Is ''a new identifiable facility'' (as defined in paragraph (b) of this section).

For profitmaking abatement works limitation, see paragraph (d) of this section.

(2) *Treatment facility.* For purposes of subparagraph (1)(i) of this paragraph, a ''treatment facility'' is a facility which (i) is used to abate or control water or atmospheric pollution or contamination by removing, altering, disposing, or storing of pollutants, contaminants, wastes, or heat and (ii) is used in connection with a plant or other property in operation before January 1, 1969. Determinations under subdivision (i) of this subparagraph shall be made solely by the Federal certifying authority. See subparagraph (3) of this paragraph. For meaning of the phrases ''plant or other property'' and ''in operation before January 1, 1969,'' see subparagraphs (4) and (5), respectively, of this paragraph.

(3) *Facilities performing multiple functions or used in connection with several plants, etc.* (i) If a facility is designed to perform or does perform a function in addition to abating or controlling water or atmospheric pollution or contamination by removing, altering, disposing or storing pollutants, contaminants, wastes, or heat, such facility shall be a treatment facility only with respect to that part of the cost thereof which is certified by the Federal certifying authority as attributable to abating of controlling water or atmospheric pollution or contamination. For example, if a machine which performs a function in addition to abating water pollution is installed at a cost of $100,000 in, and is used only in connection with, a plant which was in operation before January 1, 1969, and if the Federal certifying authority certifies that $30,000 of the cost of such machine is allocable to its function of abating water pollution, such $30,000 will be deemed to be the adjusted basis for purposes of determining gain for purposes of paragraph (a) of §1.169–3.

(ii) If a facility is used in connection with more than one plant or other property, and at least one such plant or other property was not in operation before January 1, 1969, such facility shall be a treatment facility only to the extent of that part of the cost thereof certified by the Federal certifying authority as attributable to abating or controlling water or atmospheric pollution in connection with plants or other property in operation before January 1, 1969. For example, if a machine is constructed after December 31, 1968, at a cost of $100,000 and is used in connection with a number of plants only some of which were in operation before January 1, 1969, and if the Federal certifying authority certifies that $20,000 of the cost of such machine is allocable to its function of abating or controlling water pollution in connection with the plants or other property in operation before January 1, 1969, such $20,000 will be deemed to be the adjusted basis for purposes of determining gain for purposes of paragraph (a) of §1.169–3. In a case in which the Federal certifying authority certifies the percentage of a facility which is used in connection with plants or other property in operation before January 1, 1969, the adjusted basis for the purposes of determining gain for purposes of paragraph (a) of §1.169–3 of the portion of the facility so used shall be the adjusted basis for determining gain of the entire facility multiplied by such percentage.

(4) *Plant or other property.* As used in subparagraph (2) of this paragraph, the phrase ''plant or other property'' means any tangible property whether or not such property is used in the trade or business or held for the production of income. Such term includes, for example, a papermill, a motor vehicle, or a furnace in an apartment house.

(5) *In operation before January 1, 1969.* (i) For purposes of subparagraph (2) of this paragraph and section 169 (d), a plant or other property will be considered to be in operation before January 1, 1969, if prior to that date such plant or other property was actually performing the function for which it was constructed or acquired. For example, a papermill which is completed in July 1968, but which is not actually used to produce paper until 1969 would not be considered to be in operation before January 1, 1969. The fact that such plant or other property was only operating at partial capacity prior to January 1, 1969, or was being used as a standby facility prior to such date, shall not prevent its being considered to be in operation before such date.

(ii)(*a*) A piece of machinery which replaces one which was in operation prior to January 1, 1969, and which was a part of the manufacturing operation carried on by the plant but which does not substantially increase the capacity of the plant will be considered to be in operation prior to January 1, 1969. However, an additional machine that is added to a plant which was in operation before January 1, 1969, and which represents a substantial increase in the plant's capacity will not be considered to have been in operation before such date. There shall be deemed to be a substantial increase in the capacity of a plant or other property as of the time its capacity exceeds by more than 20 percent its capacity on December 31, 1968.

(*b*) In addition, if the total replacements of equipment in any single taxable year beginning after December 31, 1968, represents the replacement of a substantial portion of a manufacturing plant which had been in operation before such date, such replacement shall be considered to result in a new plant which was not in operation before such date. Thus, if a substantial portion of a plant which was in existence before January 1, 1969, is subsequently destroyed by fire and such substantial portion is replaced in a taxable year beginning after that date, such replacement property shall not be considered to have been in operation before January 1, 1969. The replacement of a substantial portion of a plant or other property shall be deemed to have occurred if, during a single taxable year, the taxpayer replaces manufacturing or production facilities or equipment which comprises such plant or other property and which has an adjusted basis (determined without regard to the adjustments provided in section 1016(a) (2) and (3)) in excess of 20 percent of the adjusted basis (so determined) of such plant or other property determined as of the first day of such taxable year.

(6) *Useful life.* For purposes of section 169 and the regulations thereunder, the terms ''useful life'' and ''actual useful life'' shall mean the shortest period authorized under section 167 and the regulations thereunder if an election were not made under section 169.

(b) *New identifiable facility*—(1) *In general.* For purposes of paragraph (a)(1)(ii) of this section, the term ''new identifiable facility'' includes only tangible property (not including a building and its structural components referred to in subparagraph (2)(i) of this paragraph, other than a building and its structural components which under subparagraph (2)(ii) of this paragraph is exclusively a treatment facility) which—

(i) Is of a character subject to the allowance for depreciation provided in section 167,

(ii)(*a*) Is property the construction, reconstruction, or erection (as defined in subparagraph (2)(iii) of this paragraph) of which is completed by the taxpayer after December 31, 1968, or

(*b*) Is property acquired by the taxpayer after December 31, 1968, if the original use of the property commences with the taxpayer and commences after such date (see subparagraph (2)(iii) of this paragraph), and

(iii) Is placed in service (as defined in subparagraph (2)(v) of this paragraph) prior to January 1, 1975.

(2) *Meaning of terms.* (i) For purposes of subparagraph (1) of this paragraph, the terms ''building'' and ''structural component'' shall be construed in a manner consistent with the principles set forth in paragraph (e) of §1.48–1. Thus, for example, the following rules are applicable:

(*a*) The term ''building'' generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, structures such as apartment houses, factory and office buildings, warehouses, barns, garages, railway or bus stations, and stores. Such term includes any such structure constructed by, or for, a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term does not include (*1*) a structure which is essentially an item of machinery or equipment, or (*2*) an enclosure which is so closely combined with the machinery or equipment which it supports, houses, or serves that it must be replaced, retired, or abandoned contemporaneously with such machinery or equipment, and which is depreciated over the life of such machinery or equipment. Thus, the term ''building'' does not include such structures as oil and gas storage tanks, grain storage bins, silos, fractioning towers, blast furnaces, coke ovens, brick kilns, and coal tipples.

(*b*) The term ''structural components'' includes, for example, chimneys, and other components relating to the operating or maintenance of a building. However, the term ''structural components'' does not include machinery or a device which serves no function other than the abatement or control of water or atmospheric pollution.

(ii) For purposes of subparagraph (1) of this paragraph, a building and its structural components will be considered to be exclusively a treatment facility if its only function is the abatement or control of air or water pollution. However, the incidental recovery of profits from wastes or otherwise shall not be deemed to be a function other than the abatement or control of air or water pollution. A building and its structural components which serve no function other than the treatment of wastes will be considered to be exclusively a treatment facility even if it contains areas for employees to operate the treatment facility, rest rooms for such workers, and an office for the management of such treatment facility. However, for example, if a portion of a building is used for the treatment of sewage and another portion of the building is used for the manufacture of machinery, the building is not exclusively a treatment facility. The Federal certifying authority will not certify as to what is a building and its structural components within the meaning of subdivision (i) of this subparagraph.

(iii) For purposes of subparagraph (1)(ii) (*a*) and (*b*) of this paragraph (relating to construction, reconstruction, or erection after December 31, 1968, and original use after December 31, 1968) and paragraph (b)(1) of §1.169–3 (relating to definition of amortizable basis), the principles set forth in paragraph (a) (1) and (2) of §1.167(c)–1 and in paragraphs (b) and (c) of §1.48–2 shall be applied. Thus, for example, the following rules are applicable:

(*a*) Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications.

(*b*) The portion of the basis of property attributable to construction, reconstruction, or erection after December 31, 1968, consists of all costs of construction, reconstruction, or erection allocable to the period after December 31, 1968, including the cost or other basis of materials entering into such work (but not including, in the case of reconstruction of property, the adjusted basis of the property as of the time such reconstruction is commenced).

(*c*) It is not necessary that materials entering into construction, reconstruction or erection be acquired after December 31, 1968, or that they be new in use.

(*d*) If construction or erection by the taxpayer began after December 31, 1968, the entire cost or other basis of such construction or erection may be taken into account for purposes of determining the amortizable basis under section 169.

(*e*) Construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(*f*) Property shall be deemed to be acquired when reduced to physical possession or control.

(*g*) The term ''original use'' means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired by the taxpayer after December 31, 1968, for pollution control purposes will not be treated as being put to original use by the taxpayer regardless of whether it was used for purposes other than pollution control by its previous owner. Whether property is reconditioned or rebuilt property is a question of fact. Property will not be treated as reconditioned or rebuilt merely because it contains some used parts.

(iv) For purposes of subparagraph (1)(iii) of this paragraph (relating to property placed in service prior to January 1, 1975), the principles set forth in paragraph (d) of §1.46–3 are applicable. Thus, property shall be considered placed in service in the earlier of the following taxable years:

(*a*) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins or would have begun; or

(*b*) The taxable year in which the property is placed in a condition or state of readiness and availability for the abatement or control of water or atmospheric pollution.

Thus, if property meets the conditions of (*b*) of this subdivision in a taxable year, it shall be considered placed in service in such year notwithstanding that the period for depreciation with respect to such property begins or would have begun in a succeeding taxable year because, for example, under the taxpayer's depreciation practice such property is or would have been accounted for in a multiple asset account and depreciation is or would have been computed under an ''averaging convention'' (§1.167(a)–10), or depreciation with respect to such property would have been computed under the completed contract method, the unit of production method, or the retirement method. In the case of property acquired by a taxpayer for use in his trade or business (or in the production of income), property shall be considered in a condition or state of readiness and availability for the abatement or control of water or atmospheric pollution if, for example, equipment is acquired for the abatement or control of water or atmospheric pollution and is operational but is undergoing testing to eliminate any defects. However, materials and parts acquired to be used in the construction of an item of equipment shall not be considered in a condition or state of readiness and availability for the abatement or control of water or atmospheric pollution.

(c) *Certification*—(1) *In general.* For purposes of paragraph (a)(1) of this section, a facility is certified in accordance with the rules prescribed in this paragraph if—

(i) The State certifying authority (as defined in subparagraph (2) of this paragraph) having jurisdiction with respect to such facility has certified to the Federal certifying authority (as defined in subparagraph (3) of this paragraph) that the facility was constructed, reconstructed, erected, or acquired in conformity with the State program or requirements for the abatement or control of water or atmospheric pollution or contamination applicable at the time of such certification, and

(ii) The Federal certifying authority has certified such facility to the Secretary or his delegate as (*a*) being in compliance with the applicable regulations of Federal agencies (such as, for example, the Atomic Energy Commission's regulations pertaining to radiological discharge (10 CFR Part 20)) and (*b*) being in furtherance of the general policy of the United States for cooperation with the States in the prevention and abatement of water pollution under the Federal Water Pollution Control Act, as amended (33 U.S.C. 1151–1175) or in the prevention and abatement of atmospheric pollution and contamination under the Clean Air Act, as amended (42 U.S.C. 1857 *et seq.*).

