Internal Revenue bulletin

Bulletin No. 2006-41
October 10, 2006

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2006–50, page 672.

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for October 2006.

Rev. Rul. 2006–51, page 632.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through December 2006. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through December 2006.

T.D. 9283, page 633.

Final regulations under sections 168(k) and 1400L(b) of the Code provide guidance regarding the additional first year depreciation deduction for qualified property and 50-percent bonus depreciation property under section 168(k) and for qualified New York Liberty Zone property under section 1400L(b).

T.D. 9285, page 656.

Final regulations under section 448 of the Code provide rules relating to the use of a nonaccrual-experience method of accounting by taxpayers using an accrual method of accounting and performing services. The regulations affect qualifying taxpayers that want to adopt, change to, or change a nonaccrual-experience method of accounting under section 448(d)(5).

REG–109367–06, page 683.

Proposed regulations clarify the circumstances in which accounts or notes receivable are "acquired ... for services rendered" within the meaning of section 1221(a)(4) of the Code. A public hearing is scheduled for November 7, 2006. Simultaneously with the publication of these proposed regulations in the Federal Register, the following revenue rulings are being declared obsolete: Rev. Ruls. 72–238 and 73–558.

Notice 2006–78, page 675.

This notice announces the phase-out of the qualified hybrid motor vehicle credit and the new advanced lean burn technology motor vehicle credit for passenger automobiles and light trucks manufactured by Toyota Motor Corporation that are purchased for use or lease in the United States beginning on October 1, 2006.

Notice 2006–84, page 677.

This notice concludes that income from performing services at the U.S. Naval Base at Guantanamo Bay is not income earned in a restricted country (Cuba) for purposes of the limitation set forth in section 911(d)(8)(A) of the Code and thus, an individual working at Guantanamo Bay is eligible for the section 911 foreign earned income exclusion, provided that the other requirements of that section are met.

Notice 2006–85, page 677.

This notice announces that the IRS and Treasury intend to issue regulations under section 367(b) to address certain triangular reorganizations involving foreign corporations. The regulations will apply to triangular reorganizations where either the parent corporation or its subsidiary are foreign and where the subsidiary acquires from the parent, in exchange for property, parent stock that is used to acquire the stock or assets of a target corporation. The regulations will treat the transfer of property from the subsidiary to its parent as a distribution of property under section 301(c) and make corresponding adjustments.

(Continued on the next page)

Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

Notice 2006–86, page 680.

This notice provides interim guidance under section 152(c)(4) of the Code, the rule for determining which taxpayer may claim a qualifying child when two or more taxpayers claim the same child. It clarifies that, unless the special rule in section 152(e) applies, the tie-breaking rule in section 152(c)(4) applies to the head of household filing status, the child and dependent care credit, the child tax credit, the earned income credit, the exclusion for dependent care assistance, and the dependency deduction as a group, rather than on a section-by-section basis.

The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are compiled semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

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Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 42.—Low-Income Housing Credit

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Low-income housing credit; satisfactory bond; "bond factor" amounts for the period January through December 2006. This ruling provides the monthly bond factor amounts to be used by taxpayers who dispose of qualified low-income buildings or interests therein during the period January through December 2006.

Rev. Rul. 2006–51

In Rev. Rul. 90–60, 1990–2 C.B. 3, the Internal Revenue Service provided guidance to taxpayers concerning the general methodology used by the Treasury Department in computing the bond factor amounts used in calculating the amount of bond considered satisfactory by the Secretary under § 42(j)(6) of the Internal Revenue Code. It further announced that the Secretary would publish in the Internal Revenue Bulletin a table of bond factor amounts for dispositions occurring during each calendar month.

Rev. Proc. 99–11, 1999–1 C.B. 275, established a collateral program as an alternative to providing a surety bond for taxpayers to avoid or defer recapture of the low-income housing tax credits under § 42(j)(6). Under this program, taxpayers may establish a Treasury Direct Account and pledge certain United States Treasury securities to the Internal Revenue Service as security.

This revenue ruling provides in Table 1 the bond factor amounts for calculating the amount of bond considered satisfactory under § 42(j)(6) or the amount of United States Treasury securities to pledge in a Treasury Direct Account under Rev. Proc. 99–11 for dispositions of qualified low-income buildings or interests therein during the period January through December 2006.

Table 1
Rev. Rul. 2006–51
Monthly Bond Factor Amounts for Dispositions Expressed
As a Percentage of Total Credits

	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year										
Month of Disposition	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Jan '06	16.49	30.74	43.01	53.65	62.94	64.28	65.95	67.76	69.76	72.19	74.98
Feb '06	16.49	30.74	43.01	53.65	62.94	64.14	65.81	67.62	69.61	72.03	74.80
Mar '06	16.49	30.74	43.01	53.65	62.94	64.00	65.67	67.47	69.46	71.89	74.63
Apr '06	16.49	30.74	43.01	53.65	62.94	63.87	65.53	67.33	69.32	71.73	74.46
May '06	16.49	30.74	43.01	53.65	62.94	63.73	65.40	67.20	69.18	71.58	74.30
Jun '06	16.49	30.74	43.01	53.65	62.94	63.61	65.27	67.06	69.05	71.44	74.15
Jul '06	17.40	32.42	45.37	56.59	66.39	67.61	70.07	72.72	75.62	79.01	82.82
Aug '06	17.40	32.42	45.37	56.59	66.39	67.47	69.93	72.57	75.47	78.86	82.65
Sep '06	17.40	32.42	45.37	56.59	66.39	67.34	69.79	72.43	75.33	78.71	82.49
Oct '06	17.40	32.42	45.37	56.59	66.39	67.20	69.66	72.30	75.19	78.56	82.34
Nov '06	17.40	32.42	45.37	56.59	66.39	67.07	69.53	72.16	75.05	78.42	82.19
Dec '06	17.40	32.42	45.37	56.59	66.39	66.95	69.40	72.03	74.92	78.28	82.04

Table 1 (cont'd) Rev. Rul. 2006–51 Monthly Bond Factor Amounts for Dispositions Expressed As a Percentage of Total Credits										
	Calendar Year Building Placed in Service or, if Section 42(f)(1) Election Was Made, the Succeeding Calendar Year									
Month of Disposition	2003	2004	2005	2006						
Jan '06	78.01	81.02	83.60	83.98						
Feb '06	77.81	80.77	83.28	83.98						
Mar '06	77.61	80.53	83.00	83.98						
Apr '06	77.42	80.32	82.76	83.98						
May '06	77.25	80.12	82.54	83.98						
Jun '06	77.08	79.93	82.35	83.98						
Jul '06	86.92	90.99	94.61	97.21						
Aug '06	86.74	90.79	94.41	97.21						
Sep '06	86.56	90.60	94.23	97.21						
Oct '06	86.39	90.42	94.07	97.21						
Nov '06	86.23	90.25	93.92	97.21						
Dec '06	86.08	90.09	93.78	97.21						

For a list of bond factor amounts applicable to dispositions occurring during other calendar years, see: Rev. Rul. 98–3, 1998–1 C.B. 248; Rev. Rul. 2001–2, 2001–1 C.B. 255; Rev. Rul. 2001–53, 2001–2 C.B. 488; Rev. Rul. 2002–72, 2002–2 C.B. 759; Rev. Rul. 2003–117, 2003–2 C.B. 1051; Rev. Rul. 2004–100, 2004–2 C.B. 718; and Rev. Rul. 2005–67, 2005–43 I.R.B. 771.

DRAFTING INFORMATION

The principal author of this revenue ruling is David McDonnell of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue ruling, contact Mr. McDonnell at (202) 622–3040 (not a toll-free call).

Section 168.—Accelerated Cost Recovery System

26 CFR 1.168(d)(1): Applicable conventions—half-year and mid-quarter convention.

T.D. 9283

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Special Depreciation Allowance

AGENCY: Internal Revenue Service (IRS), Treasury

ACTION: Final and temporary regulations.

SUMMARY: This document contains final regulations relating to the depreciation of property subject to section 168 of the Internal Revenue Code (MACRS property) and the depreciation of computer software subject to section 167. Specifically, these final regulations provide guidance regarding the additional first year depreciation allowance provided by sections 168(k) and 1400L(b) for certain MACRS property and computer software. The regulations reflect changes to the law made by the Job Creation and Worker Assistance Act of 2002, the Jobs and Growth Tax Relief Reconciliation Act of 2003, the Working Families Tax Relief Act of 2004, the American Jobs Creation Act of 2004, and the Gulf Opportunity Zone Act of 2005.

DATES: *Effective Dates:* These regulations are effective August 31, 2006.

Applicability Dates: For dates of applicability, see §§1.167(a)–14(e), 1.168(d)–1(d), 1.168(d)–1T(d), 1.168(k)–1(g), 1.169–3(g), and 1.1400L(b)–1(g).

FOR FURTHER INFORMATION CONTACT: Douglas Kim, (202) 622–3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1. On September 8, 2003, the IRS and Treasury Department published temporary regulations (T.D. 9091, 2003–2 C.B. 939) in the **Federal Register** (68 FR 52986) relating to the additional first year depreciation deduction provisions of sections 168(k) and 1400L(b) of the Internal Revenue Code (Code). On the same date, the IRS published a notice of proposed rulemaking (REG–157164–02, 2003–2

C.B. 1004) cross-referencing the temporary regulations in the **Federal Register** (68 FR 53008). On March 1, 2004, the temporary regulations (T.D. 9091) were amended by the temporary regulations (T.D. 9115, 2004–1 C.B. 680) published by the IRS and Treasury Department in the **Federal Register** (69 FR 9529) relating to the depreciation of property acquired in a like-kind exchange or as a result of an involuntary conversion, and the notice of proposed rulemaking (REG–157164–02) was amended by the notice of proposed rulemaking (REG–106590–00, 2004–1 C.B. 704, REG–138499–02, 2003–2 C.B. 541) published by the IRS in the **Federal Register** (69 FR 9560) cross-referencing T.D. 9115. No public hearing was requested or held. Several comments responding to the notice of proposed rulemaking (REG–157164–02) were received. After consideration of all the comments, the proposed regulations (REG–157164–02) as amended by this Treasury decision are adopted as final, and the corresponding temporary regulations (T.D. 9091) are removed. The revisions are discussed below. Additionally, minor changes are made to the temporary regulations (T.D. 9115) to reflect the proper cites of the final regulations.

Section 1400N(d), which was added to the Code by section 101(a) of the Gulf Opportunity Zone Act of 2005, Public Law 109–135 (119 Stat. 2577), generally allows a 50-percent additional first year depreciation deduction (GO Zone additional first year depreciation deduction) for qualified Gulf Opportunity Zone property. Notice 2006–67, 2006–33 I.R.B. 248, provides guidance with respect to the GO Zone additional first year depreciation deduction. Because Notice 2006–67 contains citations to the temporary regulations under section 168(k) (T.D. 9091), the IRS intends to update Notice 2006–67 to change these citations to this Treasury decision.

Explanation of Provisions

Section 167 allows as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in a trade or business or held for the production of income. The depreciation allowable for tangible, depreciable property placed in service after 1986 generally is determined under section 168 (MACRS property). The depreciation allowable for computer software that is placed in service after August 10, 1993, and is not an amortizable section 197 intangible is determined under section 167(f)(1).

Section 168(k)(1) allows a 30-percent additional first year depreciation deduction for qualified property acquired after September 10, 2001, and, in most cases, placed in service before January 1, 2005. Section 168(k)(4) allows a 50-percent additional first year depreciation deduction for 50-percent bonus depreciation property acquired after May 5, 2003, and, in most cases, placed in service before January 1, 2005. Section 1400L(b) allows a 30-percent additional first year depreciation deduction for qualified New York Liberty Zone property (Liberty Zone property) acquired after September 10, 2001, and placed in service before January 1, 2007 (January 1, 2010, in the case of qualifying nonresidential real property and residential rental property).

The final regulations provide the requirements that must be met for depreciable property to qualify for the additional first year depreciation deduction provided by sections 168(k) and 1400L(b). Further, the final regulations instruct taxpayers how to determine the additional first year depreciation deduction and the amount of depreciation otherwise allowable for eligible depreciable property. Unless specifically stated, references to the temporary regulations are to T.D. 9091.

Property Eligible for the Additional First Year Depreciation Deduction

The final regulations retain the rules contained in the temporary regulations providing that depreciable property must meet four requirements to be qualified property under section 168(k)(2) (property for which the 30-percent additional first year depreciation deduction is allowable) or 50-percent bonus depreciation property under section 168(k)(4) (property for which the 50-percent additional first year depreciation deduction is allowable). These requirements are: (1) the depreciable property must be of a specified type; (2) the original use of the depreciable property must commence with the taxpayer after September 10, 2001, for qualified property or after May 5, 2003, for 50-percent bonus depreciation property; (3) the depreciable property must be acquired by the taxpayer within a specified time period; and (4) the depreciable property must be placed in service by a specified date.

Several commentators questioned whether these requirements must be met in the year in which the depreciable property is placed in service by the taxpayer. The statute is clear that additional first year depreciation is allowed in the taxable year in which qualified property or 50 percent bonus depreciation property is placed in service by the taxpayer for use in its trade or business or for production of income. Therefore, only property that meets all of these requirements in the year in which placed in service by the taxpayer for use in its trade or business or for production of income is allowed additional first year depreciation in the year the property is placed in service by the taxpayer for use in its trade or business or for production of income. In response to this comment, the final regulations state more explicitly that all of the requirements must be met in the first taxable year in which the property is subject to depreciation by the taxpayer whether or not depreciation deductions are allowable.

Property of a Specified Type

The final regulations retain the rules contained in the temporary regulations providing that qualified property or 50-percent bonus depreciation property must be one of the following: (1) MACRS property that has a recovery period of 20 years or less; (2) computer software as defined in, and depreciated under, section 167(f)(1); (3) water utility property as defined in section 168(e)(5) and depreciated under section 168; or (4) qualified leasehold improvement property depreciated under section 168.