(2) *State certifying authority.* The term ''state certifying authority'' means—

(i) In the case of water pollution, the State water pollution control agency as defined in section 23(a) of the Federal Water Pollution Control Act, as amended (33 U.S.C. 1173(a)),

(ii) In the case of air pollution, the air pollution control agency designated pursuant to section 302(b)(1) of the Clean Air Act, as amended (42 U.S.C. 1857h(b)), and

(iii) Any interstate agency authorized to act in place of a certifying authority of a State. See section 23(a) of the Federal Water Pollution Control Act, as amended (33 U.S.C. 1173(b)) and section 302(c) of the Clean Air Act, as amended (42 U.S.C. 1857h(c)).

(3) *Federal certifying authority.* The term ''Federal certifying authority'' means the Administrator of the Environmental Protection Agency (see Reorganization Plan No. 3 of 1970, 35 FR 15623).

(d) *Profitmaking abatement works, etc.*—(1) *In general.* Section 169(e) provides that the Federal certifying authority shall not certify any property to the extent it appears that by reason of estimated profits to be derived through the recovery of wastes or otherwise in the operation of such property its costs will be recovered over the period referred to in paragraph (a) (6) of this section for such property. The Federal certifying authority need not certify the amount of estimated profits to be derived from such recovery of wastes or otherwise with respect to such facility. Such estimated profits shall be determined pursuant to subparagraph (2) of this paragraph. However, the Federal certifying authority shall certify—

(i) Whether, in connection with any treatment facility so certified, there is potential cost recovery through the recovery of wastes or otherwise, and

(ii) A specific description of the wastes which will be recovered, or the nature of such cost recovery if otherwise than through the recovery of wastes.

For effect on computation of amortizable basis, see paragraph (c) of §1.169–3.

(2) *Estimated profits.* For purpose of this paragraph, the term ''estimated profits'' means the estimated gross receipts from the sale of recovered wastes reduced by the sum of the (i) estimated average annual maintenance and operating expenses, including utilities and labor, allocable to that portion of the facility which is certified as a treatment facility pursuant to paragraph (a)(1)(i) of this section which produces the recovered waste from which the gross receipts are derived, and (ii) estimated selling expenses. However, in determining expenses to be subtracted neither depreciation nor amortization of the facility is to be taken into account. Estimated profits shall not include any estimated savings to the taxpayer by reason of the taxpayer's reuse or recycling of wastes or other items recovered in connection with the operation of the plant or other property served by the treatment facility.

(3) *Special rules.* The estimates of cost recovery required by subparagraph (2) of this paragraph shall be based on the period referred to in paragraph (a)(6) of this section. Such estimates shall be made at the time the election provided for by section 169 is made and shall also be set out in the application for certification made to the Federal certifying authority. There shall be no redetermination of estimated profits due to unanticipated fluctuations in the market price for wastes or other items, to an unanticipated increase or decrease in the costs of extracting them from the gas or liquid released, or to other unanticipated factors or events occurring after certification.

[T.D. 7116, 36 FR 9013, May 18, 1971; 36 FR 9770, May 28, 1971]

§ 1.169–3 Amortizable basis.

(a) *In general.* The amortizable basis of a certified pollution control facility for the purpose of computing the amortization deduction under section 169 is the adjusted basis of the facility for purposes of determining gain (see part II (section 1011 and following), subchapter O, chapter 1 of the Internal Revenue Code), in conjunction with paragraphs (b), (c), and (d) of this section. The adjusted basis for purposes of determining gain (computed without regard to paragraphs (b), (c), and (d) of this section) of a facility that performs a function in addition to pollution control, or that is used in connection with more than one plant or other property, or both, is determined under §1.169–2(a)(3). For rules as to additions and improvements to such a facility, see paragraph (f) of this section. Before computing the amortization deduction allowable under section 169, the adjusted basis for purposes of determining gain for a facility that is placed in service by a taxpayer after September 10, 2001, and that is qualified property under section 168(k)(2) or §1.168(k)–1, 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)–1, or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)–1 must be reduced by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k) or section 1400L(b), as applicable, for the facility. Further, before computing the amortization deduction allowable under section 169, the adjusted basis for purposes of determining gain for a facility that is acquired and placed in service after September 27, 2017, and that is qualified property under section 168(k), as amended by the Tax Cuts and Jobs Act, Public Law 115–97 (131 Stat. 2054 (December 22, 2017)) (the ''Act''), or §1.168(k)–2, must be reduced by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k), as amended by the Act.

(b) *Limitation to post-1968 construction, reconstruction, or erection.* (1) If the construction, reconstruction, or erection was begun before January 1, 1969, there shall be included in the amortizable basis only so much of the adjusted basis of such facility for purposes of determining gain (referred to in paragraph (a) of this section) as is properly attributable under the rules set forth in paragraph (b)(2)(iii) of §1.169–2 to construction, reconstruction, or erection after December 31, 1968. See section 169 (d)(4). For example, assume a certified pollution control facility for which the shortest period authorized under section 167 is 10 years has a cost of $500,000, of which $450,000 is attributable to construction after December 31, 1968. Further, assume such facility does not perform a function in addition to pollution control and is used only in connection with a plant in operation before January 1, 1969. The facility would have an amortizable basis of $450,000 (computed without regard to paragraphs (c) and (d) of this section). For depreciation of the remaining portion ($50,000) of the cost, see section 169(g) and paragraph (a)(3)(ii) of §1.169–1. For the definition of the term ''certified pollution control facility'' see paragraph (a) of §1.169–2.

(2) If the taxpayer elects to begin the 60-month amortization period with the first month of the taxable year succeeding the taxable year in which the facility is completed or acquired and a depreciation deduction is allowable under section 167 (including an additional first-year depreciation allowance under former section 179; for a facility that is acquired by the taxpayer after September 10, 2001, and that is qualified property under section 168(k)(2) or §1.168(k)–1 or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)–1, the additional first year depreciation deduction under section 168(k)(1) or 1400L(b), as applicable; and for a facility that is acquired by the taxpayer after May 5, 2003, and that is 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)–1, the additional first year depreciation deduction under section 168(k)(4)) with respect to the facility for the taxable year in which it is completed or acquired, the amount determined under paragraph (b)(1) of this section shall be reduced by an amount equal to the amount of the depreciation deduction allowed or allowable, whichever is greater, multiplied by a fraction the numerator of which is the amount determined under paragraph (b)(1) of this section, and the denominator of which is the facility's total cost. The additional first-year allowance for depreciation under former section 179 will be allowable only for the taxable year in which the facility is completed or acquired and only if the taxpayer elects to begin the amortization deduction under section 169 with the taxable year succeeding the taxable year in which such facility is completed or acquired. For a facility that is acquired by a taxpayer after September 10, 2001, and that is qualified property under section 168(k)(2) or §1.168(k)–1 or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)–1, see §1.168(k)–1(f)(4) or §1.1400L(b)–1(f)(4), as applicable, with respect to when the additional first year depreciation deduction under section 168(k)(1) or 1400L(b) is allowable. For a facility that is acquired by a taxpayer after May 5, 2003, and that is 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)–1, see §1.168(k)–1(f)(4) with respect to when the additional first year depreciation deduction under section 168(k)(4) is allowable.

(c) *Modification for profitmaking abatement works, etc.* If it appears that by reason of estimated profits to be derived through the recovery of wastes or otherwise (as determined by applying the rules prescribed in paragraph (d) of §1.169–2) a portion or all of the total costs of the certified pollution control facility will be recovered over the period referred to in paragraph (a)(b) of §1.169–2, its amortizable basis (computed without regard to this paragraph and paragraph (d) of this section) shall be reduced by an amount equal to (1) its amortizable basis (so computed) multiplied by (2) a fraction the numerator of which is such estimated profits and the denominator of which is its adjusted basis for purposes of determining gain. See section 169(e).

(d) *Cases in which the period referred to in paragraph (a)(6) of §1.169–2 exceeds 15 years.* If as to a certified pollution control facility the period referred to in paragraph (a)(6) of §1.169–2 exceeds 15 years (determined as of the first day of the first month for which a deduction is allowable under the election made under the section 169(b) and paragraph (a) of §1.169–4), the amortizable basis of such facility shall be an amount equal to (1) its amortizable basis (computed without regard to this paragraph) multiplied by (2) a fraction the numerator of which is 15 years and the denominator of which is the number of years of such period. See section 169(f) (2)(A).

(e) *Examples.* This section may be illustrated by the following example:

Example 1. The X Corporation, which uses the calendar year as its taxable year, began the installation of a facility on November 1, 1968, and completed the installation on June 30, 1970, at a cost of $400,000. All of the facility qualifies as a certified pollution control facility within the meaning of paragraph (a) of §1.169–2. $40,000 of such cost is attributable to construction prior to January 1, 1969. The X Corporation elects to take amortization deductions under section 169(a) with respect to the facility and to begin the 60-month amortization period with January 1, 1971. The corporation takes a depreciation deduction under sections 167 and 179 of $10,000 (the amount allowable, of which $2,000 is for additional first year depreciation under section 179) for the last 6 months of 1970. It is estimated that over the period referred to in paragraph (a) (6) of §1.169–2 (20 years) as to such facility, $80,000 in profits will be realized from the sale of wastes recovered in its operation. The amortizable basis of the facility for purposes of computing the amortization deduction as of January 1, 1971, is $210,600, computed as follows:

(1) Portion of $400,000 cost attributable to post-1968 construction, reconstruction, or erection		$360,000
(2) Reduction for portion of depreciation deduction taken for the taxable year in which the facility was completed:		
(a) $10,000 depreciation deduction taken for last 6 months of 1970 including $2,000 for additional first year depreciation under section 179	$10,000	
(b) Multiplied by the amount in line (1) and divided by the total cost of the facility ($360,000/ $400,000)	0.9	$9,000
(3) Subtotal		$351,000
(4) Modification for profitmaking abatement works: Multiply line (3) by estimated profits through waste recovery ($80,000) and divide by the adjusted basis for determining gain of the facility ($400,000).		
(5) Reduction		$70,200
(6) Subtotal		$280,800
(7) Modification for period referred to in paragraph (a)(6) of § 1.169–2 exceeding 15 years: Multiply by 15 years and divide by such period (determined in accordance with paragraph (d) of this section) (20 years)		0.75
(8) Amortizable basis		$210,600

Example 2. Assume the same facts as in example (1) except that the facility is used in connection with a number of separate plants some of which were in operation before January 1, 1969, that the Federal certifying authority certifies that 80 percent of the capacity of the facility is allocable to the plants which were in operation before such date, and that all of the waste recovery is allocable to the portion of the facility used in connection with the plants in operation before January 1, 1969. The amortizable basis of such facility, for purposes of computing the amortization deduction as of January 1, 1971, is $157,950 computed as follows:

(1) Adjusted basis for purposes of determining gain: Multiply percent certified as allocable to plants in operation before January 1, 1969 (80 percent) by cost of entire facility ($400,000)		$320,000
(2) Portion of adjusted basis for determining gain attributable to post-1968 construction, reconstruction, or rection: Multiply line (1) by portion of total cost of facility attributable to post-1968 construction, reconstruction, or erection ($360,000) and divide by the total cost of the facility ($400,000)		$288,000
(3) Reduction for portion of depreciation deduction taken for the taxable year in which the facility was completed:		
(a) $10,000 depreciation deduction taken for last 6 months of 1970 including $2,000 for additional first year depreciation under section 170	$10,000	
(b) Multiplied by the amount in line (2) and divided by the total cost of the facility ($288,000/$400,000)	0.72	$7,200
(4) Subtotal		$280,800
(5) Modification for profitmaking abatement works; Multiply line (4) by estimated profits through waste recovery ($80,000) and divide by the amount in line (1) ($320,000).		
(6) Reduction		$70,200
(7) Subtotal		$210,600
(8) Modification for period referred to in paragraph (a)(6) of § 1.169–2 exceeding 15 years: Multiply by 15 years and divide by such period (determined in accordance with paragraph (d) of this section) (20 years)		0.75
(9) Amortizable basis		$157,950

(f) *Additions or improvements.* (1) If after the completion or acquisition of a certified pollution control facility further expenditures are made for additional construction, reconstruction, or improvements, the cost of such additions or improvements made prior to the beginning of the amortization period shall increase the amortizable basis of such facility, but the cost of additions or improvements made after the amortization period has begun, shall not increase the amortizable basis. See section 169(f)(2)(B).

(2) If expenditures for such additional construction, reconstruction, or improvements result in a facility which is

new and is separately certified as a certified pollution control facility as defined in section 169(d)(1) and paragraph (a) of § 1.169–2, and, if proper election is made, such expenditures shall be taken into account in computing under paragraph (a) of this section the amortizable basis of such new and separately certified pollution control facility.

(g) *Effective date for qualified property, 50-percent bonus depreciation property, and qualified New York Liberty Zone property*. This section applies to a certified pollution control facility. This section also applies to a certified pollution control facility that is qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to a certified pollution control facility that is 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. The last sentence of paragraph (a) of this section applies to a certified pollution control facility that is qualified property under section 168(k)(2) and placed in service by a taxpayer during or after the taxpayer's taxable year that includes September 24, 2019. However, a taxpayer may choose to apply the last sentence of paragraph (a) of this section to a certified pollution control facility that is qualified property under section 168(k)(2) and acquired and placed in service after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017. A taxpayer may rely on the last sentence in paragraph (a) of this section in regulation project REG–104397–18 (2018–41 IRB 558) (see § 601.601(d)(2)(ii)(b) of this chapter) for a certified pollution control facility that is qualified property under section 168(k)(2) and acquired and placed in service after September 27, 2017, by the taxpayer during taxable years ending on or after September 28, 2017, and ending before the taxpayer's taxable year that includes September 24, 2019.

[T.D. 7116, 36 FR 9015, May 18, 1971; 36 FR 9770, May 28, 1971, as amended by T.D. 9091, 68 FR 53004, Sept. 8, 2003; T.D. 9283, 71 FR 51746, Aug. 31, 2006; T.D. 9874, 84 FR 50149, Sept. 24, 2019]

§ 1.169–4 Time and manner of making elections.

(a) *Election of amortization*—(1) *In general*. Under section 169(b), an election by the taxpayer to take an amortization deduction with respect to a certified pollution control facility and to begin the 60-month amortization period (either with the month following the month in which the facility is completed or acquired, or with the first month of the taxable year succeeding the taxable year in which such facility is completed or acquired) shall be made by a statement to that effect attached to its return for the taxable year in which falls the first month of the 60-month amortization period so elected. Such statement shall include the following information (if not otherwise included in the documents referred to in subdivision (ix) of this subparagraph):

(i) A description clearly identifying each certified pollution control facility for which an amortization deduction is claimed;

(ii) The date on which such facility was completed or acquired (see paragraph (b)(2)(iii) of § 1.169–2);

(iii) The period referred to in paragraph (a)(6) of § 1.169–2 for the facility as of the date the property is placed in service;

(iv) The date as of which the amortization period is to begin;

(v) The date the plant or other property to which the facility is connected began operating (see paragraph (a)(5) of § 1.169–2);

(vi) The total costs and expenditures paid or incurred in the acquisition, construction, and installation of such facility;

(vii) A description of any wastes which the facility will recover during the course of its operation, and a reasonable estimate of the profits which will be realized by the sale of such wastes whether pollutants or otherwise, over the period referred to in paragraph (a)(6) of § 1.169–2 as to the facility. Such estimate shall include a schedule setting forth a detailed computation illustrating how the estimate was arrived at including every element prescribed in the definition of estimated profits in paragraph (d)(2) of § 1.169–2;

(viii) A computation showing the amortizable basis (as defined in §1.169–3) of the facility as of the first month for which the amortization deduction provided for by section 169(a) is elected; and

(ix)(*a*) A statement that the facility has been certified by the Federal certifying authority, together with a copy of such certification, and a copy of the application for certification which was filed with and approved by the Federal certifying authority or (*b*), if the facility has not been certified by the Federal certifying authority, a statement that application has been made to the proper State certifying authority (see paragraph (c)(2) of §1.169–2) together with a copy of such application and (except in the case of an election to which subparagraph (4) of this paragraph applies) a copy of the application filed or to be filed with the Federal certifying authority.

If subdivision (ix)(*b*) of this subparagraph applies, within 90 days after receipt by the taxpayer, the certification from the Federal certifying authority shall be filed by the taxpayer with the district director, or with the director of the internal revenue service center, with whom the return referred to in this subparagraph was filed.

(2) *Special rule.* If the return for the taxable year in which falls the first month of the 60-month amortization period to be elected is filed before November 16, 1971, without making the election for such year, then on or before December 31, 1971 (or if there is no State certifying authority in existence on November 16, 1971, on or before the 90th day after such authority is established), the election may be made by a statement attached to an amended income tax return for the taxable year in which falls the first month of the 60-month amortization period so elected. Amended income tax returns or claims for credit or refund must also be filed at this time for other taxable years which are within the amortization period and which are subsequent to the taxable year for which the election is made. Nothing in this paragraph should be construed as extending the time specified in section 6511 within which a claim for credit or refund may be filed.

(3) *Other requirements and considerations.* No method of making the election provided for in section 169(a) other than that prescribed in this section shall be permitted on or after May 18, 1971. A taxpayer which does not elect in the manner prescribed in this section to take amortization deductions with respect to a certified pollution control facility shall not be entitled to such deductions. In the case of a taxpayer which elects prior to May 18, 1971, the statement required by subparagraph (1) of this paragraph shall be attached to its income tax return for either its taxable year in which December 31, 1971, occurs or its taxable year preceding such year.

(4) *Elections filed before February 29, 1972.* If a statement of election required by subparagraph (1) of this paragraph is attached to a return (including an amended return referred to in subparagraph (2) of this paragraph) filed before February 29, 1972, such statement of election need not include a copy of the Federal application to be filed with the Federal certifying authority but a copy of such application must be filed no later than February 29, 1972, by the taxpayer with the district director, or with the director of the internal revenue service center, with whom the return or amended return referred to in this subparagraph was filed.

(b) *Election to discontinue or revoke amortization*—(1) *Election to discontinue.* An election to discontinue the amortization deduction provided by section 169(c) and paragraph (a)(1) of §1.169–1 shall be made by a statement in writing filed with the district director, or with the director of the internal revenue service center, with whom the return of the taxpayer is required to be filed for its taxable year in which falls the first month for which the election terminates. Such statement shall specify the month as of the beginning of which the taxpayer elects to discontinue such deductions. Unless the election to discontinue amortization is one to which subparagraph (2) of this paragraph applies, such statement shall be filed before the beginning of the month specified therein. In addition, such statement shall contain a description clearly identifying the certified pollution control facility with respect to which the taxpayer elects to discontinue the amortization deduction, and, if a certification has previously been issued, a copy of the certification by the Federal certifying authority. If at the time of such election a certification has not been issued (or if one has been issued it has not been filed as provided in paragraph (a)(1) of this section), the taxpayer shall file, with respect to any taxable year or years for which a deduction under section 169 has been taken, a copy of such certification within 90 days after receipt thereof. For purposes of this paragraph, notification to the Secretary or his delegate from the Federal certifying authority that the facility no longer meets the requirements under which certification was originally granted by the State or Federal certifying authority shall have the same effect as a notice from the taxpayer electing to terminate amortization as of the month following the month such facility ceased functioning in accordance with such requirements.

(2) *Revocation of elections made prior to May 18, 1971.* If on or before May 18, 1971, an election under section 169(a) has been made, such election may be revoked (see paragraph (a)(1) of §1.169–1) by filing on or before August 16, 1971, a statement of revocation of an election under section 169(a) in accordance with the requirements in subparagraph (1) of this paragraph for filing a notice to discontinue an election. If such election to revoke is for a period which falls within one or more taxable years for which an income tax return has been filed, amended income tax returns shall be filed for any such taxable years in which deductions were taken under section 169 on or before August 16, 1971.

[T.D. 7116, 36 FR 9016, May 18, 1971, as amended by T.D. 7135, 36 FR 14183, July 31, 1971; 36 FR 24995, Dec. 28, 1971]

FINDING AIDS

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Table of OMB Control Numbers

The OMB control numbers for chapter I of title 26 were consolidated into §§ 601.9000 and 602.101 at 50 FR 10221, Mar. 14, 1985. At 61 FR 58008, Nov. 12, 1996, § 601.9000 was removed. Section 602.101 is reprinted below for the convenience of the user.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

§ 602.101 OMB Control numbers.

(a) *Purpose.* This part collects and displays the control numbers assigned to collections of information in Internal Revenue Service regulations by the Office of Management and Budget (OMB) under the Paperwork Reduction Act of 1980. The Internal Revenue Service intends that this part comply with the requirements of §§ 1320.7(f), 1320.12, 1320.13, and 1320.14 of 5 CFR part 1320 (OMB regulations implementing the Paperwork Reduction Act), for the display of control numbers assigned by OMB to collections of information in Internal Revenue Service regulations. This part does not display control numbers assigned by the Office of Management and Budget to collections of information of the Bureau of Alcohol, Tobacco, and Firearms.