The final regulations also retain the rules contained in the temporary regulations providing that qualified property or 50-percent bonus depreciation property does not include: (1) property excluded from the application of section 168 as a result of section 168(f); (2) property that is required to be depreciated under the alternative depreciation system of section 168(g) (ADS); (3) any class of property for which the taxpayer elects not to deduct

the 30-percent or 50-percent additional first year depreciation; or (4) qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c).

Property is required to be depreciated under the ADS if the property is described under section 168(g)(1)(A) through (D) or if other provisions of the Code require depreciation for the property to be determined under the ADS (for example, section 263A(e)(2)(A) or section 280F(b)(1)). A commentator questioned whether depreciable property held by taxpayers that made the election under section 263A(d)(3) should be excluded from eligibility for the additional first year depreciation deduction. Section 263A(e)(2)(A) provides that if a taxpayer (or a related person) makes an election under section 263A(d)(3) (relating to an election not to apply section 263A to any plant produced in any farming business carried on by the taxpayer), the ADS applies to all property of the taxpayer used predominantly in the farming business and placed in service in any taxable year during which any such election is in effect. Section 168(k) does not exclude property for which the section 263A(d)(3) election was made from the application of section 168(k)(2)(D)(i), which provides that property required to be depreciated under the ADS is not qualified property and 50-percent bonus depreciation property. For this reason, the final regulations do not adopt the suggestion that depreciable property held by taxpayers that made the election under section 263A(d)(3) is eligible for the additional first year depreciation deduction. Another commentator requested clarification as to whether the reference to "property described in section 263A(e)(2)(A)" in §1.168(k)–1T(b)(2)(ii)(A)(*2*) includes only property held by a taxpayer that has made an election under section 263A(d)(3). In response to this comment, the final regulations clarify that if the taxpayer (or a related person) has made the election under section 263A(d)(3), the property described in section 263A(e)(2)(A) is not eligible for the additional first year depreciation deduction.

Original Use

The final regulations clarify and make conforming changes to the original use rules in the temporary regulations in several respects. First, a commentator inquired whether the rule providing that the cost of reconditioned or rebuilt property acquired by the taxpayer does not satisfy the original use requirement also applies to self-constructed property. A few commentators inquired whether the 20-percent test for determining whether property is reconditioned or rebuilt applies to self-constructed property. The IRS and Treasury Department intended that these rules apply to the cost of any reconditioned or rebuilt property, whether the taxpayer originally acquired the property or self-constructed the property. Accordingly, the final regulations clarify that the cost of reconditioned or rebuilt property does not satisfy the original use requirement and that the 20-percent test applies to acquired or self-constructed property.

Second, *Example 2* of §1.168(k)–1T(b)(3)(v) provides that property held primarily for sale to customers in the ordinary course of a person's business (inventory) does not constitute a use for purposes of the original use requirement. A commentator noted that this rule is not in the operative rules of the temporary regulations. In response to this comment, the final regulations make the rule explicit and provide that if a person initially acquires new property and holds the property as inventory 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. The final regulations also provide that if a taxpayer initially acquires new property and holds the property as inventory and then 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. In both situations, the final regulations provide that 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.

A commentator questioned whether *Example 2* in §1.168(k)– 1T(b)(3)(v) is the appropriate place to resolve the issue of the tax treatment of demonstrator automobiles for depreciation and other purposes when the issue may have a potential broader scope and significance that may continue to arise long after the additional first year depreciation under section 168(k) has ceased to be available. The IRS and Treasury Department believe that this example illustrates only the concept that if property is held by a person as inventory and then sold to a taxpayer for use in the taxpayer's trade or business, the taxpayer is the original user of the property, and, therefore, that this example is in the appropriate place.

Third, the final regulations retain the special rules contained in the temporary regulations for certain sale-leaseback transactions and syndication transactions. A commentator suggested that the title of §1.168(k)–1T(b)(3)(iii)(B), "Syndication transaction," should be changed in the final regulations to reflect that this rule, by its terms, can apply to any sale of property within three months after the date on which it is placed in service, regardless of whether that sale constitutes a syndication. The final regulations adopt this suggestion and modify the titles of, and make conforming changes to, the applicable paragraphs. Similar changes also are made to the paragraphs relating to the placed-in-service date requirement.

Fourth, the final regulations modify the provision in the temporary regulations to implement section 403(a) of the Working Families Tax Relief Act of 2004, (Public Law 108–311, 118 Stat. 1166) (October 4, 2004) (WFTRA) and section 337 of the American Jobs Creation Act of 2004 (Public Law 108–357, 118 Stat. 1418) (October 22, 2004) (AJCA). Section 403(a) of the WFTRA amended section 168(k) by adding the provision in section 168(k)(2)(E)(iii). Section 403(f) of the WFTRA provides that this amendment is effective as if included in the provisions of the Job Creation and Worker Assistance Act of 2002 (Public Law 107–147, 116 Stat. 21) (March 9, 2002) (JCWAA). Section 337(a) of the AJCA amended the syndication transaction provision in section 168(k)(2)(E)(iii)(II) by adding at the end the following: "(or, in the case of multiple units of property subject to the same

lease, within 3 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)." Section 337(b) of the AJCA provides that this amendment is effective for property sold after June 4, 2004.

Fifth, if property placed in service by a person is sold and leased back within three months, and a syndication transaction occurs within three months after the sale-leaseback, a commentator questioned whether the purchaser of the property in the syndication transaction is considered the original user of the property and whether the property is treated as having been placed in service by the purchaser in the syndication transaction. Pursuant to §§1.168(k)–1T(b)(3)(iii)(C) and (5)(ii)(C), the purchaser of the property in the syndication transaction is considered the original user of the property and the property is treated as having been placed in service by the purchaser in the syndication transaction. The final regulations retain this rule and provide an example illustrating both the original use and the placed in service aspects of this situation.

Finally, the final regulations retain the rule contained in the temporary regulations providing that if, in the ordinary course of its business, a taxpayer sells fractional interests in qualified property or 50-percent bonus depreciation property to unrelated third parties, each first fractional owner of the property is considered as the original user of its proportionate share of the property. A commentator questioned whether the rule requiring the sale to be to unrelated third parties means that the purchasers must be unrelated to the seller, the purchasers must be unrelated to each other, or both. The IRS and Treasury Department intended that the purchasers be unrelated to the seller. Accordingly, the final regulations clarify this point.

A commentator questioned whether there are circumstances when the placed-in-service year of property is before the taxable year of original use. Pursuant to §1.46–3(d)(1)(ii), property is considered placed in service in the taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity. Original use begins when new property is placed in service. Consequently, the placed-in-service year of new property cannot be before the taxable year in which original use of the property occurs.

Acquisition of Property

The final regulations modify the acquisition dates in the temporary regulations to reflect section 405 of the Gulf Opportunity Zone Act of 2005 (Public Law 109–135, 119 Stat. 2577) (December 21, 2005) (GOZA). Section 405(a)(1) of the GOZA amended section 168(k)(4)(B)(ii) to provide that 50-percent bonus depreciation property is property (I) 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 (II) acquired by the taxpayer pursuant to a written binding contract which was entered into after May 5, 2003, and before January 1, 2005. Section 405(b) provides that this amendment is effective as if included in section 201 of the Jobs and Growth Tax Relief and Reconciliation Act of 2003 (Public Law 108–27, 117 Stat. 752) (May 28, 2003).

Binding Contracts

The final regulations also modify in three respects the rules contained in the temporary regulations defining a binding contract. First, the temporary regulations provide that if a contract provides for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation by the seller, the contract is not considered binding. A commentator suggested that this rule should apply to a breach or cancellation by the buyer, not the seller. However, the IRS and Treasury Department believe that this rule relates to a breach or cancellation by either party. Accordingly, the final regulations provide that if a contract provides 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.

Second, with respect to a contract subject to a condition, the temporary regulations provide that a contract that 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. A commentator questioned whether this rule implies that a contract that imposes significant obligations will not be treated as binding if substantial terms remain to be negotiated. The IRS and Treasury Department believe that this implication was not intended. As a consequence, the final regulations clarify this rule by providing that 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.

Third, with respect to a supply agreement, a commentator suggested that the existence of agreed pricing terms should not be relevant in determining whether or not a supply agreement is a binding contract, except to the extent that their absence causes the contract not to be enforceable under local law. The commentator further suggested that if the existence of pricing terms is considered relevant to the result in the example of the operative rule and in some of the examples that illustrate the application of the rule, that requirement should be stated in the operative rule, and if not relevant, the references to pricing terms should be deleted. Pricing terms are not relevant in determining whether a supply agreement is a binding contract for purposes of these regulations. Accordingly, the final regulations adopt the suggestion by eliminating the reference to agreed pricing terms in the example of the operative rule. While the examples that illustrate the application of the rule continue to contain the agreed price as a fact, the conclusions in these examples depend upon only whether or not the quantity and the design specification of the property to be purchased are specified.

Self-constructed property

With respect to self-constructed property, the final regulations clarify the rules in the temporary regulations in several respects. First, with respect to property described in section 168(k)(2)(B) (longer production period property) or section 168(k)(2)(C) (certain aircraft), the final regulations clarify that if a taxpayer enters into a written binding contract after September 10, 2001, and before January 1,

2005, with another person to manufacture, construct, or produce such property and the manufacture, construction, or production begins after December 31, 2004, the taxpayer has acquired the property pursuant to a written binding contract entered into after September 10, 2001, and before January 1, 2005 (for qualified property) or after May 5, 2003, and before January 1, 2005 (for 50-percent bonus depreciation property).

Second, a commentator asked whether the rules in the temporary regulations providing for when construction begins are intended also to apply to manufacture and production because self-constructed property can be manufactured, constructed, or produced for purposes of the additional first year depreciation deduction. The IRS and Treasury Department intended these rules to apply to manufacture, construction, or production. Accordingly, the final regulations make this clarification.

Third, the temporary regulations provide that construction of property begins when physical work of a significant nature begins and the determination of when physical work of a significant nature begins depends on the facts and circumstances. The temporary regulations also provide that physical work of a significant nature will not be considered to begin before the taxpayer incurs or pays more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities). Several commentators questioned whether this 10-percent test is a safe harbor. The preamble to the temporary regulations (68 FR 52987) states that the 10-percent test is a safe harbor. Consequently, the final regulations are clarified to provide that the 10-percent test is a safe harbor. Further, when another party manufactures, constructs, or produces property for the taxpayer, the final regulations clarify that the safe harbor test must be met by the taxpayer. Thus, under the final regulations, a taxpayer can determine when manufacture, construction, or production of the property begins either (1) by using the 10 percent safe harbor or (2) by using its own facts and circumstances.

Fourth, the final regulations retain the rules contained in the temporary regulations relating to components of self-constructed property. One of these rules is that if the binding contract to acquire a component is entered into, or 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 begins after December 31, 2004, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not. In the case of a self-constructed component that is to be incorporated into a larger self-constructed property, some commentators noted that the applicability of this rule is limited. Specifically, one commentator stated that if the 10 percent test mentioned in the preceding paragraph is not a safe harbor test, then the only case in which self-constructed components could qualify for the additional first year depreciation deduction is one in which the taxpayer's pre-January 1, 2005, costs are 10 percent or less of the total cost of the larger self-constructed property (but more than 10 percent of the total cost of the component). Another commentator stated that a self-constructed component that is to be incorporated into a larger self-constructed property may not be placed in service before the larger self-constructed property. The IRS and Treasury Department agree that the rule has limited applicability. The rule applies when the larger self-constructed property is property that is manufactured, constructed, or produced by the taxpayer for its own use and that is described in section 168(k)(2)(B) (longer production period property) or section 168(k)(2)(C) (certain aircraft) and, therefore, the property is eligible for the extended placed-in-service date of January 1, 2006.

Disqualified transactions

The final regulations clarify the disqualified transaction rules in the temporary regulations to reflect section 403(a) of the WFTRA. This section amended section 168(k) by adding section 168(k)(2)(E)(iv), which provides limitations related to users and related parties (disqualified transactions). Section 168(k)(2)(E)(iv) provides that the term *qualified property* does not include any property if: (I) the user of such property (as of the date on which the property is originally placed in service) or a person that is related (within the meaning of section 267(b) or 707(b)) to such user or to the taxpayer had a written binding contract in effect for the acquisition of the property at any time on or before September 10, 2001; or (II) in the case of property manufactured, constructed, or produced for such user's or person's own use, the manufacture, construction, or production of the property began at any time on or before September 10, 2001. Section 403(f) of the WFTRA provides that this amendment is effective as if included in the provisions of the JCWAA.

Finally, the IRS and Treasury Department decided to add new examples to illustrate the above rules. Further, in *Example 10* of §1.168(k)–1T(b)(4)(v), a commentator inquired whether the taxpayer (S) is considered to be self-constructing the property, acquiring the property, or both. The IRS and Treasury Department intended to have the taxpayer both self-constructing and acquiring the property. The final regulations make this clarification.

A commentator questioned whether the result in *Example 10* of §1.168(k)–1T(b)(4)(v) also would apply if before September 11, 2001, a partnership began construction of a power plant for its own use, then after September 10, 2001, and before completion of the plant, there is a technical termination of the partnership under section 708(b)(1)(B), and then subsequently the new partnership incurred additional expenditures to complete the construction of the power plant and placed the power plant in service before January 1, 2005. Assuming the terminated partnership and the new partnership are not related parties, the new partnership is considered to have acquired the uncompleted power plant and completed the construction of the power plant and, thus, the result in *Example 10* of §1.168(k)–1T(b)(4)(v) will apply to the new partnership in this case. While the additional first year depreciation deduction for Liberty Zone property requires the property to be acquired by purchase, the same result would apply because for purposes of that requirement, §1.1400L(b)–1T(c)(5)(ii) treats the new partnership as acquiring the property by purchase and the final regulations retain this rule.