(b) *Display.*

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1.362–2	1545–0123
1.362–4	1545–2247
1.367(a)–1T	1545–0026
1.367(a)–2T	1545–0026
1.367(a)–3	1545–0026
	1545–1478
1.367(a)–3T	1545–2183
1.367(a)–6T	1545–0026
1.367(a)–7	1545–2183
1.367(a)–7T	1545–2183
1.367(a)–8	1545–1271
	1545–2056
	1545–2183
1.367(b)–1	1545–1271

CFR part or section where identified and described	Current OMB control No.
1.367(b)–3T	1545–1666
1.367(d)–1T	1545–0026
1.367(e)–1	1545–1487
1.367(e)–2	1545–1487
1.368–1	1545–1691
1.368–3	1545–2019
1.371–1	1545–0123
1.371–2	1545–0123
1.374–3	1545–0123
1.381(b)–1	1545–0123
1.381(c)(4)–1	1545–0123
	1545–0152
	1545–0879
1.381(c)(5)–1	1545–0123
	1545–0152
1.381(c)(6)–1	1545–0123
	1545–0152
1.381(c)(8)–1	1545–0123
1.381(c)(10)–1	1545–0123
1.381(c)(11)–1(k)	1545–0123
1.381(c)(13)–1	1545–0123
1.381(c)(17)–1	1545–0045
1.381(c)(22)–1	1545–1990
1.381(c)(25)–1	1545–0045
1.382–1T	1545–0123
1.382–2	1545–0123
1.382–2T	1545–0123
1.382–3	1545–1281
	1545–1345
1.382–4	1545–1120
1.382–6	1545–1381
1.382–8	1545–1434
1.382–9	1545–1120
	1545–1260
	1545–1275
	1545–1324
1.382–11	1545–2019
1.382–91	1545–1260
	1545–1324
1.383–1	1545–0074
	1545–1120
1.401–1	1545–0020
	1545–0197
	1545–0200
	1545–0534
	1545–0710
1.401(a)–11	1545–0710
1.401(a)–20	1545–0928
1.401(a)–31	1545–1341
1.401(a)–50	1545–0710
1.401(a)(9)–1	1545–1573
1.401(a)(9)–3	1545–1466
1.401(a)(9)–4	1545–1573
1.401(a)(9)–6	1545–2234
1.401(a)(31)–1	1545–1341
1.401(b)–1	1545–0197
1.401(f)–1	1545–0710
1.401(k)–1	1545–1039
	1545–1069
	1545–1669
	1545–1930
1.401(k)–2	1545–1669
1.401(k)–3	1545–1669
1.401(k)–4	1545–1669
1.401(m)–3	1545–1699
1.401–14	1545–0710
1.402(c)–2	1545–1341
1.402(f)–1	1545–1341
	1545-1632
1.402A–1	1545–1992
1.403(b)–1	1545–0710
1.403(b)–3	1545–0996
1.403(b)–7	1545–1341
1.403(b)–10	1545–2068
1.404(a)–12	1545–0710
1.404A–2	1545–0123
1.404A–6	1545–0123
1.408–2	1545–0390
1.408–5	1545–0747
1.408–6	1545–0203
	1545–0390
1.408–7	1545–0119
1.408(q)–1	1545–1841
1.408A–2	1545–1616
1.408A–4	1545–1616
1.408A–5	1545–1616
1.408A–7	1545–1616
1.410(a)–2	1545–0710
1.410(d)–1	1545–0710
1.411(a)–11	1545–1471
	1545–1632
1.411(d)–4	1545–1545
1.411(d)–6	1545–1477
1.412(c)(1)–2	1545–0710
1.412(c)(2)–1	1545–0710
1.412(c)(3)–2	1545–0710
1.414(c)–5	1545–0797
1.414(r)–1	1545–1221
1.415–2	1545–0710
1.415–6	1545–0710
1.417(a)(3)–1	1545–0928
1.417(e)–1	1545–1471
	1545–1724
1.417(e)–1T	1545–1471
1.419A(f)(6)–1	1545–1795
1.422–1	1545–0820
1.430(f)–1	1545–2095
1.430(g)–1	1545–2095
1.430(h)(2)–1	1545–2095
1.432(e)(9)–1T	1545–2260
1.436–1	1545–2095
1.441–2	1545–1748
1.442–1	1545–0074
	1545–0123
	1545–0134
	1545–0152
	1545–0820
	1545–1748
1.443–1	1545–0123
1.444–3T	1545–1036
1.444–4	1545–1591
1.446–1	1545–0074
	1545–0152
1.446–4(d)	1545–1412
1.448–1(g)	1545–0152
1.448–1(h)	1545–0152
1.448–1(i)	1545–0152
1.448–2	1545–1855
1.448–2T	1545–0152
	1545–1855
1.451–1	1545–0091
1.451–4	1545–0123
1.451–5	1545–0074
1.451–6	1545–0074
1.451–7	1545–0074
1.453–1	1545–0152
1.453–2	1545–0152
1.453–8	1545–0152
	1545–0228
1.453A–1	1545–0152
	1545–1134
1.453A–3	1545–0963
1.454–1	1545–0074
1.455–2	1545–0152

CFR part or section where identified and described	Current OMB control No.
1.455–6	1545–0123
1.456–2	1545–0123
1.456–6	1545–0123
1.456–7	1545–0123
1.457–8	1545–1580
1.458–1	1545–0879
1.458–2	1545–0152
1.460–1	1545–1650
1.460–6	1545–1031
	1545–1572
	1545–1732
1.461–1	1545–0074
1.461–2	1545–0096
1.461–4	1545–0917
1.461–5	1545–0917
1.463–1T	1545–0916
1.465–1T	1545–0712
1.466–1T	1545–0152
1.466–4	1545–0152
1.468A–3	1545–1269
	1545–1378
	1545–1511
1.468A–3(h), 1.468A–7, and 1.468A–8(d)	1545–2091
1.468A–4	1545–0954
1.468A–7	1545–0954
	1545–1511
1.468A–8	1545–1269
1.468B–1	1545–1631
1.468B–1(j)	1545–1299
1.468B–2(k)	1545–1299
1.468B–2(l)	1545–1299
1.468B–3(b)	1545–1299
1.468B–3(e)	1545–1299
1.468B–5(b)	1545–1299
1.468B–9	1545–1631
1.469–1	1545–1008
1.469–2T	1545–0712
	1545–1091
1.469–4T	1545–0985
	1545–1037
1.469–7	1545–1244
1.471–2	1545–0123
1.471–5	1545–0123
1.471–6	1545–0123
1.471–8	1545–0123
1.471–11	1545–0123
	1545–0152
1.472–1	1545–0042
	1545–0152
1.472–2	1545–0152
1.472–3	1545–0042
1.472–5	1545–0152
1.472–8	1545–0028
	1545–0042
	1545–1767
1.475(a)–4	1545–1945
1.481–4	1545–0152
1.481–5	1545–0152
1.482–1	1545–1364
1.482–4	1545–1364
1.482–7	1545–1364
	1545–1794
1.482–9(b)	1545–2149
1.501(a)–1	1545–0056
	1545–0057
1.501(c)(3)–1	1545–0056
1.501(c)(9)–5	1545–0047
1.501(c)(17)–3	1545–0047
1.501(e)–1	1545–0814
1.501(r)–3	1545–0047
1.501(r)–4	1545–0047
1.501(r)–6	1545–0047
1.503(c)–1	1545–0047
	1545–0052
1.505(c)–1T	1545–0916
1.506–1T	1545–2268
1.507–1	1545–0052
1.507–2	1545–0052
1.508–1	1545–0052
	1545–0056
1.509(a)–3	1545–0047
1.509(a)–4	1545–2157
1.509(a)–5	1545–0047
1.509(c)–1	1545–0052
1.512(a)–1	1545–0687
1.512(a)–4	1545–0047
	1545–0687
1.521–1	1545–0051
	1545–0058
1.527–2	1545–0129
1.527–5	1545–0129
1.527–6	1545–0129
1.527–9	1545–0129
1.528–8	1545–0127
1.533–2	1545–0123
1.534–2	1545–0123
1.542–3	1545–0123
1.545–2	1545–0123
1.545–3	1545–0123
1.547–2	1545–0045
	1545–0123
1.547–3	1545–0123
1.561–1	1545–0044
1.561–2	1545–0123
1.562–3	1545–0123
1.563–2	1545–0123
1.564–1	1545–0123
1.565–1	1545–0043
	1545–0123
1.565–2	1545–0043
1.565–3	1545–0043
1.565–5	1545–0043
1.565–6	1545–0043
1.585–1	1545–0123
1.585–3	1545–0123
1.585–8	1545–1290
1.597–2	1545–1300
1.597–4	1545–1300
1.597–6	1545–1300
1.597–7	1545–1300
1.611–2	1545–0099
1.611–3	1545–0007
	1545–0099
	1545–1784
1.612–4	1545–0074
1.612–5	1545–0099
1.613–3	1545–0099
1.613–4	1545–0099
1.613–6	1545–0099
1.613–7	1545–0099
1.613A–3	1545–0919
1.613A–3(e)	1545–1251
1.613A–3(l)	1545–0919
1.613A–5	1545–0099
1.613A–6	1545–0099
1.614–2	1545–0099
1.614–3	1545–0099
1.614–5	1545–0099
1.614–6	1545–0099
1.614–8	1545–0099
1.617–1	1545–0099
1.617–3	1545–0099
1.617–4	1545–0099
1.631–1	1545–0007

CFR part or section where identified and described	Current OMB control No.
1.631–2	1545–0007
1.641(b)–2	1545–0092
1.642(c)–1	1545–0092
1.642(c)–2	1545–0092
1.642(c)–5	1545–0074
1.642(c)–6	1545–0020
	1545–0074
	1545–0092
1.642(g)–1	1545–0092
1.642(i)–1	1545–0092
1.645–1	1545–1578
1.663(b)–2	1545–0092
1.664–1	1545–0196
1.664–1(a)(7)	1545–1536
1.664–1(c)	1545–2101
1.664–2	1545–0196
1.664–3	1545–0196
1.664–4	1545–0020
	1545–0196
1.665(a)–0A through 1.665(g)–2A	1545–0192
1.666(d)–1A	1545–0092
1.671–4	1545–1442
1.671–5	1545–1540
1.701–1	1545–0099
1.702–1	1545–0074
1.703–1	1545–0099
1.704–2	1545–1090
1.706–1	1545–0074
	1545–0099
	1545–0134
1.706–1T	1545–0099
1.706–4(f)	1545–0123
1.707–3(c)(2)	1545–1243
1.707–5(a)(7)(ii)	1545–1243
1.707–6(c)	1545–1243
1.707–8	1545–1243
1.708–1	1545–0099
1.732–1	1545–0099
	1545–1588
1.736–1	1545–0074
1.743–1	1545–0074
	1545–1588
1.751–1	1545–0074
	1545–0099
	1545–0941
1.752–2	1545–1905
1.752–5	1545–1090
1.752–7	1545–1843
1.754–1	1545–0099
1.755–1	1545–0099
1.761–2	1545–1338
1.801–1	1545–0123
	1545–0128
1.801–3	1545–0123
1.801–5	1545–0128
1.801–8	1545–0128
1.804–4	1545–0128
1.811–2	1545–0128
1.812–2	1545–0128
1.815–6	1545–0128
1.818–4	1545–0128
1.818–5	1545–0128
1.818–8	1545–0128
1.819–2	1545–0128
1.822–5	1545–1027
1.822–6	1545–1027
1.822–8	1545–1027
1.822–9	1545–1027
1.826–1	1545–1027
1.826–2	1545–1027
1.826–3	1545–1027

CFR part or section where identified and described	Current OMB control No.
1.826–4	1545–1027
1.826–6	1545–1027
1.831–3	1545–0123
1.832–4	1545–1227
1.832–5	1545–0123
1.848–2(g)(8)	1545–1287
1.848–2(h)(3)	1545–1287
1.848–2(i)(4)	1545–1287
1.851–2	1545–1010
1.851–4	1545–0123
1.852–1	1545–0123
1.852–4	1545–0123
	1545–0145
1.852–6	1545–0123
	1545–0144
1.852–7	1545–0074
1.852–9	1545–0074
	1545–0123
	1545–0144
	1545–0145
	1545–1783
1.852–11	1545–1094
1.853–3	1545–2035
1.853–4	1545–2035
1.854–2	1545–0123
1.855–1	1545–0123
1.856–2	1545–0123
	1545–1004
1.856–6	1545–0123
1.856–7	1545–0123
1.856–8	1545–0123
1.857–8	1545–0123
1.857–9	1545–0074
1.858–1	1545–0123
1.860–2	1545–0045
1.860–4	1545–0045
	1545–1054
	1545–1057
1.860E–1	1545–1675
1.860E–2(a)(5)	1545–1276
1.860E–2(a)(7)	1545–1276
1.860E–2(b)(2)	1545–1276
1.860G–2	1545–2110
1.861–2	1545–0089
1.861–3	1545–0089
1.861–4	1545–1900
1.861–8	1545–0126
1.861–8(e)(6) and (g)	1545–1224
1.861–9T	1545–0121
	1545–1072
1.861–18	1545–1594
1.863–1	1545–1476
1.863–3	1545–1476
	1545–1556
1.863–3A	1545–0126
1.863–4	1545–0126
1.863–7	1545–0132
1.863–8	1545–1718
1.863–9	1545–1718
1.864–4	1545–0126
1.871–1	1545–0096
1.871–6	1545–0795
1.871–7	1545–0089
1.871–10	1545–0089
	1545–0165
1.874–1	1545–0089
1.881–4	1545–1440
1.882–4	1545–0126
1.883–0	1545–1677
1.883–1	1545–1677
1.883–2	1545–1677
1.883–3	1545–1677

CFR part or section where identified and described	Current OMB control No.
1.883–4	1545–1677
1.883–5	1545–1677
1.884–0	1545–1070
1.884–1	1545–1070
1.884–2	1545–1070
1.884–2T	1545–0126
	1545–1070
1.884–4	1545–1070
1.884–5	1545–1070
1.892–1T	1545–1053
1.892–2T	1545–1053
1.892–3T	1545–1053
1.892–4T	1545–1053
1.892–5T	1545–1053
1.892–6T	1545–1053
1.892–7T	1545–1053
1.897–2	1545–0123
	1545–0902
1.897–3	1545–0123
1.897–5T	1545–0902
1.897–6T	1545–0902
1.901–2	1545–0746
1.901–2A	1545–0746
1.901–3	1545–0122
1.902–1	1545–0122
	1545–1458
1.904–1	1545–0121
	1545–0122
1.904–2	1545–0121
	1545–0122
1.904–3	1545–0121
1.904–4	1545–0121
1.904–5	1545–0121
1.904–7	1545–2104
1.904–7T	1545–2104
1.904(f)–1	1545–0121
	1545–0122
1.904(f)–2	1545–0121
1.904(f)–3	1545–0121
1.904(f)–4	1545–0121
1.904(f)–5	1545–0121
1.904(f)–6	1545–0121
1.904(f)–7	1545–1127
1.905–2	1545–0122
1.905–3T	1545–1056
1.905–4T	1545–1056
1.905–5T	1545–1056
1.911–1	1545–0067
	1545–0070
1.911–2	1545–0067
	1545–0070
1.911–3	1545–0067
	1545–0070
1.911–4	1545–0067
	1545–0070
1.911–5	1545–0067
	1545–0070
1.911–6	1545–0067
	1545–0070
1.911–7	1545–0067
	1545–0070
1.913–13	1545–0067
1.921–1T	1545–0190
	1545–0884
	1545–0935
	1545–0939
1.921–2	1545–0884
1.927(a)–1T	1545–0935
1.927(d)–2T	1545–0935
1.931–1	1545–0074
	1545–0123
1.934–1	1545–0782
1.935–1	1545–0074
	1545–0087
	1545–0803
1.936–1	1545–0215
	1545–0217
1.936–4	1545–0215
1.936–5	1545–0704
1.936–6	1545–0215
1.936–7	1545–0215
1.936–10(c)	1545–1138
1.937–1	1545–1930
1.952–2	1545–0126
1.953–2	1545–0126
1.954–1	1545–1068
1.954–2	1545–1068
1.955–2	1545–0123
1.955–3	1545–0123
1.955A–2	1545–0755
1.955A–3	1545–0755
1.956–1	1545–0704
1.956–2	1545–0704
1.959–1	1545–0704
1.959–2	1545–0704
1.960–1	1545–0122
1.962–2	1545–0704
1.962–3	1545–0704
1.964–1	1545–0126
	1545–0704
	1545–1072
	1545–2104
1.964–3	1545–0126
1.970–2	1545–0126
1.985–2	1545–1051
	1545–1131
1.985–3	1545–1051
1.987–1	1545–2265
1.987–3	1545–2265
1.987–9	1545–2265
1.987–10	1545–2265
1.988–0	1545–1131
1.988–1	1545–1131
1.988–2	1545–1131
1.988–3	1545–1131
1.988–4	1545–1131
1.988–5	1545–1131
1.988–6	1545–1831
1.992–1	1545–0190
	1545–0938
1.992–2	1545–0190
	1545–0884
	1545–0938
1.992–3	1545–0190
	1545–0938
1.992–4	1545–0190
	1545–0938
1.993–3	1545–0938
1.993–4	1545–0938
1.994–1	1545–0938
1.995–5	1545–0938
1.1001–1	1545–1902
1.1012–1	1545–0074
	1545–1139
1.1014–4	1545–0184
1.1015–1	1545–0020
1.1017–1	1545–1539
1.1031(d)–1T	1545–1021
1.1033(a)–2	1545–0184
1.1033(g)–1	1545–0184
1.1039–1	1545–0184
1.1041–1T	1545–0074
1.1041–2	1545–1751
1.1042–1T	1545–0916

CFR part or section where identified and described	Current OMB control No.
1.1044(a)–1	1545–1421
1.1045–1	1545–1893
1.1060–1	1545–1658
	1545–1990
1.1071–1	1545–0184
1.1071–4	1545–0184
1.1081–4	1545–0028
	1545–0046
	1545–0123
1.1081–11	1545–2019
1.1082–1	1545–0046
1.1082–2	1545–0046
1.1082–3	1545–0046
	1545–0184
1.1082–4	1545–0046
1.1082–5	1545–0046
1.1082–6	1545–0046
1.1083–1	1545–0123
1.1092(b)–1T	1545–0644
1.1092(b)–2T	1545–0644
1.1092(b)–3T	1545–0644
1.1092(b)–4T	1545–0644
1.1092(b)–5T	1545–0644
1.1211–1	1545–0074
1.1212–1	1545–0074
1.1221–2	1545–1480
1.1231–1	1545–0177
	1545–0184
1.1231–2	1545–0177
	1545–0184
1.1231–2	1545–0074
1.1232–3	1545–0074
1.1237–1	1545–0184
1.1239–1	1545–0091
1.1242–1	1545–0184
1.1243–1	1545–0123
1.1244(e)–1	1545–0123
	1545–1447
1.1245–1	1545–0184
1.1245–2	1545–0184
1.1245–3	1545–0184
1.1245–4	1545–0184
1.1245–5	1545–0184
1.1245–6	1545–0184
1.1248–7	1545–0074
1.1248(f)–2	1545–2183
1.1248(f)–3T	1545–2183
1.1250–1	1545–0184
1.1250–2	1545–0184
1.1250–3	1545–0184
1.1250–4	1545–0184
1.1250–5	1545–0184
1.1251–1	1545–0184
1.1251–2	1545–0074
	1545–0184
1.1251–3	1545–0184
1.1251–4	1545–0184
1.1252–1	1545–0184
1.1252–2	1545–0184
1.1254–1(c)(3)	1545–1352
1.1254–4	1545–1493
1.1254–5(d)(2)	1545–1352
1.1258–1	1545–1452
1.1272–3	1545–1353
1.1273–2(f)(9)	1545–1353
1.1273–2(h)(2)	1545–1353
1.1274–3(d)	1545–1353
1.1274–5(b)	1545–1353
1.1274A–1(c)	1545–1353
1.1275–2	1545–1450
1.1275–3	1545–0887
	1545–1353
	1545–1450
1.1275–4	1545–1450
1.1275–6	1545–1450
1.1287–1	1545–0786
1.1291–9	1545–1507
1.1291–10	1545–1304
	1545–1507
1.1294–1T	1545–1002
	1545–1028
1.1295–1	1545–1555
1.1295–3	1545–1555
1.1298–3	1545–1507
1.1301–1	1545–1662
1.1311(a)–1	1545–0074
1.1361–1	1545–0731
	1545–1591
	1545–2114
1.1361–3	1545–1590
1.1361–5	1545–1590
1.1362–1	1545–1308
1.1362–2	1545–1308
1.1362–3	1545–1308
1.1362–4	1545–1308
1.1362–5	1545–1308
1.1362–6	1545–1308
1.1362–7	1545–1308
1.1362–8	1545–1590
1.1363–2	1545–1906
1.1366–1	1545–1613
1.1367–1(f)	1545–1139
1.1368–1(f)(2)	1545–1139
1.1368–1(f)(3)	1545–1139
1.1368–1(f)(4)	1545–1139
1.1368–1(g)(2)	1545–1139
1.1374–1A	1545–0130
1.1377–1	1545–1462
1.1378–1	1545–1748
1.1383–1	1545–0074
1.1385–1	1545–0074
	1545–0098
1.1388–1	1545–0118
	1545–0123
1.1397E–1	1545–1908
1.1398–1	1545–1375
1.1398–2	1545–1375
1.1402(a)–2	1545–0074
1.1402(a)–5	1545–0074
1.1402(a)–11	1545–0074
1.1402(a)–15	1545–0074
1.1402(a)–16	1545–0074
1.1402(b)–1	1545–0171
1.1402(c)–2	1545–0074
1.1402(e)(1)–1	1545–0074
1.1402(e)(2)–1	1545–0074
1.1402(e)–1A	1545–0168
1.1402(e)–2A	1545–0168
1.1402(e)–3A	1545–0168
1.1402(e)–4A	1545–0168
1.1402(e)–5A	1545–0168
1.1402(f)–1	1545–0074
1.1402(h)–1	1545–0064
1.1411–10(g)	1545–2227
1.1441–1	1545–1484
1.1441–2	1545–0795
1.1441–3	1545–0165
	1545–0795
1.1441–4	1545–1484
1.1441–5	1545–0096
	1545–0795
	1545–1484
1.1441–6	1545–0055
	1545–0795