Placed-in-service Date

The final regulations retain the rule contained in the temporary regulations providing, pursuant to section 168(k)(2)(A)(iv) and section 168(k)(4)(B)(iii), that qualified property or 50-percent bonus depreciation property is property that is placed in service by the taxpayer before January 1, 2005. The temporary regulations also provide that property described in section 168(k)(2)(B) (longer production period property) must be placed in service before January 1, 2006. The final regulations modify this extended placed-in-service date requirement in two respects. First, the final regulations reflect that the extended placed-in-service date of before January 1, 2006, also applies to property described in section 168(k)(2)(C) (certain aircraft), which was added to section 168(k) by section 336 of the AJCA. Second, the final regulations reflect that the extended placed-in-service date of before January 1, 2006, is extended for one year to before January 1, 2007, for property to which Announcement 2006–29, 2006–19 I.R.B. 879 applies. Announcement 2006–29 applies to property described in section 168(k)(2)(B) or (C) that is either placed in service by the taxpayer or manufactured by a person in the Gulf Opportunity (GO) Zone, the Rita GO Zone, or the Wilma GO Zone, provided the taxpayer was unable to meet the December 31, 2005, placed-in-service date deadline for such property as a result of Hurricane Katrina, Hurricane Rita, or Hurricane Wilma.

Qualified Leasehold Improvement Property

The final regulations retain the rules contained in the temporary regulations relating to qualified leasehold improvement property. The temporary regulations provide that 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, among other things, 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. A commentator questioned whether this rule means an improvement that is permitted or required by a lease. The IRS and Treasury Department believe that the improvement must be made under or pursuant to a lease, regardless of whether the improvement is permitted or required under the lease.

Computation of Additional First Year Depreciation Deduction and Otherwise Allowable Depreciation

The final regulations retain the rules contained in the temporary regulations for determining the amount of the additional first year depreciation deduction and otherwise allowable depreciation deduction. In addition, the final regulations clarify that the additional first year depreciation deduction generally 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.

Election Not to Claim Additional First Year Depreciation Deduction

With respect to the election not to claim the additional first year depreciation deduction, the final regulations retain the rules contained in the temporary regulations for making this election and for defining what is a class of property for purposes of the election. For any class of property that is qualified property, a taxpayer may elect out of the 30-percent additional first year depreciation deduction for any class of qualified property. For any class of property that is 50-percent bonus depreciation property, a taxpayer may elect either to deduct the 30-percent, instead of the 50-percent, additional first year depreciation or to deduct no additional first year depreciation. A commentator asked whether a taxpayer with 50-percent bonus depreciation property must make two elections to elect not to deduct any additional first year depreciation. The final regulations clarify that only one election is needed to elect not to deduct both the 30-percent and 50-percent additional first year depreciation for 50-percent bonus depreciation property.

If a taxpayer elects not to deduct any additional first year depreciation for a class of property, another commentator asked whether the depreciation adjustments under section 56 apply to property included in such class for purposes of computing the taxpayer's alternative minimum taxable income. The non-applicability of the depreciation adjustments under section 56 provided by section 168(k)(2)(G) applies only to qualified property or 50-percent bonus depreciation property. If a taxpayer elects not to deduct any additional first year depreciation for a class of property, the property included in such class is not qualified property or 50-percent bonus depreciation property. Accordingly, the final regulations provide that if a taxpayer elects not to deduct any additional first year depreciation for a class of property, the depreciation adjustments under section 56 apply to that property for purposes of computing the taxpayer's alternative minimum taxable income.

The final regulations also include the procedures provided by section 3.04 of Rev. Proc. 2002–33, 2002–1 C.B. 963, for revoking an election not to deduct the additional first year depreciation for a class of property. These procedures provide that this election is revocable only with the prior written consent of the Commissioner of Internal Revenue and, to seek the Commissioner's consent, the taxpayer must submit a request for a letter ruling. However, the final regulations also provide an automatic 6-month extension from the due date of the taxpayer's Federal tax return (excluding extensions) for the placed-in-service year to revoke the election, provided the taxpayer timely filed its Federal tax return for the placed-in-service year.

Liberty Zone Property

Generally, the requirements for determining the eligibility of property for the additional first year depreciation deduction for Liberty Zone property provided by section 1400L(b) are similar to the requirements for the 30-percent additional first year depreciation deduction for qualified property provided by section 168(k)(1) in the final regulations. The final regulations made several changes to the temporary regulations with respect to the Liberty Zone property, which are discussed below.

The final regulations retain the rule contained in the temporary regulations providing that Liberty Zone property includes the same property that is described as qualified property or 50-percent bonus depreciation property for purposes of section 168(k). In

addition, Liberty Zone property includes nonresidential real property or residential rental property to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001. Real property is considered to have been destroyed or condemned only if an entire building or structure was destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed or condemned property if, as part of an integrated plan, the property replaces real property that is included in a continuous area that includes real property destroyed or condemned. A commentator noted that the temporary regulations simply reiterate the statute but do not define the word *continuous*. The IRS and Treasury Department believe that the common meaning of *continuous* applies.

The temporary regulations define *real property* as a building or its structural components, or other tangible real property except: (1) property described in section 1245(a)(3)(B) (relating to depreciable property used as an integral part of a specified activity or as a specified facility); (2) property described in section 1245(a)(3)(D) (relating to a single purpose agricultural or horticultural structure); and (3) property described in section 1245(a)(3)(E) (relating to storage facility used in connection with the distribution of petroleum or any primary product of petroleum). A commentator suggested that these exclusions to the definition of real property should be deleted in the final regulations. As a result of this definition, nonresidential real property or residential rental property that rehabilitates or replaces any of the excluded properties that were damaged, destroyed, or condemned, is not eligible for the Liberty Zone additional first year depreciation deduction. For this reason, the IRS and Treasury Department agree. Accordingly, the final regulations provide that real property is a building or its structural components, or other tangible real property.

The temporary regulations provide that Liberty Zone property does not include property that is described as qualified property or 50-percent bonus depreciation property for purposes of section 168(k), or property that is described in §1.168(k)–1T(b)(2)(ii). The property described in §1.168(k)–1T(b)(2)(ii) is property that is: (1) described in section 168(f); (2) required to be depreciated under the alternative depreciation system; (3) included in any class of property for which the taxpayer elects out of the additional first year depreciation deduction under section 168(k); or (4) qualified Liberty Zone leasehold improvement property. Instead of providing a cross-reference to §1.168(k)–1(b)(2)(ii), the final regulations list the property that is described in §1.168(k)–1(b)(2)(ii) with one modification to the exclusion for property that is included in any class of property for which the taxpayer elects out of the additional first year depreciation deduction under section 168(k). In this regard, a commentator stated that while section 1400L(b)(2)(C)(iv) provides that the election out rules for purposes of section 1400L(b) are to be similar to the election out rules under section 168(k), section 1400L(b)(2)(C)(iv) does not mean that the same election must be made with respect to both sections 168(k) and 1400L(b). Accordingly, the commentator suggested that a taxpayer be permitted to elect not to apply section 168(k) to its property of a particular class of property to the extent that such property is not located within the Liberty Zone, while still being entitled to the benefits of section 1400L(b) for its property of the same class that is located within the Liberty Zone. The IRS and Treasury Department agree with this suggestion. Accordingly, the final regulations make clear that Liberty Zone property is not property included in any class of property for which the taxpayer elects out of the additional first year depreciation deduction under section 1400L(b).

The final regulations retain the rule contained in the temporary regulations providing that Liberty Zone property is property that is acquired by the taxpayer by purchase after September 10, 2001, but only if no written binding contract for the acquisition of the property was in effect before September 10, 2001. The term *by purchase* is defined in section 179(d) and §1.179–4(c). The final regulations also retain the rule contained in the temporary regulations providing that the new partnership resulting from a technical termination under section 708(b)(1)(B) or a transferee in section 168(i)(7) transactions is deemed to acquire the depreciable property by purchase. A commentator suggested that the rule should apply only if the old transferor partnership had itself acquired the property by purchase, as the mere existence of a technical termination does not provide sufficient reason to deem the statutory purchase requirement to have been met. The final regulations do not adopt this suggestion. The rule is the result of the rules provided in the temporary regulations regarding the additional first year depreciation deduction under sections 168(k) and 1400L(b) that allow the new partnership resulting from a technical termination to be entitled to the additional first year depreciation deduction for eligible property that was placed in service by the terminated partnership during the taxable year of termination. As a result, the IRS and Treasury Department determined that the rule should not be changed.

The final regulations also retain the rules contained in the temporary regulations for electing not to deduct the Liberty Zone additional first year depreciation deduction for a class of property. In addition, the final regulations for this election include provisions similar to those previously discussed relating to the alternative minimum tax and the revocation of the election with respect to the election not to deduct the additional first year depreciation deduction under section 168(k).

Special Rules

Similar to the temporary regulations, the final regulations provide special rules for the following situations: (1) qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service and disposed of in the same taxable year; (2) redetermination of basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (3) recapture of additional first year depreciation for purposes of section 1245 and section 1250; (4) a certified pollution control facility that is qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (5) like-kind exchanges and involuntary conversions of qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (6) a change in use of qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (7) the computation of earnings and profits;

(8) the increase in the limitation of the amount of depreciation for passenger automobiles; and (9) the step-up in basis due to a section 754 election. For some of these situations, the final regulations modify or clarify the rules contained in the temporary regulations. In addition, the final regulations provide rules for two new situations: the rehabilitation credit under section 47 and the computation of depreciation for purposes of section 514(a)(3).

Property placed in service and disposed of in the same taxable year

With respect to qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service and disposed of in the same taxable year, the final regulations retain the rules contained in the temporary regulations. In general, the regulations provide that the additional first year depreciation deduction is not allowed. If qualified property or 50-percent bonus depreciation property is placed in service and disposed of by a taxpayer in the same taxable year and then, in a subsequent taxable year, is reacquired and again placed in service by the taxpayer, a commentator inquired whether the additional first year depreciation deduction is allowable in the subsequent taxable year. Because the property is used property in the subsequent taxable year, the additional first year depreciation deduction is not allowable for the property in the subsequent taxable year. Accordingly, in this situation, the final regulations clarify that the additional first year depreciation deduction is not allowable for the property in the subsequent taxable year.

The temporary regulations provide two exceptions to the general rule. First, the additional first year depreciation deduction is allowable for qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service by a terminated partnership in the same taxable year in which a technical termination of the partnership occurs. In this case, the new partnership, and not the terminated partnership, claims the additional first year depreciation deduction. Second, the additional first year depreciation deduction is allowable for qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service by a transferor in the same taxable year in which the property is transferred in a transaction described in section 168(i)(7). In this case, the additional first year depreciation deduction 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. The 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. If the transferee has a different taxable year than the transferor, a commentator questioned whether the allocation of the additional first year depreciation deduction would be made between the transferor and the transferee in accordance with the above rules. Because the allocation rules in §1.168(d)–1(b)(7)(ii) cover this situation, the IRS and Treasury Department did not modify the rule in the final regulations.

Redetermination of basis

The final regulations also retain the rules contained in the temporary regulations with respect to a redetermination of basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property (for example, due to a contingent purchase price or a discharge of indebtedness). These rules apply to a redetermination of the unadjusted depreciable basis of the property occurring before January 1, 2005 (January 1, 2006, for the extended placed-in-service date property) for qualified property or 50-percent bonus depreciation property, or before January 1, 2007 (January 1, 2010, in the case of nonresidential real property and residential rental property) for Liberty Zone property. A commentator suggested that the rules should be expanded to include redeterminations of basis occurring on or after these dates. The commentator pointed out that the rule results in additional first year depreciation not being allowable for additional purchase price paid on or after January 1, 2005, with respect to qualified property or 50-percent bonus depreciation property acquired before 2005. The final regulations do not adopt this suggestion. While the current rule may be unfavorable when, for example, a redetermination of basis results in an increase of basis on or after January 1, 2005, for qualified property or 50-percent bonus depreciation property acquired before 2005, the current rule may be favorable when, for example, a redetermination of basis results in a decrease of basis on or after January 1, 2005, with respect to qualified property or 50-percent bonus depreciation property acquired before 2005. Further, the IRS and Treasury Department limited the rules to redeterminations occurring before the dates mentioned above to be consistent with the dates on which property must be placed in service to be eligible for the additional first year depreciation deduction. For this reason, the IRS and Treasury Department determined not to change the rule in the final regulations.

In the case of a redetermination of basis that results in a decrease in basis, a commentator noted that the operative rule provides that the taxpayer includes in the taxpayer's income the excess additional first year depreciation deduction previously claimed for the qualified property, the 50-percent bonus depreciation property, or the Liberty Zone property but the example illustrating the application of this rule allows the taxpayer to reduce current year depreciation deductions by the amount of the excess additional first year depreciation deduction previously claimed for the qualified property, the 50-percent bonus depreciation property, or Liberty Zone property. Because the IRS and Treasury Department recognize that the lump-sum inclusion in income approach provided in the operative rule of the temporary regulation may adversely affect real estate investment trusts and similar entities, the final regulations provide that the excess additional first year depreciation deduction offsets the amount otherwise allowable for depreciation for the taxable year. Even if the amount of the offset exceeds the amount otherwise allowable for depreciation for the taxable year, the taxpayer takes into account a negative depreciation deduction in computing taxable income.

The final regulations retain the rule contained in the temporary regulations providing that, for purposes of the redetermination of basis rules: (1) an increase in basis occurs in the taxable year an amount is taken into account under section 461; and (2) a decrease in basis occurs in the taxable year an amount is taken into account under section 451. A commentator questioned whether because the event in question is giving rise to a basis adjust-

ment, rather than to an item of income or deduction, it is appropriate for the rule to tie the timing of the adjustment to accounting method rules concerning the timing of income and deductions. The commentator also noted that one apparent effect of applying the accounting method rules is to override the basis reduction rule of section 1017(a) as illustrated in *Example 2* of §1.168(k)–1T(f)(2)(iv). The IRS and Treasury Department did not intend to change the section 1017(a) rules. While the IRS and Treasury Department continue to believe that the current rule is appropriate, the final regulations have been modified for cases in which the Code, the regulations under the Code, or other published guidance expressly provides an exception to such rule (for example, section 1017(a)). Therefore, *Example 2* of §1.168(k)–1(f)(2)(iv) in the final regulations reflects the basis adjustment rules of section 1017(a).

Like-kind exchanges and involuntary conversions

With respect to MACRS property or computer software acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033, the final regulations change the rules contained in the temporary regulations (T.D. 9091 as amended by T.D. 9115) in several respects. First, the final regulations modify the scope of this provision to include property described in section 168(k)(2)(C) (certain aircraft), which was added to section 168(k) by section 336 of the AJCA, and to include property to which Announcement 2006–29, 2006–19 I.R.B. 879, applies if the time of replacement is after September 10, 2001, and before January 1, 2007. As previously noted, Announcement 2006–29 applies to property described in section 168(k)(2)(B) or (C) that is either placed in service by the taxpayer or manufactured by a person in the Gulf Opportunity (GO) Zone, the Rita GO Zone, or the Wilma GO Zone, provided the taxpayer was unable to meet the December 31, 2005, placed-in-service date deadline for such property as a result of Hurricane Katrina, Hurricane Rita, or Hurricane Wilma. Similar changes also are made to the paragraph relating to the computation of the additional first year depreciation deduction for MACRS property or computer software acquired in a like-kind exchange or as a result of an involuntary conversion.

A commentator inquired whether the rules should be expanded to include exchanged or involuntarily converted property that is subject to former section 168 (the accelerated cost recovery system or ACRS) or that is pre–1981 depreciation property. The current rules apply only to exchanged or involuntarily converted property that is MACRS property in order to conform with §1.168(i)–6T (relating to depreciation of property acquired in like-kind exchanges or as a result of involuntary conversions). Accordingly, the IRS and Treasury Department believe that this issue is outside the scope of these regulations and should be addressed when the temporary regulations under §1.168(i)–6T are finalized.

Second, the temporary regulations define the time of replacement as the later of when the acquired MACRS property or acquired computer software is placed in service, or the time of disposition of the exchanged or involuntarily converted property. A commentator expressed concern that in the case of an involuntary conversion under section 1033, the final regulations may confer an unintended benefit in the case of taxpayers who acquired property prior to September 11, 2001, in order to replace property that was ultimately requisitioned or condemned after September 10, 2001, but as to which the threat or imminence of condemnation existed prior to that date. The IRS and Treasury Department acknowledge that the rule confers a benefit under such circumstances, but continue to believe that the rule is appropriate. Additionally, the IRS and Treasury Department decided to provide rules in the final regulations to address how the additional first year depreciation deduction is treated when §1.168(i)–6T(d)(4) applies. Section 1.168(i)–6T(d)(4) applies when, in an involuntary conversion, a taxpayer acquires and places in service acquired MACRS property before the time of disposition of the involuntarily converted MACRS property. If the time of disposition of the involuntarily converted MACRS property 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 Announcement 2006–29 applies), the final regulations provide that the time of replacement is when the acquired MACRS property is placed in service, provided the threat or imminence of requisition or condemnation of the converted property existed prior to 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 Announcement 2006–29 applies). In this case, the final regulations also modify the income inclusion rule in §1.168(i)–6T(d)(4) to allow the additional first year depreciation deduction on the remaining carryover basis of the acquired MACRS property that is qualified property, 50-percent bonus depreciation property, or Liberty Zone property.

Third, the final regulations clarify the rules contained in the temporary regulations relating to the computation of the additional first year depreciation deduction for property described in section 168(k)(2)(B) (longer production period property) and for alternative minimum tax purposes. In both cases, the temporary regulations provide a cross-reference to §1.168(k)–1T(d) (computation of depreciation deduction for qualified property or 50-percent bonus depreciation property). A commentator suggested that the purpose of the reference to §1.168(k)–1T(d) should be clarified. The final regulations adopt this suggestion by deleting the cross-reference and providing rules for computing the additional first year depreciation deduction for property described in section 168(k)(2)(B) (longer production period property) and for alternative minimum tax purposes.

Also, a commentator questioned whether the rule that the additional first year depreciation is calculated separately with respect to the carryover basis and the excess basis is appropriate, and suggested that the rule should be simplified by eliminating the requirement of separate calculations. The IRS and Treasury Department believe that the rule is appropriate because it conforms with §1.168(i)–6T, which requires separate calculations of depreciation for the carryover basis and the excess basis.

Fourth, the final regulations clarify the rules contained in the temporary regulations relating to exchanged or involuntarily converted MACRS property or exchanged or involuntarily converted computer software that is placed in service and disposed of in an exchange or involuntary conversion in the same taxable year. In this case, the temporary regulations provide that 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 MACRS property or computer software is placed in service and disposed of in an exchange or involuntary conversion in the same taxable year. A commentator suggested that the final regulations clarify that the reference in the above rule to the MACRS property or computer software that is placed in service and disposed of in the same taxable year is the exchanged or involuntarily converted MACRS property or exchanged or involuntarily converted computer software. The final regulations adopt this suggestion.

Finally, a new example is added and the facts in several of the examples are clarified to reflect that the acquired property must be new property in order to meet the original use requirement and, therefore, qualify for the additional first year depreciation deduction.

Change in use

The final regulations retain the rules contained in the temporary regulations providing when the use of qualified property, 50-percent bonus depreciation property, or Liberty Zone property changes in the hands of the same taxpayer during the placed-in-service year or a subsequent taxable year. One of these rules provide that 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 the requirements for the additional first year depreciation deduction are met). Another rule provides that if depreciable property is not qualified property, 50-percent bonus depreciation property, or Liberty Zone property in the placed-in-service year, 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 placed-in-service year results in the property being qualified property, 50-percent bonus depreciation property, or Liberty Zone property in the taxable year of the change in use. A commentator questioned whether these two rules are inconsistent. The commentator further noted that under §1.167(a)–11(e)(1)(i), property that is ready for use in a personal activity is considered to be placed in service. The IRS and Treasury Department do not believe that the two rules are inconsistent. Property is eligible for the additional first year depreciation deduction if in the first year in which the property is subject to depreciation, the property meets all the requirements to qualify for the additional first year depreciation deduction. In the case of property that changes from personal use to a business or income-producing use, the first year such property is subject to depreciation is the year of conversion to business or income-producing use. But in the case of property that changes from a depreciable use not eligible for the additional first year depreciation deduction to a depreciable use that is eligible for the additional first year depreciation deduction, such property did not meet the requirements to qualify for the additional first year depreciation deduction in the first year in which the property is subject to depreciation.

Earnings and profits

The final regulations retain the rule contained in the temporary regulations providing that the additional first year depreciation deduction is not allowable for purposes of computing earnings and profits. A commentator suggested that because this provision interprets section 312(k), the regulations under section 312 should include a cross-reference to the regulations under section 168(k). The IRS and Treasury Department agree and, accordingly, the final regulations adopt this suggestion.

280F(a)(1) limitation

The final regulations also retain the rules contained in the temporary regulations providing the increase in the limitation under section 280F(a)(1) of the amount of depreciation for certain passenger automobiles that are qualified property or 50-percent bonus depreciation property. A commentator had three inquiries about this increase in the limitation under section 280F(a)(1). First, the commentator asked whether the increase in the limitation can be taken as a section 179 expense. The increase in the limitation under section 280F(a)(1) that is provided in the final regulations may be taken as a section 179 expense. Second, the commentator asked whether the increase in the limitation of amount of depreciation for certain passenger automobiles needs to be prorated in a short taxable year. Because the additional first year depreciation deduction is not prorated for a short taxable year, the increase in the limitation under section 280F(a)(1) that is provided in the final regulations also is not prorated. Third, when calculating depreciation for an asset with less than 100 percent business use, the commentator asked whether the business use percentage is applied to the increase in the limitation of amount of depreciation for certain passenger automobiles. If a taxpayer's business use of the automobile is less than 100 percent, the business use percentage is applied to the automobile's depreciation deduction, including the additional first year depreciation deduction, for the taxable year. The IRS and Treasury Department believe that these issues are outside the scope of these regulations and, accordingly, the final regulations do not address these issues.

Section 754 election

Finally, the final regulations retain the rules contained in the temporary regulations relating to any increase in basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property due to a section 754 election. Under these rules, such increase in basis generally is not eligible for the additional first year depreciation deduction. However, if qualified property, 50-percent bonus depreciation property, or Liberty Zone property is placed in service by a partnership in the taxable year the partnership terminates under section 708(b)(1)(B), any increase of basis of the qualified property, 50-percent bonus depreciation property, or

Liberty Zone property due to a section 754 election is eligible for the additional first year depreciation deduction. A commentator requested that we expand this terminating partnership rule to any increase in basis due to a section 754 election that arises before or during the placed-in-service year of the property. The IRS and Treasury Department decided not to do so. The rule for a termination of a partnership under section 708(b)(1)(B) was made to be consistent with the special rule allowing the new partnership, instead of the terminated partnership, to claim the additional first year depreciation deduction for property placed in service during the taxable year of termination and contributed by the terminated partnership to a new partnership. The IRS and Treasury Department believe that these rules should not be expanded to cover any other situations.

A commentator also suggested that we clarify the regulation to provide that any increase in basis due to a section 754 election that arises before or during the year in which the qualified property, 50-percent bonus depreciation property, or Liberty Zone property is placed in service will be taken into account for the additional first year depreciation deduction. The IRS and Treasury Department did not adopt this suggestion in the final regulations. The additional first year depreciation deduction rules provide for the accelerated recovery of a taxpayer's cost of qualified property, 50-percent bonus depreciation property, or Liberty Zone property. Many basis increases resulting from a section 754 election bear no relation whatsoever to the cost of qualified property, 50-percent bonus depreciation property, or Liberty Zone property. For example, if a partnership with a section 754 election in effect made a liquidating distribution of high-basis property to a partner with low basis in his partnership interest, the basis of the partnership's undistributed property would be increased under section 734(b) by an amount equal to the decrease in basis to the distributed property under section 732(b). The amount of the section 734(b) basis increase allocable to qualified property under section 755 would have no correlation to the taxpayer's cost of the property. The IRS and Treasury Department believe that the rules regarding any basis increase due to a section 754 election should remain limited to those provided in the temporary regulations.

Rehabilitation credit

Several commentators asked whether property that is qualified property, 50-percent bonus depreciation property, or Liberty Zone property qualifies for the rehabilitation credit under section 47. Section 47 allows a rehabilitation credit for qualified rehabilitation expenditures for certain buildings. Section 47(c)(2) defines the term *qualified rehabilitation expenditure* as meaning, in general, any amount properly chargeable to capital account for property for which depreciation is allowable under section 168 and that is nonresidential real property, residential rental property, real property that has a class life of more than 12.5 years, or an addition or improvement thereof. However, a qualified rehabilitation expenditure does not include any expenditure with respect to which the taxpayer does not use the straight line method over a recovery period determined under section 168(c) or (g). Because the additional first year depreciation deduction is not a straight line method, the IRS and Treasury Department have decided to provide in the final regulations that if qualified rehabilitation expenditures (as defined in section 47(c)(2) and §1.48–12(c)) are qualified property, 50-percent bonus depreciation property, or Liberty Zone property, the taxpayer may claim the additional first year depreciation deduction for the unadjusted depreciable basis of the qualified rehabilitation expenditures and may claim the rehabilitation credit (provided the requirements of section 47 are met) for the remaining basis of the qualified rehabilitation expenditures (unadjusted depreciable basis less the additional first year depreciation deduction allowed or allowable, whichever is greater) provided the taxpayer depreciates the remaining adjusted depreciable basis of such expenditures using the straight line method over a recovery period determined under section 168(c) or (g). The taxpayer may also claim the rehabilitation credit for the portion of the basis of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures if the taxpayer elects not to deduct the additional first year depreciation for the class of property that includes the qualified rehabilitated expenditures.

Depreciation under section 514(a)(3)

Finally, a few commentators questioned whether a tax-exempt partner in a partnership that has debt-financed property may take advantage of the additional first year depreciation deduction. In computing under section 512 the unrelated business taxable income for any taxable year, section 514 provides the rules for determining the amount of unrelated business taxable income related to debt-financed property. Under section 514(a)(3), the deductions allowable with respect to each debt-financed property is the sum of the deductions under chapter 1 of the Code that are directly connected with the debt-financed property or the income therefrom, except that if the debt-financed property is depreciable property, the allowance must be computed only by use of the straight-line method. The final regulations provide that the additional first year depreciation deduction is not allowable for purposes of section 514(a)(3).

Changes in Method of Accounting

The IRS and Treasury Department intend to issue administrative guidance providing procedures for automatic consent for taxpayers that wish to seek a change in method of accounting to comply with these final regulations.

Effective Date

In general, the final regulations apply to qualified property or Liberty Zone property acquired by a taxpayer after September 10, 2001, and for 50-percent bonus depreciation property acquired by a taxpayer after May 5, 2003. Modifications to §1.168(k)–1(b)(3)(iii)(B) and (5)(ii)(B) relating to syndication and other lease transactions that provide a special rule for multiple units of property subject to the same lease apply to property sold after June 4, 2004.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment

is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking was previously submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Douglas H. Kim, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.48–12 is amended by adding a new sentence at the end of paragraph (a)(2)(i) and adding a new sentence at the end of paragraph (c)(8)(i) to read as follows:

§1.48–12 Qualified rehabilitated building; expenditures incurred after December 31, 1981.

(a) * * *

(2) * * *

(i) * * * The last sentence of paragraph (c)(8)(i) of this section applies to qualified rehabilitation expenditures that are qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to qualified rehabilitation expenditures that are 50 percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003.

* * * * *

(c) * * *

(8) * * *

(i) * * * However, see §1.168(k)–1(f)(10) if the qualified rehabilitation expenditures are qualified property or 50-percent bonus depreciation property under section 168(k) and see §1.1400L(b)–1(f)(9) if the qualified rehabilitation expenditures are qualified New York Liberty Zone property under section 1400L(b).

* * * * *

Par. 3. Section 1.167(a)–14 is amended by revising paragraphs (b)(1), (e)(2), and (e)(3) to read as follows:

§1.167(a)–14 Treatment of certain intangible property excluded from section 197.