CFR part or section where identified and described	Current OMB control No.
	1545–1484
1.1441–7	1545–0795
1.1441–8	1545–1053
	1545–1484
1.1441–9	1545–1484
1.1443–1	1545–0096
1.1445–1	1545–0902
1.1445–2	1545–0902
	1545–1060
	1545–1797
1.1445–3	1545–0902
	1545–1060
	1545–1797
1.1445–4	1545–0902
1.1445–5	1545–0902
1.1445–6	1545–0902
	1545–1060
1.1445–7	1545–0902
1.1445–8	1545–0096
1.1445–9T	1545–0902
1.1445–10T	1545–0902
1.1446–1	1545–1934
1.1446–3	1545–1934
1.1446–4	1545–1934
1.1446–5	1545–1934
1.1446–6	1545–1934
1.1451–1	1545–0054
1.1451–2	1545–0054
1.1461–1	1545–0054
	1545–0055
	1545–0795
	1545–1484
1.1461–2	1545–0054
	1545–0055
	1545–0096
	1545–0795
1.1462–1	1545–0795
1.1502–5	1545–0257
1.1502–9	1545–1634
1.1502–9A	1545–0121
1.1502–13	1545–0123
	1545–0885
	1545–1161
	1545–1433
1.1502–16	1545–0123
1.1502–18	1545–0123
1.1502–19	1545–0123
	1545–1774
1.1502–20	1545–1774
1.1502–21	1545–1237
1.1502–21T	1545–2171
1.1502–31	1545–1344
1.1502–32	1545–1344
	1545–1774
1.1502–33	1545–1344
1.1502–35	1545–1828
1.1502–36	1545–2096
1.1502–47	1545–0123
1.1502–75	1545–0025
	1545–0123
	1545–0133
	1545–0152
1.1502–76	1545–1344
1.1502–76T	1545–2019
1.1502–77	1545–1699
1.1502–77A	1545–0123
	1545–1046
1.1502–77B	1545–1699
1.1502–78	1545–0582
1.1502–95	1545–1218
1.1502–95A	1545–1218
1.1502–96	1545–1218
1.1503–2	1545–1583
1.1503–2A	1545–1083
1.1503(d)–1	1545–1946
1.1503(d)–3	1545–1946
1.1503(d)–4	1545–1946
1.1503(d)–5	1545–1946
1.1503(d)–6	1545–1946
1.1552–1	1545–0123
1.1561–3	1545–0123
1.1563–1	1545–0123
	1545–0797
	1545–2019
1.1563–3	1545–0123
1.5000A–3	1545–0074
1.5000A–4	1545–0074
1.5000C–2	1545–0096
	1545–2263
1.5000C–3	1545–0096
	1545–2263
1.5000C–4	1545–1223
	1545–0074
1.6001–1	1545–0058
	1545–0074
	1545–0099
	1545–0123
	1545–0865
1.6011–1	1545–0055
	1545–0074
	1545–0085
	1545–0089
	1545–0090
	1545–0091
	1545–0096
	1545–0121
	1545–0458
	1545–0666
	1545–0675
	1545–0908
1.6011–2	1545–0055
	1545–0938
1.6011–3	1545–0238
	1545–0239
1.6011–4	1545–1685
1.6012–1	1545–0067
	1545–0074
	1545–0085
	1545–0089
	1545–0675
1.6012–2	1545–0047
	1545–0051
	1545–0067
	1545–0123
	1545–0126
	1545–0128
	1545–0130
	1545–0175
	1545–0687
	1545–0890
	1545–1023
	1545–1027
1.6012–3	1545–0047
	1545–0067
	1545–0092
	1545–0196
	1545–0687
1.6012–4	1545–0067
1.6012–5	1545–0067
	1545–0936
	1545–0967
	1545–0970
	1545–0991
	1545–1023

CFR part or section where identified and described	Current OMB control No.
	1545–1033
	1545–1079
1.6012–6	1545–0067
	1545–0089
	1545–0129
1.6013–1	1545–0074
1.6013–2	1545–0091
1.6013–6	1545–0074
1.6013–7	1545–0074
1.6015–5	1545–1719
1.6015(a)–1	1545–0087
1.6015(b)–1	1545–0087
1.6015(d)–1	1545–0087
1.6015(e)–1	1545–0087
1.6015(f)–1	1545–0087
1.6015(g)–1	1545–0087
1.6015(h)–1	1545–0087
1.6015(i)–1	1545–0087
1.6017–1	1545–0074
	1545–0087
	1545–0090
1.6031(a)–1	1545–1583
1.6031(b)–1T	1545–0099
1.6031(c)–1T	1545–0099
1.6032–1	1545–0099
1.6033–2	1545–0047
	1545–0049
	1545–0052
	1545–0092
	1545–0687
	1545–1150
	1545–2117
1.6033–3	1545–0052
1.6034–1	1545–0092
	1545–0094
1.6035–2	1545–0704
1.6037–1	1545–0130
	1545–1023
1.6038–2	1545–1617
	1545–2020
1.6038–3	1545–1617
1.6038A–2	1545–1191
1.6038A–3	1545–1191
	1545–1440
1.6038B–1	1545–1617
	1545–2183
1.6038B–1T	1545–0026
	1545–2183
1.6038B–2	1545–1617
1.6039–2	1545–0820
1.6041–1	1545–0008
	1545–0108
	1545–0112
	1545–0115
	1545–0120
	1545–0295
	1545–0350
	1545–0367
	1545–0387
	1545–0441
	1545–0957
	1545–1705
1.6041–2	1545–0008
	1545–0119
	1545–0350
	1545–0441
	1545–1729
1.6041–3	1545–1148
1.6041–4	1545–0115
	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6041–5	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6041–6	1545–0008
	1545–0115
1.6041–7	1545–0112
	1545–0295
	1545–0350
	1545–0367
	1545–0387
	1545–0441
	1545–0957
1.6042–1	1545–0110
1.6042–2	1545–0110
	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6042–3	1545–0295
	1545–0367
	1545–0387
	1545–0957
1.6042–4	1545–0110
1.6043–1	1545–0041
1.6043–2	1545–0041
	1545–0110
	1545–0295
	1545–0387
1.6043–3	1545–0047
1.6044–1	1545–0118
1.6044–2	1545–0118
1.6044–3	1545–0118
1.6044–4	1545–0118
1.6044–5	1545–0118
1.6045–1	1545–0715
	1545–1705
1.6045–1(c)(3)(xi)(C)	1545–2186
1.6045–1(n)(5)	1545–2186
1.6045A–1	1545–2186
1.6045–2	1545–0115
1.6045–4	1545–1085
1.6046–1	1545–0704
	1545–0794
	1545–1317
1.6046–2	1545–0704
1.6046–3	1545–0704
1.6046A	1545–1646
1.6047–1	1545–0119
	1545–0295
	1545–0387
1.6047–2	1545–2234
1.6049–1	1545–0112
	1545–0117
	1545–0295
	1545–0367
	1545–0387
	1545–0597
	1545–0957
1.6049–2	1545–0117
1.6049–3	1545–0117
1.6049–4	1545–0096
	1545–0112
	1545–0117
	1545–1018
	1545–1050
1.6049–5	1545–0096
	1545–0112
	1545–0117
1.6049–6	1545–0096
1.6049–7	1545–1018

CFR part or section where identified and described	Current OMB control No.
1.6050A–1	1545–0115
1.6050B–1	1545–0120
1.6050D–1	1545–0120
	1545–0232
1.6050E–1	1545–0120
1.6050H–1	1545–0901
	1545–1380
1.6050H–2	1545–0901
	1545–1339
	1545–1380
1.6050I–2	1545–1449
1.6050J–1T	1545–0877
1.6050K–1	1545–0941
1.6050S–1	1545–1678
1.6050S–2	1545–1729
1.6050S–3	1545–1678
1.6050S–4	1545–1729
1.6052–1	1545–0008
1.6052–2	1545–0008
1.6055–1	1545–2252
1.6055–2	1545–2252
1.6060–1	1545–0074
1.6060–1(a)(1)	1545–1231
1.6061–1	1545–0123
1.6062–1	1545–0123
1.6063–1	1545–0123
1.6065–1	1545–0123
1.6071–1	1545–0123
	1545–0810
1.6072–1	1545–0074
1.6072–2	1545–0123
	1545–0807
1.6073–1	1545–0087
1.6073–2	1545–0087
1.6073–3	1545–0087
1.6073–4	1545–0087
1.6074–1	1545–0123
1.6074–2	1545–0123
1.6081–1	1545–0066
	1545–0148
	1545–0233
	1545–1057
	1545–1081
1.6081–2	1545–0148
	1545–1036
	1545–1054
1.6081–3	1545–0233
1.6081–4	1545–0188
	1545–1479
1.6081–6	1545–0148
	1545–1054
1.6081–7	1545–0148
	1545–1054
1.6091–3	1545–0089
1.6107–1	1545–0074
	1545–1231
1.6109–1	1545–0074
1.6109–2	1545–2176
1.6115–1	1545–1464
1.6151–1	1545–0074
1.6153–1	1545–0087
1.6153–4	1545–0087
1.6161–1	1545–0087
1.6162–1	1545–0087
1.6164–1	1545–0135
1.6164–2	1545–0135
1.6164–3	1545–0135
1.6164–5	1545–0135
1.6164–6	1545–0135
1.6164–7	1545–0135
1.6164–8	1545–0135
1.6164–9	1545–0135
1.6302–1	1545–0257
1.6302–2	1545–0098
	1545–0257
1.6411–1	1545–0098
	1545–0135
	1545–0582
1.6411–2	1545–0098
	1545–0582
1.6411–3	1545–0098
	1545–0582
1.6411–4	1545–0582
1.6414–1	1545–0096
1.6425–1	1545–0170
1.6425–2	1545–0170
1.6425–3	1545–0170
1.6654–1	1545–0087
	1545–0140
1.6654–2	1545–0087
1.6654–3	1545–0087
1.6655(e)–1	1545–1421
1.6662–3(c)	1545–0889
1.6662–4(e) and (f)	1545–0889
1.6662–6	1545–1426
1.6694–1	1545–0074
1.6694–2	1545–0074
1.6694–2(c)	1545–1231
1.6694–2(c)(3)	1545–1231
1.6694–3(e)	1545–1231
1.6695–1	1545–0074
	1545–1385
1.6696–1	1545–0074
	1545–0240
1.6851–1	1545–0086
	1545–0138
1.6851–2	1545–0086
	1545–0138
1.7476–1	1545–0197
1.7476–2	1545–0197
1.7519–2T	1545–1036
1.7520–1	1545–1343
1.7520–2	1545–1343
1.7520–3	1545–1343
1.7520–4	1545–1343
1.7701(l)–3	1545–1642
1.7872–15	1545–1792
1.9100–1	1545–0074
1.9101–1	1545–0008
2.1–4	1545–0123
2.1–5	1545–0123
2.1–6	1545–0123
2.1–10	1545–0123
2.1–11	1545–0123
2.1–12	1545–0123
2.1–13	1545–0123
2.1–20	1545–0123
2.1–22	1545–0123
2.1–26	1545–0123
3.2	1545–0123
4.954–1	1545–1068
4.954–2	1545–1068
5.6411–1	1545–0042
	1545–0074
	1545–0098
	1545–0129
	1545–0172
	1545–0582
	1545–0619
5c.44F–1	1545–0619
5c.128–1	1545–0123
5c.305–1	1545–0110
5c.442–1	1545–0152
5f.103–1	1545–0720