* * * * *

(b) * * * (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) 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) 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).

* * * * *

(e) * * *

(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 and before 2010.

§1.167(a)–14T [Removed]

Par. 4. Section 1.167(a)–14T is removed.

Par. 5. Section 1.168(d)–1 is amended by revising paragraph (d)(2) to read as follows:

§1.168(d)–1 Applicable conventions—half-year and mid-quarter convention.

* * * * *

(d) * * *

(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.

* * * * *

Par. 6. In §1.168(d)–1T, paragraphs (b)(3)(ii) and (d)(2) are amended as follows:

1. The last sentence in paragraph (b)(3)(ii) is amended by removing the language "§1.168(k)–1T(f)(1)" and adding "§1.168(k)–1(f)(1)" in its place.

2. The last sentence in paragraph (b)(3)(ii) is amended by removing the language "§1.1400L(b)–1T(f)(1)" and adding "§1.1400L(b)–1(f)(1)" in its place.

3. Paragraph (d)(2) is revised.

The revision reads as follows:

§1.168(d)–1T Applicable conventions-half-year and mid-quarter conventions (temporary).

* * * * *

(d) * * *

(2) *Qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property*. For further guidance, see §1.168(d)–1(d)(2).

* * * * *

Par. 7. Section 1.168(i)–6T is amended by adding a new sentence at the end of paragraph (d)(4) to read as follows:

§1.168(i)–6T Like-kind exchanges and involuntary conversions (temporary).

* * * * *

(d) * * *

(4) * * * 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.

* * * * *

Par. 8. Section 1.168(k)–0T is redesignated as §1.168(k)–0 and newly designated §1.168(k)–0 is amended as follows:

1. The word "temporary" is removed from the section heading.

2. The introductory text and the table of contents heading are revised.

3. The entries for §1.168(k)–1(b)(3)(ii)(A) and (B) are added.

4. The entries for §1.168(k)–1(b)(3)(iii), (iii)(B), and (iii)(C) are revised.

5. The entry for §1.168(k)–1(b)(4)(iii)(B) is revised.

6. The entries for §1.168(k)–1(b)(4)(iii)(B)(*1*) and (*2*) are added.

7. The entries for §1.168(k)–1(b)(5)(ii), (ii)(B), and (ii)(C) are revised.

8. The entry for §1.168(k)–1(b)(5)(v) is added.

9. The entries for §1.168(k)–1(e)(6), (7), (7)(i), and (7)(ii) are added.

10. The entries for §1.168(k)–1(f)(5)(iii)(C) and (D) are added.

11. The entry for §1.168(k)–1(f)(5)(v) is redesignated as §1.168(k)–1(f)(5)(vi).

12. The entries for §1.168(k)–1(f)(5)(v), (v)(A), and (v)(B) are added.

13. The entries for §1.168(k)–1(f)(10) and (11) are added.

14. The entries for §1.168(k)–1(g)(5) and (6) are added.

The additions and revisions read as follows:

§1.168(k)–0 Table of contents.

This section lists the headings that appear in §1.168(k)–1.

§1.168(k)–1 Additional first year depreciation deduction.

* * * * *

(b) * * *

(3) * * *

(ii) * * *

(A) Personal use to business or income-producing use.

(B) Inventory to business or income-producing use.

(iii) Sale-leaseback, syndication, and certain other transactions.

* * * * *

(B) Syndication transaction and certain other transactions.

(C) Sale-leaseback transaction followed by a syndication transaction and certain other transactions.

* * * * *

(4) * * *

(iii) * * *

(B) When does manufacture, construction, or production begin.

(*1*) In general.

(*2*) Safe harbor.

* * * * *

(5) * * *

(ii) Sale-leaseback, syndication, and certain other transactions. * * *

(B) Syndication transaction and certain other transactions.

(C) Sale-leaseback transaction followed by a syndication transaction and certain other transactions.

* * * * *

(v) Example.

* * * * *

(e) * * *

(6) Alternative minimum tax.

(7) Revocation.

(i) In general.

(ii) Automatic 6-month extension.

* * * * *

(f) * * *

(5) * * *

(iii) * * *

(C) Property having a longer production period.

(D) Alternative minimum tax.

* * * * *

(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.

(A) Time of replacement.

(B) Depreciation of acquired MACRS property or acquired computer software.

* * * * *

(10) Coordination with section 47.

(11) Coordination with section 514(a)(3).

(g) * * *

(5) Revisions to paragraphs (b)(3)(ii)(B) and (b)(5)(ii)(B).

(6) Rehabilitation credit.

Par. 9. Section 1.168(k)–1T is redesignated as §1.168(k)–1 and newly designated §1.168(k)–1 is amended as follows:

1. The word "temporary" is removed from the section heading.

2. Paragraph (a)(2)(iii) is revised.

3. Paragraph (a)(2)(iv) is amended by removing the language "§1.168(k)–1T(a)(2)(iii)" and adding "§1.168(k)–1(a)(2)(iii)" in its place.

4. Paragraph (b)(1) is revised.

5. Paragraph (b)(2)(i)(A) is amended by removing the language "§1.168(k)–

1T(a)(2)(ii)" and adding "§1.168(k)–1(a)(2)(ii)" in its place.

6. Paragraphs (b)(2)(ii)(A)(*2*), (b)(3)(i), and (b)(3)(ii) are revised.

7. The heading of paragraph (b)(3)(iii) is revised.

8. Paragraphs (b)(3)(iii)(B) and (C) are revised.

9. The first and second sentences of paragraph (b)(3)(iv) are revised.

10. Paragraph (b)(3)(v) is amended by revising the fourth sentence in *Example 4* and by adding new *Example 5*.

11. Paragraph (b)(4)(i)(B) is revised.

12. The last sentences of paragraphs (b)(4)(ii)(A), (B), and (D) are revised.

13. Paragraph (b)(4)(iii)(A) is amended by adding a new sentence at the end.

14. Paragraphs (b)(4)(iii)(B) and (b)(4)(iv)(A) are revised.

15. Paragraph (b)(4)(v) is amended by revising the third sentence in *Example 10*, by adding a sentence at the end of *Example 11*, and by adding *Examples 12*, *13* and *14*.

16. Paragraph (b)(5)(i) is revised.

17. The heading of paragraph (b)(5)(ii) is revised.

18. Paragraphs (b)(5)(ii)(B) and (C) are revised.

19. Paragraph (b)(5)(v) is added.

20. Paragraph (d)(1)(i) is revised.

21. Paragraph (d)(1)(ii) is amended by removing the language "§1.168(k)–1T(a)(2)(iii)" and adding "§1.168(k)–1(a)(2)(iii)" in its place.

22. Paragraphs (d)(1)(iii) and (e)(1)(ii)(B) are revised.

23. Paragraphs (e)(6) and (e)(7) are added.

24. Paragraph (f)(1)(i) is amended by adding a new sentence at the end.

25. The introductory text of paragraph (f)(2) is revised.

26. Paragraph (f)(2)(ii) and the introductory text of paragraph (f)(2)(iii) are revised.

27. Paragraph (f)(2)(iv) is amended by revising *Example 2*.

28. Paragraph (f)(5)(i) is revised.

29. Paragraphs (f)(5)(ii)(F) and (f)(5)(ii)(J)(*2*) are revised.

30. Paragraphs (f)(5)(ii)(K) and (L) are added.

31. Paragraph (f)(5)(iii)(A) is revised.

32. The last sentence of paragraph (f)(5)(iii)(B) is revised.

33. Paragraphs (f)(5)(iii)(C) and (D) are added.

34. Paragraph (f)(5)(v) is redesignated as paragraph (f)(5)(vi) and newly designated paragraph (f)(5)(vi) is amended by revising the facts in *Examples 1*, *3*, *4*, and *5*, and by adding new *Example 6*.

35. New paragraph (f)(5)(v) is added.

36. Paragraphs (f)(10) and (11) are added.

37. Paragraph (g)(1) is revised.

38. The last sentence in paragraph (g)(3)(ii) is removed.

39. Paragraphs (g)(5) and (6) are added.

The additions and revisions read as follows:

§1.168(k)–1 Additional first year depreciation deduction.

(a) * * *

(2) * * *

(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).

* * * * *

(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) * * *

(ii) * * *

(A) * * *

(*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) * * *

(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 ini-

tially 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*. * * *

(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. * * *

(v) * * *

Example 4. * * * On June 1, 2003, G sells to I, an unrelated party to G, the remaining unsold 3/8 fractional interests in the aircraft. * * *

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) * * *

(i) * * *

(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) * * *

(A) * * * 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) * * * 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.

* * * * *

(D) * * * 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.

* * * * *

(iii) * * *

(A) * * * 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 driv-

ing 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*).

* * * * *

(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).

* * * * *

(v) * * *

Example 10. * * * 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. * * *

Example 11. * * * 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 (Public Law 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*. * * *

(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.

* * * * *

(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.

* * * * *

(d) * * *

(1) * * * (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.

* * * * *

(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.

* * * * *

(e) * * *

(1) * * *

(ii) * * *

(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.

* * * * *

(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) * * *

(1) * * *

(i) * * * 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.

* * * * *

(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 (Public Law 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:

* * * * *

(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) *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 (see §601.601(d)(2)(ii)(*b*) of this chapter), for purposes of this paragraph (f)(2):

* * * * *

(iv) * * *

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).

* * * * *

(5) * * * (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 (Public Law 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) * * *

(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.

* * * * *

(J) * * *

(*2*) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179 or section 179C;

* * * * *

(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) * * * (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 (Public Law 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) * * * 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.

* * * * *

(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 (Public Law 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 (Public Law 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)–6T(b)(7)) and the excess basis (as defined in §1.168(i)–6T(b)(8)) of the acquired MACRS property and begins to depreciate the depreciable exchanged basis (as defined in §1.168(i)–6T(b)(9)) of the acquired MACRS property in accordance with §1.168(i)–6T(c). The depreciable excess basis (as defined in §1.168(i)–6T(b)(10)) of the acquired MACRS property continues to be depreciated by the taxpayer in accordance with the first sentence of this paragraph. 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)–6T(k)(2)(i), EE decided to apply §1.168(i)–6T to the involuntary conversion of Canopy V1 with the replacement of Canopy W1, the acquired MACRS property.

* * * * *

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)–6T(k)(2)(i), FF decided to apply §1.168(i)–6T to the exchange of Computer X2 for Computer Y2, the acquired MACRS property.

* * * * *

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)–6T(k)(2)(i), GG decided to apply §1.168(i)–6T to the exchange of Equipment X3 for Equipment Y3, the acquired MACRS property.

* * * * *

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)–6T(k)(2)(i), GG decided to apply §1.168(i)–6T to the exchange of Equipment Y3 for Equipment Z3, the acquired MACRS property.

* * * * *

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.

* * * * *

(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) * * *

(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.

* * * * *

(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.

Par. 10. Section 1.169–3 is amended by revising paragraphs (a), (b)(2), and (g) to read as follows:

§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.

(b) * * *

(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.

* * * * *

(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.

§ 1.169–3T [Removed]

Par. 11. Section 1.169–3T is removed.

Par. 12. Section 1.312–15 is amended by adding a new sentence at the end of paragraph (a)(1) to read as follows:

§1.312–15 Effect of depreciation on earnings and profits.

(a)* * * (1) * * * See §1.168(k)–1(f)(7) with respect to the treatment of the additional first year depreciation deduction allowable under section 168(k) for qualified property or 50-percent bonus depreciation property, and §1.1400L(b)–1(f)(7) with respect to the treatment of the additional first year depreciation deduction allowable under section 1400L(b) for qualified New York Liberty Zone property, for purposes of computing the earnings and profits of a corporation.

* * * * *

Par. 13. Section 1.1400L(b)–1T is redesignated as §1.1400L(b)–1 and newly designated §1.1400l(b)–1 is amended as follows:

1. The word "(temporary)" is removed from the section heading.

2. Paragraph (b) is amended by removing the language "§1.168(k)–1T(a)(2)" and adding "§1.168(k)–1(a)(2)" in its place.

3. Paragraph (b)(4) is revised.

4. Paragraph (c)(1) is revised.

5. Paragraph (c)(2)(i)(A) is amended by removing the language "§1.168(k)–1T(b)(2)(i)" and adding "§1.168(k)–1(b)(2)(i)" in its place.

6. Paragraph (c)(2)(ii) is revised.

7. Paragraph (c)(4) is amended by removing the language "§1.168(k)–1T(b)(3)" and adding "§1.168(k)–1(b)(3)" in its place.

8. Paragraph (c)(5)(i) is amended by removing the language "§1.168(k)–1T(b)(4)(ii)" and adding "§1.168(k)–1(b)(4)(ii) in its place, removing the language "§1.168(k)–1T(b)(4)(iii)" and adding "§1.168(k)–1(b)(4)(iii) in its place, and removing the language "§1.168(k)–1T(b)(4)(iv)" and adding "§1.168(k)–1(b)(4)(iv)" in its place.

9. Paragraph (c)(5)(ii) is amended by removing the language "§1.168(k)–1T(f)(1)(ii)" and adding "§1.168(k)–1(f)(1)(ii)" in its place, and removing the language "§1.168(k)–1T(f)(1)(iii)" and adding "§1.168(k)–1(f)(1)(iii)" in its place.

10. Paragraph (c)(6) is amended by removing the language "§1.168(k)–1T(b)(5)(ii)" and adding "§1.168(k)–1(b)(5)(ii)" in its place, removing the language "§1.168(k)–1T(b)(5)(iii)" and adding "§1.168(k)–1(b)(5)(iii)" in its place, and removing the language "§1.168(k)–1T(b)(5)(iv)" and adding "§1.168(k)–1(b)(5)(iv)" in its place.

11. Paragraph (d) is amended by removing the language "§1.168(k)–1T(d)(1)(i)" and adding "§1.168(k)–1(d)(1)(i)" in its place.

12. Paragraphs (e)(6) and (e)(7) are added.

13. Paragraph (f)(1) is amended by removing the language "§1.168(k)–1T(f)(1)" and adding "§1.168(k)–1(f)(1)" in its place.

14. Paragraph (f)(2) is amended by removing the language "§1.168(k)–

1T(a)(2)(iii)" and adding "§1.168(k)–1(a)(2)(iii)" in its place, and removing the language "§1.168(k)–1T(f)(2)" and adding "§1.168(k)–1(f)(2)" in its place.

15. Paragraph (f)(3) is amended by removing the language "§1.168(k)–1T(f)(3)" and adding "§1.168(k)–1(f)(3)" in its place.

16. Paragraph (f)(4) is amended by removing the language "§1.168(k)–1T(f)(4)" and adding "§1.168(k)–1(f)(4)" in its place.

17. Paragraph (f)(5) is amended by removing the language "§1.168(k)–1T(f)(5)(ii)(A)" and adding "§1.168(k)–1(f)(5)(ii)(A)" in its place, removing the language "§1.168(k)–1T(f)(5)(ii)(C)" and adding "§1.168(k)–1(f)(5)(ii)(C)" in its place, and removing the language "§1.168(k)–1T(f)(5)" and adding "§1.168(k)–1(f)(5)" in its place.

18. Paragraph (f)(6) is amended by removing the language "§1.168(k)–1T(f)(6)" and adding "§1.168(k)–1(f)(6)" in its place.

19. Paragraph (f)(7) is amended by removing the language "§1.168(k)–1T(f)(7)" and adding "§1.168(k)–1(f)(7)" in its place.

20. Paragraph (f)(8) is amended by removing the language "§1.168(k)–1T(f)(9)" and adding "§1.168(k)–1(f)(9)" in its place.

21. Paragraphs (f)(9) and (10) are added.

22. Paragraph (g)(1) is revised.

23. Paragraphs (g)(4)(iii), (g)(5), and (g)(6) are added.

The additions and revisions read as follows:

§1.1400L(b)–1 Additional first year depreciation deduction for qualified New York Liberty Zone property.

* * * * *

(b) * * *

(4) *Real property* is a building or its structural components, or other tangible real property.

(c) *Qualified New York Liberty Zone property*—(1) *In general.* Qualified New York Liberty Zone property is depreciable property that meets all the following requirements in the first taxable year in which the property is subject to depreciation by the taxpayer whether or not depreciation deductions for the property are allowable—

(i) The requirements in §1.1400L(b)–1(c)(2) (description of property);

(ii) The requirements in §1.1400L(b)–1(c)(3) (substantial use);

(iii) The requirements in §1.1400L(b)–1(c)(4) (original use);

(iv) The requirements in §1.1400L(b)–1(c)(5) (acquisition of property by purchase); and

(v) The requirements in §1.1400L(b)–1(c)(6) (placed-in-service date).

(2) * * *

(ii) *Property not eligible for additional first year depreciation deduction.* Depreciable property will not meet the requirements of this paragraph (c)(2) if—

(A) Section 168(k) or §1.168(k)–1 applies to the property;

(B) The property is described in section 168(f);

(C) The property is required to be depreciated under the alternative depreciation system of section 168(g) pursuant to section 168(g)(1)(A) through (D) or other provisions of the Internal Revenue Code (for example, property described in section 263A(e)(2)(A) if the taxpayer (or any related person) has made an election under section 263A(d)(3), or property described in section 280F(b)(1));

(D) The property is included in any class of property for which the taxpayer elects not to deduct the additional first year depreciation under paragraph (e) of this section; or

(E) The property is qualified New York Liberty Zone leasehold improvement property as described in section 1400L(c)(2).

* * * * *

(e) * * *

(6) *Alternative minimum tax.* If a taxpayer makes an election under this paragraph (e) for a class of property, the depreciation adjustments under section 56 and the regulations under section 56 apply to the property to which the election applies for purposes of computing the taxpayer's alternative minimum taxable income.

(7) *Revocation of election*—(i) *In general.* Except as provided in paragraph (e)(7)(ii) of this section, an election under this paragraph (e), once made, may be revoked only with the written consent of the Commissioner of Internal Revenue. To seek the Commissioner's consent, the taxpayer must submit a request for a letter ruling.

(ii) *Automatic 6-month extension.* If a taxpayer made an election under this paragraph (e) for a class of property, an automatic extension of 6 months from the due date of the taxpayer's Federal tax return (excluding extensions) for the placed-in-service year of the class of property is granted to revoke that election, provided the taxpayer timely filed the taxpayer's Federal tax return for the placed-in-service year of the class of property and, within this 6-month extension period, the taxpayer (and all taxpayers whose tax liability would be affected by the election) files an amended Federal tax return for the placed-in-service year of the class of property in a manner that is consistent with the revocation of the election.

* * * * *

(f) * * *

(9) *Coordination with section 47.* Rules similar to those provided in §1.168(k)–1(f)(10) apply for purposes of this paragraph (f)(9).

(10) *Coordination with section 514(a)(3).* Rules similar to those provided in §1.168(k)–1(f)(11) apply for purposes of this paragraph (f)(10).

(g) * * *

(1) *In general.* Except as provided in paragraphs (g)(2), (3), and (5) of this section, this section applies to qualified New York Liberty Zone property acquired by a taxpayer after September 10, 2001.

* * * * *

(4) * * *

(iii) *Revisions made in paragraphs (b)(4) and (c)(2)(ii) of this section.* If a taxpayer did not claim on a Federal tax return for a taxable year ending on or after September 11, 2001, and on or before September 1, 2006, any additional first year depreciation deduction for qualified New York Liberty Zone property because of the application of §1.1400L(b)–1T(b)(4) or because the taxpayer made an election under §1.168(k)–1T(e)(1) for a class of property that included such qualified New York Liberty Zone property, the taxpayer may claim the additional first year depreciation deduction for such qualified New York Liberty Zone property under this section in accordance with the applicable

administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent to a change in method of accounting. Section 481(a) applies to a request to claim the additional first year depreciation deduction for such qualified New York Liberty Zone property under this paragraph (g)(4)(iii).

(5) *Revision to paragraphs (b)(4) and (b)(6)*. The addition of "(or, in the case of multiple units of property subject to the same lease, within three months after the date the final unit is placed in service, so long as the period between the time the first unit is placed in service and the time the last unit is placed in service does not exceed 12 months)" to §1.168(k)–1(b)(3)(iii)(B) and §1.168(k)–1(b)(5)(ii)(B) applies to property sold after June 4, 2004, for purposes of paragraphs (b)(4) and (b)(6) of this section.

(6) *Rehabilitation credit*. If a taxpayer did not claim on a Federal tax return for a taxable year ending on or before September 1, 2006, the rehabilitation credit provided by section 47(a) with respect to the portion of the basis of a qualified rehabilitated building that is attributable to qualified rehabilitation expenditures and the qualified rehabilitation expenditures are qualified New York Liberty Zone property, and the taxpayer did not make the election specified in paragraph (e)(1) of this section for the class of property that includes the qualified rehabilitation expenditures, the taxpayer may claim the rehabilitation credit for the remaining rehabilitated basis (as defined in §1.168(k)–1(f)(10)(i)(B)) of the qualified rehabilitated building that is attributable to the qualified rehabilitation expenditures (assuming all the requirements of section 47 are met) in accordance with paragraph (f)(9) of this section by filing an amended Federal tax return for the taxable year for which the rehabilitation credit is to be claimed. The amended Federal tax return must include the adjustment to the tax liability for the rehabilitation credit and any collateral adjustments to taxable income or to the tax liability (for example, the amount of depreciation allowed or allowable in that taxable year for the qualified rehabilitated building). Such adjustments must also be made on amended Federal tax returns for any affected succeeding taxable years.

Steven T. Miller,
Acting Deputy Commissioner for Services and Enforcement.

Approved August 25, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on August 28, 2006, 4:28 p.m., and published in the issue of the Federal Register for August 31, 2006, 71 F.R. 51727)

Section 280G.—Golden Parachute Payments

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 382.—Limitation on Net Operating Loss Carryforwards and Certain Built-In Losses Following Ownership Change

The adjusted applicable federal long-term rate is set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 412.—Minimum Funding Standards

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 448.—Limitation on Use of Cash Method of Accounting

26 CFR 1.448–2: Nonaccrual of certain amounts by service providers.

T.D. 9285

DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Parts 1 and 602

Nonaccrual-Experience Method of Accounting Under Section 448(d)(5)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the use of a nonaccrual-experience method of accounting by taxpayers using an accrual method of accounting and performing services. The final regulations reflect amendments under the Job Creation and Worker Assistance Act of 2002. The final regulations affect qualifying taxpayers that want to adopt, change to, or change a nonaccrual-experience method of accounting under section 448(d)(5) of the Internal Revenue Code (Code).

DATES: *Effective Date:* These regulations are effective September 6, 2006.

Applicability Date: These regulations are applicable for taxable years ending on or after August 31, 2006.

Comment Date: Written comments must be received by January 4, 2007. These regulations require that a taxpayer's nonaccrual-experience method must be self-tested against the taxpayer's actual experience to determine whether the nonaccrual-experience method clearly reflects the taxpayer's experience. The determination of actual experience is reserved in these regulations. Comments are requested concerning how to determine actual experience for purposes of timely performing self-testing. Send submissions to: CC:PA:LPD:PR (REG–141402–02), Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Taxpayers also may submit comments electronically to the IRS internet site at *www.irs.gov/regs*.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, W. Thomas McElroy, Jr., (202) 622–4970; concerning submission of comments, Kelly Banks, (202) 622–0392 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1855.

The collection of information in these final regulations is in §1.448–2(d)(8) and (e)(5). This information is required to enable the IRS to verify that a taxpayer is reporting the correct amount of income or gain or claiming the correct amount of losses, deductions, or credits from the taxpayer's use of the nonaccrual-experience method of accounting. The collection of information is required to obtain a benefit.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The estimated annual burden per respondent is 3 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books and records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 448(d)(5). Section 448(d)(5) was enacted by section 801 of the Tax Reform Act of 1986 (Public Law 99–514, 100 Stat. 2085) and was amended by section 403 of the Job Creation and Worker Assistance Act of 2002 (Public Law 107–147, 116 Stat. 21) (JCWA), effective for taxable years ending after March 9, 2002. On September 4, 2003, the IRS and Treasury Department published in the **Federal Register** (68 FR 52543) proposed amendments to the regulations under section 448(d) by cross-reference to temporary regulations (REG–141402–02, 2003–2 C.B. 932) and temporary regulations (68 FR 52496) (T.D. 9090, 2003–2 C.B. 891) (collectively, the 2003 regulations) relating to the limitation on the use of the nonaccrual-experience method of accounting under section 448(d)(5). A public hearing was held on December 10, 2003. Written and electronic comments responding to the proposed regulations were received. After consideration of all of the comments, the proposed regulations are adopted as revised by this Treasury decision, and the corresponding temporary regulations are removed. The revisions are discussed below.

Explanation of Provisions and Revisions and Summary of Comments

1. *Overview*

These final regulations generally follow the rules in the 2003 regulations. The final regulations include the four safe harbor nonaccrual-experience methods provided in the 2003 regulations, but those methods have been modified to provide more flexibility. Unlike the 2003 regulations, the final regulations do not require as a general rule that a taxpayer's nonaccrual-experience method be tested against one of the safe harbor nonaccrual-experience methods. Instead, the final regulations adopt, with modifications, the general rule from the 2003 regulations as a fifth safe harbor. The final regulations also adopt a new general rule that requires a taxpayer's nonaccrual-experience method be tested against actual experience unless the taxpayer has adopted one of the five safe harbor methods. These final regulations apply to taxable years ending on or after August 31, 2006.

Certain portions of the 2003 regulations have been removed or incorporated into other paragraphs of the final regulations. Section 1.448–2T(d) regarding certain receivables for which the nonaccrual-experience method is not allowed has been combined with §1.448–2(c) in the final regulations. Special rules in various parts of the 2003 regulations such as §1.448–2T(e)(2)(ii) and (iii), 1.448–2T(e)(3)(iii), 1.448–2T(e)(4)(ii) and (iii), and 1.448–2T(e)(5)(ii) and (iii), have been combined with the special rules in §1.448–2T(e)(7) and are now in §1.448–2(b), (c), and (d) of the final regulations. Most of §1.448–2T(g), (h), and (j) of the 2003 regulations relating to methods of accounting and audit protection have been removed. The IRS and Treasury Department intend to issue administrative guidance that will contain procedures for certain changes in a nonaccrual-experience method of accounting. The general rule that a nonaccrual-experience method is a method of accounting to which sections 446 and 481 apply has been moved to §1.448–2(b).

Other portions of the 2003 regulations have been moved to a new definitions and special rules paragraph in §1.448–2(c) of the final regulations. Section 1.448–2T(d) regarding accounts receivable is included in a definition of accounts receivable in §1.448–2(c)(1) of the final regulations. Other terms in the definitions paragraph include applicable period, bad debts, charge-offs, determination date, recoveries, and uncollectible amount. The final regulations incorporate these definitions, as appropriate, throughout. For example, in the 2003 regulations the four safe harbor methods include bad debts in the numerator; however, safe harbor 2 did not refer to bad debts, but instead described them as "accounts receivable actually determined to be uncollectible and charged off...." These descriptions should not be interpreted differently. Therefore, the final regulations use the defined term *bad debts* in each numerator. Finally, the examples are changed to conform to other changes within the final regulations.