CFR part or section where identified and described	Current OMB control No.
5f.6045–1	1545–0715
6a.103A–2	1545–0123
	1545–0720
6a.103A–3	1545–0720
7.465–1	1545–0712
7.465–2	1545–0712
7.465–3	1545–0712
7.465–4	1545–0712
7.465–5	1545–0712
7.936–1	1545–0217
7.999–1	1545–0216
7.6039A–1	1545–0015
7.6041–1	1545–0115
11.410–1	1545–0710
11.412(c)–7	1545–0710
11.412(c)–11	1545–0710
12.7	1545–0190
12.8	1545–0191
12.9	1545–0195
14a.422A–1	1545–0123
15A.453–1	1545–0228
16A.126–2	1545–0074
16A.1255–1	1545–0184
16A.1255–2	1545–0184
18.1371–1	1545–0130
18.1378–1	1545–0130
18.1379–1	1545–0130
18.1379–2	1545–0130
20.2010–2	1545–0015
20.2011–1	1545–0015
20.2014–5	1545–0015
	1545–0260
20.2014–6	1545–0015
20.2016–1	1545–0015
20.2031–2	1545–0015
20.2031–3	1545–0015
20.2031–4	1545–0015
20.2031–6	1545–0015
20.2031–7	1545–0020
20.2031–10	1545–0015
20.2032–1	1545–0015
20.2032A–3	1545–0015
20.2032A–4	1545–0015
20.2032A–8	1545–0015
20.2039–4	1545–0015
20.2051–1	1545–0015
20.2053–3	1545–0015
20.2053–9	1545–0015
20.2053–10	1545–0015
20.2055–1	1545–0015
20.2055–2	1545–0015
	1545–0092
20.2055–3	1545–0015
20.2056(b)–4	1545–0015
20.2056(b)–7	1545–0015
	1545–1612
20.2056A–2	1545–1443
20.2056A–3	1545–1360
20.2056A–4	1545–1360
20.2056A–10	1545–1360
20.2106–1	1545–0015
20.2106–2	1545–0015
20.2204–1	1545–0015
20.2204–2	1545–0015
20.6001–1	1545–0015
20.6011–1	1545–0015
20.6018–1	1545–0015
	1545–0531
20.6018–2	1545–0015
20.6018–3	1545–0015
20.6018–4	1545–0015
	1545–0022
20.6036–2	1545–0015
20.6060–1(a)(1)	1545–1231
20.6061–1	1545–0015
20.6065–1	1545–0015
20.6075–1	1545–0015
20.6081–1	1545–0015
	1545–0181
	1545–1707
20.6091–1	1545–0015
20.6107–1	1545–1231
20.6161–1	1545–0015
	1545–0181
20.6161–2	1545–0015
	1545–0181
20.6163–1	1545–0015
20.6166–1	1545–0181
20.6166A–1	1545–0015
20.6166A–3	1545–0015
20.6324A–1	1545–0754
20.7520–1	1545–1343
20.7520–2	1545–1343
20.7520–3	1545–1343
20.7520–4	1545–1343
22.0	1545–0015
25.2511–2	1545–0020
25.2512–2	1545–0020
25.2512–3	1545–0020
25.2512–5	1545–0020
25.2512–9	1545–0020
25.2513–1	1545–0020
25.2513–2	1545–0020
	1545–0021
25.2513–3	1545–0020
25.2518–2	1545–0959
25.2522(a)–1	1545–0196
25.2522(c)–3	1545–0020
	1545–0196
25.2523(a)–1	1545–0020
	1545–0196
25.2523(f)–1	1545–0015
25.2701–2	1545–1241
25.2701–4	1545–1241
25.2701–5	1545–1273
25.2702–5	1545–1485
25.2702–6	1545–1273
25.6001–1	1545–0020
	1545–0022
25.6011–1	1545–0020
25.6019–1	1545–0020
25.6019–2	1545–0020
25.6019–3	1545–0020
25.6019–4	1545–0020
25.6060–1(a)(1)	1545–1231
25.6061–1	1545–0020
25.6065–1	1545–0020
25.6075–1	1545–0020
25.6081–1	1545–0020
25.6091–1	1545–0020
25.6091–2	1545–0020
25.6107–1	1545–1231
25.6151–1	1545–0020
25.6161–1	1545–0020
25.7520–1	1545–1343
25.7520–2	1545–1343
25.7520–3	1545–1343
25.7520–4	1545–1343
26.2601–1	1545–0985
26.2632–1	1545–0985
	1545–1892
26.2642–1	1545–0985
26.2642–2	1545–0985
26.2642–3	1545–0985

CFR part or section where identified and described	Current OMB control No.
26.2642–4	1545–0985
26.2642–6	1545–1902
26.2652–2	1545–0985
26.2654–1	1545–1902
26.2662–1	1545–0015
	1545–0985
26.2662–2	1545–0985
26.6060–1(a)(1)	1545–1231
26.6107–1	1545–1231
31.3102–3	1545–0029
	1545–0059
	1545–0065
31.3121(b)(19)–1	1545–0029
31.3121(d)–1	1545–0004
31.3121(i)–1	1545–0034
31.3121(r)–1	1545–0029
31.3121(s)–1	1545–0029
31.3121(v)(2)–1	1545–1643
31.3302(a)–2	1545–0028
31.3302(a)–3	1545–0028
31.3302(b)–2	1545–0028
31.3302(e)–1	1545–0028
31.3306(c)(18)–1	1545–0029
31.3401(a)–1	1545–0029
31.3401(a)(6)	1545–1484
31.3401(a)(6)–1	1545–0029
	1545–0096
	1545–0795
31.3401(a)(7)–1	1545–0029
31.3401(a)(8)(A)–1	1545–0029
	1545–0666
31.3401(a)(8)(C)–1	1545–0029
31.3401(a)(15)–1	1545–0182
31.3401(c)–1	1545–0004
31.3402(b)–1	1545–0010
31.3402(c)–1	1545–0010
31.3402(f)(1)–1	1545–0010
31.3402(f)(2)–1	1545–0010
	1545–0410
31.3402(f)(3)–1	1545–0010
31.3402(f)(4)–1	1545–0010
31.3402(f)(4)–2	1545–0010
31.3402(f)(5)–1	1545–0010
	1545–1435
31.3402(h)(1)–1	1545–0029
31.3402(h)(3)–1	1545–0010
	1545–0029
31.3402(h)(4)–1	1545–0010
31.3402(i)–(1)	1545–0010
31.3402(i)–(2)	1545–0010
31.3402(k)–1	1545–0065
31.3402(l)–(1)	1545–0010
31.3402(m)–(1)	1545–0010
31.3402(n)–(1)	1545–0010
31.3402(o)–2	1545–0415
31.3402(o)–3	1545–0008
	1545–0010
	1545–0415
	1545–0717
31.3402(p)–1	1545–0415
	1545–0717
31.3402(q)–1	1545–0238
	1545–0239
31.3404–1	1545–0029
31.3405(c)–1	1545–1341
31.3406(a)–1	1545–0112
31.3406(a)–2	1545–0112
31.3406(a)–3	1545–0112
31.3406(a)–4	1545–0112
31.3406(b)(2)–1	1545–0112
31.3406(b)(2)–2	1545–0112
31.3406(b)(2)–3	1545–0112
31.3406(b)(2)–4	1545–0112
31.3406(b)(2)–5	1545–0112
31.3406(b)(3)–1	1545–0112
31.3406(b)(3)–2	1545–0112
31.3406(b)(3)–3	1545–0112
31.3406(b)(3)–4	1545–0112
31.3406(b)(4)–1	1545–0112
31.3406(c)–1	1545–0112
31.3406(d)–1	1545–0112
31.3406(d)–2	1545–0112
31.3406(d)–3	1545–0112
31.3406(d)–4	1545–0112
31.3406(d)–5	1545–0112
31.3406(e)–1	1545–0112
31.3406(f)–1	1545–0112
31.3406(g)–1	1545–0096
	1545–0112
	1545–1819
31.3406(g)–2	1545–0112
31.3406(g)–3	1545–0112
31.3406(h)–1	1545–0112
31.3406(h)–2	1545–0112
31.3406(h)–3	1545–0112
31.3406(i)–1	1545–0112
31.3501(a)–1T	1545–0771
31.3503–1	1545–0024
31.3504–1	1545–0029
31.6001–1	1545–0798
31.6001–2	1545–0034
	1545–0798
31.6001–3	1545–0798
31.6001–4	1545–0028
31.6001–5	1545–0798
31.6001–6	1545–0029
	1459–0798
31.6011(a)–1	1545–0029
	1545–0034
	1545–0035
	1545–0059
	1545–0074
	1545–0256
	1545–0718
	1545–2097
31.6011(a)–2	1545–0001
	1545–0002
31.6011(a)–3	1545–0028
31.6011(a)–3A	1545–0955
31.6011(a)–4	1545–0034
	1545–0035
	1545–0718
	1545–1413
	1545–2097
31.6011(a)–5	1545–0028
	1545–0718
	1545–2097
31.6011(a)–6	1545–0028
31.6011(a)–7	1545–0074
31.6011(a)–8	1545–0028
31.6011(a)–9	1545–0028
31.6011(a)–10	1545–0112
31.6011(b)–1	1545–0003
31.6011(b)–2	1545–0029
31.6051–1	1545–0008
	1545–0182
	1545–0458
	1545–1729
31.6051–2	1545–0008
31.6051–3	1545–0008
31.6053–1	1545–0029
	1545–0062
	1545–0064
	1545–0065

CFR part or section where identified and described	Current OMB control No.
	1545–1603
31.6053–2	1545–0008
31.6053–3	1545–0065
	1545–0714
31.6053–4	1545–0065
	1545–1603
31.6060–1(a)(1)	1545–1231
31.6065(a)–1	1545–0029
31.6071(a)–1	1545–0001
	1545–0028
	1545–0029
31.6071(a)–1A	1545–0955
31.6081(a)–1	1545–0008
	1545–0028
31.6091–1	1545–0028
	1545–0029
31.6107–1	1545–1231
31.6157–1	1545–0955
31.6205–1	1545–0029
	1545–2097
31.6301(c)–1AT	1545–0035
	1545–0112
	1545–0257
31.6302–1	1545–1413
31.6302–2	1545–1413
31.6302–3	1545–1413
31.6302–4	1545–1413
31.6302(c)–2	1545–0001
	1545–0257
31.6302(c)–2A	1545–0955
31.6302(c)–3	1545–0257
31.6402(a)–2	1545–0256
	1545–2097
31.6413(a)–1	1545–0029
	1545–2097
31.6413(a)–2	1545–0029
	1545–0256
	1545–2097
31.6413(c)–1	1545–0029
	1545–0171
31.6414–1	1545–0029
	1545–2097
32.1	1545–0029
	1545–0415
32.2	1545–0029
35a.3406–2	1545–0112
35a.9999–5	1545–0029
36.3121(l)(1)–1	1545–0137
36.3121(l)(1)–2	1545–0137
36.3121(l)(3)–1	1545–0123
36.3121(1)(7)–1	1545–0123
36.3121(1)(10)–1	1545–0029
36.3121(1)(10)–3	1545–0029
36.3121(1)(10)–4	1545–0257
40.6060–1(a)(1)	1545–1231
40.6107–1	1545–1231
40.6302(c)–3(b)(2)(ii)	1545–1296
40.6302(c)–3(b)(2)(iii)	1545–1296
40.6302(c)–3(e)	1545–1296
40.6302(c)–3(f)(2)(ii)	1545–1296
41.4481–1	1545–0143
41.4481–2	1545–0143
41.4483–3	1545–0143
41.6001–1	1545–0143
41.6001–2	1545–0143
41.6001–3	1545–0143
41.6060–1(a)(1)	1545–1231
41.6071(a)–1	1545–0143
41.6081(a)–1	1545–0143
41.6091–1	1545–0143
41.6107–1	1545–1231
41.6109–1	1545–0143
41.6151(a)–1	1545–0143
41.6156–1	1545–0143
41.6161(a)(1)–1	1545–0143
44.4401–1	1545–0235
44.4403–1	1545–0235
44.4412–1	1545–0236
44.4901–1	1545–0236
44.4905–1	1545–0236
44.4905–2	1545–0236
44.6001–1	1545–0235
44.6011(a)–1	1545–0235
	1545–0236
44.6060–1(a)(1)	1545–1231
44.6071–1	1545–0235
44.6091–1	1545–0235
44.6107–1	1545–1231
44.6151–1	1545–0235
44.6419–1	1545–0235
44.6419–2	1545–0235
46.4371–4	1545–0023
46.4374–1	1545–0023
46.4375–1	1545–2238
46.4376–1	1545–2238
46.4701–1	1545–0023
	1545–0257
48.4041–4	1545–0023
48.4041–5	1545–0023
48.4041–6	1545–0023
48.4041–7	1545–0023
48.4041–9	1545–0023
48.4041–10	1545–0023
48.4041–11	1545–0023
48.4041–12	1545–0023
48.4041–13	1545–0023
48.4041–19	1545–0023
48.4041–20	1545–0023
48.4041–21	1545–1270
48.4042–2	1545–0023
48.4052–1	1545–1418
48.4061(a)–1	1545–0023
48.4061(a)–2	1545–0023
48.4061(b)–3	1545–0023
48.4064–1	1545–0014
	1545–0242
48.4071–1	1545–0023
48.4073–1	1545–0023
48.4073–3	1545–0023
	1545–1074
	1545–1087
48.4081–2	1545–1270
	1545–1418
48.4081–3	1545–1270
	1545–1418
	1545–1897
48.4081–4(b)(2)(ii)	1545–1270
48.4081–4(b)(3)(i)	1545–1270
48.4081–4(c)	1545–1270
48.4081–6(c)(1)(ii)	1545–1270
48.4081–7	1545–1270
	1545–1418
48.4082–1T	1545–1418
48.4082–2	1545–1418
48.4082–6	1545–1418
48.4082–7	1545–1418
48.4101–1	1545–1418
48.4101–1T	1545–1418
48.4101–2	1545–1418
48.4161(a)–1	1545–0723
48.4161(a)–2	1545–0723
48.4161(a)–3	1545–0723
48.4161(b)–1	1545–0723
48.4216(a)–2	1545–0023