2. *Self-Testing Requirement*

The 2003 regulations provide that a taxpayer may use any nonaccrual-experience method of accounting, provided the taxpayer's method meets the self-test requirements. The self-testing in the 2003 regulations requires a taxpayer to compare its proposed nonaccrual-experience method with one of the four safe harbor methods to determine whether the taxpayer's proposed method clearly reflects experience. Self-testing is required in the first taxable year to determine whether the proposed method is allowed (first-year self-testing requirement) and, if allowed, self-testing is required every three taxable years thereafter (three-year self-testing requirement). The final regulations provide, as a general rule, that a taxpayer may use any nonaccrual-experience method of accounting that clearly reflects the taxpayer's experience. The final regulations provide that taxpayers must self-test

against the taxpayer's actual experience to determine whether a method clearly reflects the taxpayer's experience unless the taxpayer has adopted one of the five safe harbor methods. The final regulations reserve on the definition of actual experience.

a. *Appropriateness of self-testing requirement*

Many commentators suggested that taxpayers should not be required to incur additional expenses to develop a separate system for performing the self-test, noting that it would be burdensome and impractical for the majority of taxpayers using an alternative nonaccrual-experience method to conduct the self-test due to the limitations of their existing automated record keeping systems. One commentator suggested that the self-test was outside the scope of the JCWA and legislative intent. These commentators all recommended that the final regulations omit the self-testing requirement.

The JCWA provides that "[a] taxpayer may adopt, or ... change to, a computation or formula that clearly reflects the taxpayer's experience," and that "[a] request [to change] shall be approved if such computation or formula clearly reflects the taxpayer's experience." Public Law 107–147, section 403(a). Taxpayers and the IRS must be able to determine whether a nonaccrual-experience method clearly reflects the taxpayer's experience. The Secretary has broad authority to determine whether a method of accounting clearly reflects the taxpayer's income. A self-testing requirement is consistent with the statute, because it is the manner by which taxpayers and the IRS determine whether a nonaccrual-experience method clearly reflects the taxpayer's experience, and thus, clearly reflects the taxpayer's income. Taxpayers must be able to show that a nonaccrual-experience method clearly reflects experience prior to adopting or changing to the method. The requirement to self-test provides an objective standard for making the determination. Therefore, the final regulations do not adopt the recommendation to omit a self-testing requirement and retain the rule that a taxpayer must maintain books and records sufficient to prove that the taxpayer's nonaccrual-experience method clearly reflects its experience for the taxable year of the exclusion.

b. *Standard for comparison*

Commentators stated that the self-testing requirements do not allow taxpayers the opportunity to demonstrate that a proposed method clearly reflects their experience, because under the 2003 regulations all methods must be compared to one of the safe harbors. The commentators stated that none of the safe harbors reflect actual experience, because all of the safe harbors are moving averages rather than a comparison of the estimated uncollectible amount for a taxable year under the taxpayer's nonaccrual-experience method to the actual collection experience of that taxable year's accounts receivable. Thus, the commentators stated, the safe harbors may or may not reflect actual experience as well as the proposed method.

The final regulations modify the self-testing requirements in response to these comments and eliminate the requirement in the 2003 regulations that a taxpayer's nonaccrual-experience method must be tested against one of the four safe harbor methods. The final regulations require that the taxpayer's nonaccrual-experience method must be tested against the taxpayer's actual experience, unless the taxpayer is using one of the safe harbor nonaccrual-experience methods, which are deemed to clearly reflect experience.

For taxpayers and the IRS to implement and administer the nonaccrual-experience method, the determination of actual experience is necessary. Although commentators stated that taxpayers should be allowed to use hindsight and that actual experience would require the use of data reflecting the portion of the subject accounts receivable that remain uncollectible, the commentators did not elaborate regarding what "remain uncollectible" means, nor did the commentators set the date at which accounts receivable "remain uncollectible." The determination and proof of actual experience generally is a simple matter for taxpayers whose collection process with respect to the subject receivables is complete by the time the Federal income tax return is filed. The collection cycle for some taxpayers, however, may routinely span several taxable years. The commentators did not elaborate how such a factual determination could be made prior to filing the Federal income tax return for the applicable taxable year (or alternatively, prior to filing the method change request for the applicable taxable year) in cases in which a taxpayer's collection cycle for the receivables goes beyond the date for the filing of the return (or method change). For taxpayers with a longer collection process, the determination of the final actual experience is not possible by the time the Federal income tax return is filed, and may continue to be incomplete upon examination by the IRS, if the taxpayer's collection process with respect to receivables is still in process. Additionally, it is possible that accounts receivable written off in one taxable year may be recovered several taxable years later, even for taxpayers whose average collection cycle is short. Therefore, the final regulations reserve the determination of actual experience.

The IRS and Treasury Department anticipate providing future guidance that may change or restrict the rules for self-testing and may address the determination of actual experience. In the meantime, taxpayers may request advance consent to use a method other than a safe harbor method, but in the request taxpayers must establish to the satisfaction of the Commissioner how the determination of actual experience is made. Comments are requested concerning how to determine actual experience. Specifically, the IRS and Treasury Department seek comments on how the use of hindsight data can be made administrable. For example, how will the IRS National Office have the necessary data furnished with the application for change in method of accounting, and how will the taxpayer be able to timely perform the self-testing? In particular, should one, fixed determination date be used as a cut-off for all information included in the determination of actual experience? What facts and circumstances, known by the filing deadline for a change in method of accounting and the filing deadline for an original Federal income tax return, can a taxpayer and the IRS rely on to determine the taxpayer's actual experience for purposes of the first-year self-testing requirements for the application for change in method of accounting and for purposes of the three-year self-testing requirements for the filing of the Federal income tax

return? For a taxpayer that is applying to adopt or change to a nonaccrual-experience method of accounting, should the taxpayer be allowed to rely on the results under the proposed method for the current taxable year compared to actual experience for old taxable years rather than a comparison of the results under the proposed method for the current taxable year compared to actual experience for the current taxable year at the time of filing, provided the taxpayer can demonstrate that there is not a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss is substantially decreased? What standards should apply to a taxpayer who has had a change in the type of a substantial portion of the outstanding accounts receivable? If a taxpayer's business has changed in a manner that impacts a substantial portion of its outstanding accounts receivable, the taxpayer's historical data for its receivables could lose much of their relevance in determining the taxpayer's current nonaccrual experience.

c. *Safe harbor comparison method*

The final regulations retain a modified version of the self-test from the 2003 regulations, which required the comparison of a taxpayer's method against one of the safe harbors. The safe harbor comparison method in the final regulations is used in conjunction with the fifth safe harbor nonaccrual-experience method, which allows a taxpayer to use any nonaccrual-experience method provided the method meets the safe harbor comparison method of self-testing. The safe harbor comparison method provided in the final regulations allows a taxpayer to compare the taxpayer's method against any of the safe harbors 1 through 4 during any self-testing period, rather than requiring the safe harbor chosen for comparison to be treated as a method of accounting. Because any of the safe harbors 1 through 4 are deemed to clearly reflect experience, a taxpayer should be able to compare its method against any of the safe harbors 1 through 4 to determine whether its method clearly reflects experience. The IRS and Treasury Department anticipate that the procedures for changes in method of accounting to use the new safe harbor nonaccrual-experience method will be provided in administrative guidance, and that these changes will be made with automatic consent.

d. *Methods that do not clearly reflect experience*

The 2003 regulations provide, as part of the three-year self-test requirement, that if the taxpayer's cumulative alternative nonaccrual-experience amount excluded from income during the test period exceeds the taxpayer's cumulative safe harbor nonaccrual-experience amount, the taxpayer must recapture the excess into income in the third taxable year of the three-year self-test. The IRS and Treasury Department intended this recapture provision to allow minor variances or fluctuations produced by the taxpayer's nonaccrual-experience method without prohibiting continued use of the method. However, when the taxpayer's nonaccrual-experience method produces results that are more than minor variations or fluctuations from the three-year self-test amounts, the method does not clearly reflect the taxpayer's experience. The recapture provision addresses situations in which the taxpayer's nonaccrual-experience method generally clearly reflects experience, but the taxpayer has an anomalous taxable year in which the method does not clearly reflect experience. However, methods may consistently provide large distortions from the taxpayer's actual experience in future taxable years despite meeting the requirements of the first-year self-test. Consequently, the final regulations include a limit in the three-year self-testing provisions that, if exceeded, deems the taxpayer's nonaccrual-experience method to not clearly reflect the taxpayer's experience. Because the taxpayer must recapture the difference between the uncollectible amount under the taxpayer's nonaccrual-experience method and the taxpayer's actual experience, a change from the taxpayer's nonaccrual-experience method to a permissible method in the subsequent taxable year does not require a section 481(a) adjustment and is made on a cut-off basis.

Additionally, to provide transparency, the IRS and Treasury Department intend to provide in future guidance descriptions of methods and characteristics of methods combined with specific taxpayer circumstances that do not clearly reflect experience.

e. *Other*

Commentators suggested that the self-test was not administrable in the context of consolidated groups. The IRS and Treasury Department believe that the final regulations do not impose more burden than any other method of accounting in the context of a consolidated group. Generally, methods of accounting, including the nonaccrual-experience method with its self-testing requirement, are adopted and applied separately by each entity within the consolidated group (or to separate trades or businesses within an entity), not at the consolidated group level.

3. *Safe Harbor Methods*

The 2003 regulations have four safe harbors: safe harbor 1 (the six-year moving average method), safe harbor 2 (the actual experience method), safe harbor 3 (the modified Black Motor method), and safe harbor 4 (the modified moving average method). Comments were received regarding safe harbors 1, 2, and 4. No comments were received regarding safe harbor 3.

a. *General issues*

Commentators questioned the need to impose different time periods for different safe harbor methods. For example, in the 2003 regulations, safe harbors 1, 3 and 4 are based on a six-year period (the current taxable year and the five immediately preceding taxable years), whereas safe harbor 2 is based on a three year period (the current taxable year and the two immediately preceding taxable years). These commentators recommended that, for consistency, the safe harbor methods should permit taxpayers to compute the uncollectible amounts using a period consisting of the current taxable year and no fewer than the two immediately preceding taxable years and no more than the five immediately preceding taxable years.

Providing options among the safe harbors, including those with different time periods, is consistent with legislative intent to provide taxpayers "with alternative computations or formulas that taxpayers may rely upon." Different taxpayers

may choose different methods with different time periods based on their individual circumstances and experience. The final regulations allow taxpayers flexibility to choose a period of at least three taxable years, but not more than six taxable years (applicable period), for purposes of the computations in each of the safe harbors. The taxable years included in the applicable period must be the most recent (which may or may not include the current taxable year, as applicable) and must be consecutive.

Additionally, commentators stated that including the current taxable year in computations can cause difficulties when preparing computations for estimated taxes. Therefore, the final regulations allow taxpayers flexibility with regard to whether the current taxable year is included in the applicable period. The choice of which taxable years and how many are included in the applicable period is part of the taxpayer's method of accounting under a safe harbor, and can be changed only with the consent of the Commissioner. Taxpayers making such a change may not have all the historical data necessary to compute a section 481(a) adjustment. Therefore, the final regulations provide that the change is done on a cut-off basis rather than with a section 481(a) adjustment.

Finally, some commentators reiterated their earlier suggestion that the Black Motor formula should be permitted as an additional safe harbor method. The IRS and Treasury Department continue to conclude that the Black Motor formula should not be provided as an additional safe harbor method because the formula overstates the uncollectible amount in many circumstances. The final regulations add a fifth safe harbor, which, as discussed above, allows taxpayers to use any alternative nonaccrual-experience method provided the method meets the requirements of the safe harbor comparison method under the self-testing requirements. The IRS and Treasury Department may provide additional safe harbors through future published guidance. In addition, if a taxpayer does not wish to rely on one of the safe harbors, the final regulations provide that a taxpayer may use any other alternative nonaccrual-experience method provided the method clearly reflects its experience and the taxpayer requests and receives consent from the Commissioner to use such method.

Commentators requested that the regulations specifically include a statement that unintentional or immaterial variances will not cause a taxpayer to be changed to the specific charge-off method. As discussed in the preamble to the 2003 regulations, the IRS and Treasury Department do not contemplate that a taxpayer be changed to the specific charge-off method due to unintentional or immaterial variances, especially if a taxpayer is disadvantaged by the variances. Such a rule is unnecessary, particularly with the flexibility added to each of the safe harbors.

b. *Safe harbor 1 — revenue-based moving average method*

Safe harbor 1 in the 2003 regulations was referred to as the six-year moving average method. It is renamed the revenue-based moving average method in the final regulations to reflect the flexibility to choose between three to six taxable years for the applicable period. The final regulations provide that the revenue-based moving average percentage of safe harbor 1 (the ratio of net write-offs for the applicable period over accounts receivable earned over the same applicable period) is multiplied by a taxpayer's accounts receivable balance at the end of the taxable year to determine the taxpayer's nonaccrual-experience amount.

A commentator suggested that a safe harbor method should be added that would modify safe harbor 1 to multiply the revenue-based moving average percentage by a taxpayer's total billings (accounts receivable earned during the taxable year in lieu of its accounts receivable balance at the end of the taxable year). The commentator suggested that this new safe harbor would provide symmetry between the denominator of the revenue-based moving average percentage and the amount against which the revenue-based moving average percentage is multiplied.

The final regulations do not adopt this recommendation. The IRS and Treasury Department previously analyzed the effects of multiplying the revenue-based moving average percentage by the total billings during the taxable year and determined that this computation overstates that portion of the taxpayer's year-end accounts receivable balance that will not be collected. The existing formula is the method provided in former §1.448–2T(e)(2), as contained in T.D. 8194, 53 FR 12513 (1988). Although the denominator and multiplicand are not symmetrical, the method accurately reflects the year-end receivables that will not be collected for taxpayers with a short collection cycle.

c. *Safe harbor 2 — actual experience method*

Under safe harbor 2 of the 2003 regulations, the taxpayer's adjusted nonaccrual-experience amount is determined by tracking the receivables in the taxpayer's accounts receivable balance at the beginning of the current taxable year to determine the dollar amount of the accounts receivable actually determined to be uncollectible and charged off and not recovered or determined to be collectible by the determination date. The determination date is the date selected by the taxpayer for the taxable year for purposes of safe harbor 2, and may not be later than the earlier of the due date, including extensions, for filing the taxpayer's Federal income tax return for that taxable year or the date on which the taxpayer timely files the return for that taxable year. Under Option A of safe harbor 2, the computation is repeated for the taxpayer's accounts receivable balance at the beginning of each of the two immediately preceding taxable years. Under Option B of safe harbor 2, taxpayers that do not have the information necessary to compute a three-year moving average in the first taxable year the method is used are allowed to transition into the method year-by-year. The total of the amounts determined to be uncollectible is divided by the total beginning accounts receivable balance for those taxable years used in the computation to determine the taxpayer's three-year (Option A), or up to three-year (Option B), moving average percentage. This percentage is then multiplied by the taxpayer's current year-end accounts receivable balance to arrive at the taxpayer's actual nonaccrual-experience amount. The taxpayer's actual nonaccrual-experience amount is then multiplied by 1.05 to determine the taxpayer's adjusted nonaccrual-experience amount.