CFR part or section where identified and described	Current OMB control No.
48.4216(a)–3	1545–0023
48.4216(c)–1	1545–0023
48.4221–1	1545–0023
48.4221–2	1545–0023
48.4221–3	1545–0023
48.4221–4	1545–0023
48.4221–5	1545–0023
48.4221–6	1545–0023
48.4221–7	1545–0023
48.4222(a)–1	1545–0014
	1545–0023
48.4223–1	1545–0023
	1545–0257
	1545–0723
48.6302(c)–1	1545–0023
	1545–0257
48.6412–1	1545–0723
48.6416(a)–1	1545–0023
	1545–0723
48.6416(a)–2	1545–0723
48.6416(a)–3	1545–0723
48.6416(b)(1)–1	1545–0723
48.6416(b)(1)–2	1545–0723
48.6416(b)(1)–3	1545–0723
48.6416(b)(1)–4	1545–0723
48.6416(b)(2)–1	1545–0723
48.6416(b)(2)–2	1545–0723
48.6416(b)(2)–3	1545–0723
	1545–1087
48.6416(b)(2)–4	1545–0723
48.6416(b)(3)–1	1545–0723
48.6416(b)(3)–2	1545–0723
48.6416(b)(3)–3	1545–0723
48.6416(b)(4)–1	1545–0723
48.6416(b)(5)–1	1545–0723
48.6416(c)–1	1545–0723
48.6416(e)–1	1545–0023
	1545–0723
48.6416(f)–1	1545–0023
	1545–0723
48.6416(g)–1	1545–0723
48.6416(h)–1	1545–0723
48.6420(c)–2	1545–0023
48.6420(f)–1	1545–0023
48.6420–1	1545–0162
	1545–0723
48.6420–2	1545–0162
	1545–0723
48.6420–3	1545–0162
	1545–0723
48.6420–4	1545–0162
	1545–0723
48.6420–5	1545–0162
	1545–0723
48.6420–6	1545–0162
	1545–0723
48.6421–0	1545–0162
	1545–0723
48.6421–1	1545–0162
	1545–0723
48.6421–2	1545–0162
	1545–0723
48.6421–3	1545–0162
	1545–0723
48.6421–4	1545–0162
	1545–0723
48.6421–5	1545–0162
	1545–0723
48.6421–6	1545–0162
	1545–0723
48.6421–7	1545–0162
	1545–0723

CFR part or section where identified and described	Current OMB control No.
48.6424–0	1545–0723
48.6424–1	1545–0723
48.6424–2	1545–0723
48.6424–3	1545–0723
48.6424–4	1545–0723
48.6424–5	1545–0723
48.6424–6	1545–0723
48.6427–0	1545–0723
48.6427–1	1545–0023
	1545–0162
	1545–0723
48.6427–2	1545–0162
	1545–0723
48.6427–3	1545–0723
48.6427–4	1545–0723
48.6427–5	1545–0723
48.6427–8	1545–1418
48.6427–9	1545–1418
48.6427–10	1545–1418
48.6427–11	1545–1418
49.4251–1	1545–1075
49.4251–2	1545–1075
49.4251–4(d)(2)	1545–1628
49.4253–3	1545–0023
49.4253–4	1545–0023
49.4264(b)–1	1545–0023
	1545–0224
	1545–0225
	1545–0226
	1545–0230
	1545–0257
	1545–0912
49.4271–1(d)	1545–0685
49.5000B–1	1545–2177
51.2(f)(2)(ii)	1545–2209
51.7	1545–2209
52.4682–1(b)(2)(iii)	1545–1153
52.4682–2(b)	1545–1153
	1545–1361
52.4682–2(d)	1545–1153
	1545–1361
52.4682–3(c)(2)	1545–1153
52.4682–3(g)	1545–1153
52.4682–4(f)	1545–0257
	1545–1153
52.4682–5(d)	1545–1361
52.4682–5(f)	1545–1361
53.4940–1	1545–0052
	1545–0196
53.4942(a)–1	1545–0052
53.4942(a)–2	1545–0052
53.4942(a)–3	1545–0052
53.4942(b)–3	1545–0052
53.4945–1	1545–0052
53.4945–4	1545–0052
53.4945–5	1545–0052
53.4945–6	1545–0052
53.4947–1	1545–0196
53.4947–2	1545–0196
53.4948–1	1545–0052
53.4958–6	1545–1623
53.4961–2	1545–0024
53.4963–1	1545–0024
53.6001–1	1545–0052
53.6011–1	1545–0049
	1545–0052
	1545–0092
	1545–0196
53.6060–1(a)(1)	1545–1231
53.6065–1	1545–0052
53.6071–1	1545–0049
53.6081–1	1545–0066

CFR part or section where identified and described	Current OMB control No.
	1545–0148
53.6107–1	1545–1231
53.6161–1	1545–0575
54.4975–7	1545–0575
54.4977–1T	1545–0771
54.4980B–6	1545–1581
54.4980B–7	1545–1581
54.4980B–8	1545–1581
54.4980F–1	1545–1780
54.6011–1	1545–0575
54.6011–1T	1545–0575
54.6060–1(a)(1)	1545–1231
54.6107–1	1545–1231
54.9801–3	1545–1537
54.9801–4	1545–1537
54.9801–5	1545–1537
54.9801–6	1545–1537
54.9812–1T	1545–2165
54.9815–1251T	1545–2178
54.9815–2711T	1545–2179
54.9815–2712T	1545–2180
54.9815–2714T	1545–2172
54.9815–2715	1545–2229
54.9815–2719AT	1545–2181
54.9815–2719T	1545–2182
55.6001–1	1545–0123
55.6011–1	1545–0123
	1545–0999
	1545–1016
55.6060–1(a)(1)	1545–1231
55.6061–1	1545–0999
55.6071–1	1545–0999
55.6107–1	1545–1231
56.4911–6	1545–0052
56.4911–7	1545–0052
56.4911–9	1545–0052
56.4911–10	1545–0052
56.6001–1	1545–1049
56.6011–1	1545–1049
56.6060–1(a)(1)	1545–1231
56.6081–1	1545–1049
56.6107–1	1545–1231
56.6161–1	1545–0257
	1545–1049
57.2(e)(2)(i)	1545–2249
145.4051–1	1545–0745
145.4052–1	1545–0120
	1545–0745
	1545–1076
145.4061–1	1545–0224
	1545–0230
	1545–0257
	1545–0745
156.6001–1	1545–1049
156.6011–1	1545–1049
156.6060–1(a)(1)	1545–1231
156.6081–1	1545–1049
156.6107–1	1545–1231
156.6161–1	1545–1049
157.6001–1	1545–1824
157.6011–1	1545–1824
157.6060–1(a)(1)	1545–1231
157.6081–1	1545–1824
157.6107–1	1545–1231
157.6161–1	1545–1824
301.6011–2	1545–0225
	1545–0350
	1545–0387
	1545–0441
	1545–0957
301.6011(g)–1	1545–2079
301.6017–1	1545–0090
301.6034–1	1545–0092
301.6036–1	1545–0013
	1545–0773
301.6047–1	1545–0367
	1545–0957
301.6056–1	1545–2251
301.6056–2	1545–2251
301.6057–1	1545–0710
301.6057–2	1545–0710
301.6058–1	1545–0710
301.6059–1	1545–0710
301.6103(c)–1	1545–1816
301.6103(n)–1	1545–1841
301.6103(p)(2)(B)–1	1545–1757
301.6104(a)–1	1545–0495
301.6104(a)–5	1545–0056
301.6104(a)–6	1545–0056
301.6104(b)–1	1545–0094
	1545–0742
301.6104(d)–1	1545–1655
301.6104(d)–2	1545–1655
301.6104(d)–3	1545–1655
301.6109–1	1545–0003
	1545–0295
	1545–0367
	1545–0387
	1545–0957
	1545–1461
	1545–2242
301.6109–3	1545–1564
301.6110–3	1545–0074
301.6110–5	1545–0074
301.6111–1T	1545–0865
	1545–0881
301.6111–2	1545–0865
	1545–1687
301.6112–1	1545–0865
	1545–1686
301.6112–1T	1545–0865
	1545–1686
301.6114–1	1545–1126
	1545–1484
301.6222(a)–2	1545–0790
301.6222(b)–1	1545–0790
301.6222(b)–2	1545–0790
301.6222(b)–3	1545–0790
301.6223(b)–1	1545–0790
301.6223(c)–1	1545–0790
301.6223(e)–2	1545–0790
301.6223(g)–1	1545–0790
301.6223(h)–1	1545–0790
301.6224(b)–1	1545–0790
301.6224(c)–1	1545–0790
301.6224(c)–3	1545–0790
301.6227(c)–1	1545–0790
301.6227(d)–1	1545–0790
301.6229(b)–2	1545–0790
301.6230(b)–1	1545–0790
301.6230(e)–1	1545–0790
301.6231(a)(1)–1	1545–0790
301.6231(a)(7)–1	1545–0790
301.6231(c)–1	1545–0790
301.6231(c)–2	1545–0790
301.6316–4	1545–0074
301.6316–5	1545–0074
301.6316–6	1545–0074
301.6316–7	1545–0029
301.6324A–1	1545–0015
301.6361–1	1545–0024
	1545–0074
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1.162(l)–1 Added 34610
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