As discussed above, the final regulations allow flexibility in the applicable period used in safe harbor 2. Additionally, because the final regulations provide definitions of terms used throughout the regulations for consistency, the terms used to describe the safe harbor 2 formula were changed to conform to the definitions in the final regulations. Although the description of the method may look as though it has changed substantially, the safe harbor 2 method is not intended to operate differently than the 2003 regulations, other than the flexibility in the applicable period and, as discussed below, the flexibility in the determination dates and in tracing recoveries.

Some commentators requested clarification as to whether safe harbor 2 is based on a computation that takes into account all known information arising both before and after the determination date. The commentators suggested that the 2003 regulations may be interpreted as taking into account only all known information arising on or before determination dates for previous taxable years involved in the computation.

The computation in safe harbor 2, Option A, in the final regulations, contemplates consideration of all known information arising on or before the determination date for the current taxable year, including beginning accounts receivable balances, charge-offs and recoveries, with respect to all taxable years included in the computation. For example, if an account receivable of a calendar year taxpayer exists on January 1, 2006, and is charged off as a bad debt on December 15, 2007, the bad debt should be included in the computation in the taxable year it is charged off and every subsequent taxable year for as long as the 2006 beginning of the year accounts receivable balance is part of the computation under this method. Consequently, the final regulations clarify that all known information arising on or before the determination date for the current taxable year, with respect to the taxable years included in the computation, should be considered.

In the 2003 regulations, Option B allows a taxpayer to transition into the actual experience safe harbor method. The final regulations allow a new taxpayer with no beginning accounts receivable to transition under either Option A or Option B (see §1.448–2(d)(4) of the final regulations). Option B in the final regulations differs from Option A in that it allows a taxpayer to use multiple determination dates (one for each taxable year of the applicable period) instead of one determination date. Therefore, under Option B in the final regulations, a taxpayer has a choice of the applicable period, three to six taxable years, and the taxpayer uses separate determination dates for each taxable year in the applicable period. That is, a taxpayer must use bad debts sustained by the separate determination date of each taxable year during the applicable period rather than bad debts sustained by the determination date of the current taxable year. The determination date used for each taxable year must be the determination date originally used for each taxable year at the time the uncollectible amount for that taxable year was computed. For example, if an account receivable of a calendar year taxpayer exists on January 1, 2006, and is charged off as a bad debt on December 15, 2007, and the determination date for the 2006 taxable year is September 1, 2007, the bad debt would never be included in the computation because it is charged off after the 2006 taxable year determination date. This method was requested by commentators to reduce the burden of having to update the total bad debts for a particular taxable year with every future computation that included that taxable year.

Other commentators requested clarification as to whether the determination date used in safe harbor 2 may shift from year to year. These commentators recommended that the final regulations confirm that a taxpayer may use a different determination date each taxable year, and that a change of determination date is not a change in method of accounting. Safe harbor 2 contemplates that a taxpayer may file its Federal income tax return at different times from year to year, and that the choice of a determination date used in the computation is not a method of accounting. However, once a determination date is selected and used for a particular taxable year, it may not be changed for that taxable year. Therefore, the final regulations clarify that the determination date may be different from year to year, and that a change in the determination date is not a change in method of accounting.

Under Option B of safe harbor 2, the 2003 regulations provide that a newly formed taxpayer that chooses Option B and does not have any accounts receivable upon formation will not be able to exclude any portion of its year-end accounts receivable from income for its first taxable year because the taxpayer does not have any accounts receivable on the first day of the taxable year that can be tracked. Some commentators recommended that the final regulations either permit newly formed taxpayers using Option B to exclude a portion of their year-end accounts receivable balance, or in the alternative, clarify the rules for adopting this safe harbor in the taxpayer's first taxable year in order to eliminate the administrative burden of filing Form 3115, "*Application for Change in Accounting Method*," in the succeeding taxable year. The final regulations retain this special rule in §1.448–(d)(4) for both safe harbor 2 and safe harbor 4, because the methods require a beginning accounts receivable balance to compute the uncollectible amount. Use of another method in the first taxable year may not clearly reflect experience. The final regulations clarify that the taxpayer must begin creating its moving average in its second taxable year by tracking the accounts receivable as of the first day of its second taxable year. The use of one of the safe harbor nonaccrual-experience methods of accounting described in paragraph (f)(2), (f)(4), or (f)(5), if applicable, of the final regulations in a taxpayer's second taxable year in this situation is not a change in method of accounting. Although the taxpayer must maintain the books and records necessary to perform the computations under the adopted safe harbor nonaccrual-experience method, the taxpayer is not required to affirmatively elect the method on its Federal income tax return for its first taxable year.

Commentators requested that safe harbor 2 be modified to permit taxpayers to use any reasonable method to determine recoveries. In response to commentators' concerns about whether taxpayers could use assumptions regarding recoveries rather than specifically trace, the preamble to the 2003 regulations stated that the IRS and Treasury Department do not intend that a taxpayer be changed to the specific charge off method due to unintentional and/or immaterial variances, especially

if the taxpayer is disadvantaged by such variances. Some commentators believe that despite the preamble, the 2003 regulations may require taxpayers to specifically trace 100% of recoveries. The IRS and Treasury Department did not intend to prevent taxpayers from using a method that allocates 100% of recoveries to current taxable year bad debts. Commentators also have stated that although some recoveries may be traceable, some recoveries may not be traceable due to lump sum recoveries from third parties.

The final regulations provide that a taxpayer specifically should trace recoveries if the taxpayer is able to do so without undue burden. However, the IRS and Treasury Department believe if the taxpayer is unable specifically to trace all recoveries without undue burden, the taxpayer should be able to use any reasonable method in determining the amount of recoveries to be traced to each taxable year's bad debts. Therefore, the final regulations allow taxpayers to use a reasonable allocation method. A method will be considered reasonable if there is a cause and effect relationship between the allocation base or ratio and the recoveries. The final regulations also provide that a taxpayer may trace only recoveries that are traceable and allocate the remaining, untraceable, recoveries to charge-offs of amounts in the relevant beginning accounts receivable balances. Methods that include, for example, receivables for which the nonaccrual-experience method is not allowed to be used (see §1.448–2(c)(1)(ii)) generally will not be considered reasonable.

d. *Safe harbor 3 — modified Black Motor method*

Safe harbor 3 is a variation of the formula addressed in *Black Motor Co. v. Commissioner*, 41 B.T.A. 300 (1940), *aff'd*, 125 F.2d 977 (6th Cir. 1942). No comments were received regarding safe harbor 3. The final regulations adopt the method in the 2003 regulations, with minor revisions made to the terms used in the formulas to conform the terms used throughout the regulations.

e. *Safe harbor 4 — modified moving average method*

The 2003 regulations provide that, for purposes of safe harbor 4, a taxpayer may determine the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by the ratio of total bad debts charged off for the current taxable year and the five preceding taxable years other than the credit charges (accounts receivable) that were charged off in the same taxable year they were generated, adjusted for recoveries of charge-offs during that period, to the sum of accounts receivable at the end of the current taxable year and the five preceding taxable years.

Some commentators argued that, by eliminating credit charges that were written off in the same taxable year they were generated, the effect of this computation for a taxpayer's first taxable year is to eliminate the intended benefit of section 448(d)(5). These commentators recommended that the final regulations permit newly formed taxpayers using safe harbor 4 to exclude a portion of their year-end accounts receivable balance, or in the alternative, clarify the rules on adopting this safe harbor method in the taxpayer's first taxable year in order to eliminate the administrative burden of filing Form 3115 in the succeeding taxable year.

This safe harbor method, like safe harbor 3, is a variation of the formula addressed in *Black Motor Co. v. Commissioner*. Safe harbor 4, by eliminating credit charges that were written off in the same taxable year they were generated, and thereby reducing the amount computed under the traditional Black Motor formula, remedies known shortcomings generally associated with the Black Motor formula, and as such, more accurately reflects a taxpayer's nonaccrual-experience. Therefore, the final regulations retain this rule.

Another commentator pointed out that there is a mismatching in the comparison of write-offs to accounts receivable in the formula used in safe harbor 4 because it compares the total accounts written off in a taxable year after the year of sale to the ending balances in accounts receivable for the six-year period. For example, the sum of the write-offs in each taxable year for the preceding taxable years' charges for services in year 7 is for services rendered in years 1 through 6, but the ending balances in accounts receivable are from years 2 through 7. This commentator opined that, if charges for services and accounts receivable are increasing, the ratio of write-offs from prior balances relative to current receivables would be understated and therefore the uncollectible amount would be understated. The commentator suggested that the sum of the write-offs in each taxable year for the preceding taxable years' charges for services should be divided by the sum of the beginning accounts receivable for the current and five preceding taxable years. The final regulations adopt this recommendation and, for purposes of safe harbor 4, the denominator is changed to reflect the beginning of the taxable year accounts receivable balances in lieu of accounts receivable balances at the end of the taxable year.

4. *Special Rules*

a. *Acquisitions and dispositions*

A commentator recommended that the final regulations clarify that newly formed or acquired taxpayers in a section 351(a) or 721(a) nontaxable transaction are allowed to use predecessor data to compute their uncollectible amount under the nonaccrual-experience method. The final regulations adopt this comment and provide special rules for acquisitions and dispositions. Taxpayers that acquire a major portion of a trade or business or a unit of a trade or business (for example, a hospital) should include the data from the predecessor in the computations to avoid potentially skewing the computations for the remainder of the applicable period. Additionally, taxpayers that dispose of a major portion of a trade or business or a unit of a trade or business should not use the data related to the disposed trade or business in the computations. For purposes of the nonaccrual-experience methods of accounting, a new, qualified taxpayer that acquires property in any transaction to which section 381(a) does not apply must adopt a nonaccrual-experience method on the basis of its own experience. However, to the extent predecessor information is available, the data must be used in the newly-adopted nonaccrual-experience method.

b. *Reportable transactions*

Some commentators recommended that the book-tax difference that may

result from the use of the nonaccrual-experience method not be taken into account in determining whether a transaction is a reportable transaction for purposes of the disclosure rules under §1.6011–4(b)(6). As a result of Notice 2006–6, 2006–5 I.R.B. 385, book-tax differences no longer create reportable transactions under §1.6011–4(b)(6). Therefore, it is not necessary to adopt this recommendation.

c. *Short taxable years*

As discussed, the 2003 regulations generally provide procedures for taxpayers that have fewer than the requisite number of taxable years to adopt or change to a safe harbor nonaccrual-experience method. Some commentators requested rules on how taxpayers may compute their nonaccrual-experience amount in the case of a short taxable year. Commentators opined that for certain safe harbors, such as safe harbors 2, 3 and 4, inaccurate income exclusion can arise because a short taxable year will have a disproportionate effect on the numerator and denominator of the computations. For example, a taxpayer that has a relatively stable balance of accounts receivable but a short period, such as three months, may generate only one-fourth of the normal write-offs. These commentators recommended that the final regulations provide that, if a taxpayer experiences a short taxable year, the net write-offs for the short period should be annualized in order to prevent distortion of the safe harbor computation. Alternatively, these commentators suggested that taxpayers should be allowed to include data from the previous twelve months in the safe harbor computation. For example, for a calendar year taxpayer who experiences a short period ending March 31st, the taxpayer would use data from the twelve months prior to the period ending on March 31st to compute its nonaccrual-experience amount.

The final regulations provide that taxpayers must make appropriate adjustments for short taxable years for nonaccrual-experience methods that are based on a comparison of accounts receivable balance to total bad debts. The IRS and Treasury Department intend to issue administrative guidance on appropriate adjustments.

d. *Periodic systems*

As with the 2003 regulations, the final regulations provide, in §1.448–2(d)(2), that a taxpayer applies its nonaccrual-experience method with respect to each specific account receivable eligible for the method. The preamble to the 2003 regulations states that a taxpayer may continue to use the periodic system described in Notice 88–51, 1988–1 C.B. 535, in conjunction with any permissible nonaccrual-experience method used by the taxpayer. The use of a periodic method remains permissible under §1.448–2(d)(2) of the final regulations.

5. *Effective date*

These final regulations are applicable to taxable years ending on or after August 31, 2006. A commentator recommended that the final regulations be applied retroactively to allow taxpayers to settle any open taxable year in which the nonaccrual-experience method is an issue under consideration in examination, in Appeals, or before the U.S. Tax Court by using one of the safe harbor methods, and thus, avoid continued disagreements between the government and taxpayers. The final regulations do not adopt this recommendation. However, the Commissioner may settle an earlier taxable year on the basis of a safe harbor method that clearly reflects the taxpayer's experience.

6. *Procedures for Adoption or Change in Method of Accounting*

The 2003 regulations include specific rules for filing an application to change to a nonaccrual-experience method of accounting. The final regulations omit these rules, which will be provided in administrative guidance. The guidance will include automatic consent procedures for filing an application to change to one of the safe harbor nonaccrual-experience methods of accounting.

To adopt or change to a method other than one of the safe harbor nonaccrual-experience methods of accounting, a taxpayer must request advance consent under the current procedures for obtaining the consent of the Commissioner of Internal Revenue to change a method of accounting for Federal income tax purposes (see, for example, Rev. Proc. 97–27, 1997–1 C.B. 680 (as modified and amplified by Rev. Proc. 2002–19, 2002–1 C.B. 696, as amplified and clarified by Rev. Proc. 2002–54, 2002–2 C.B. 432). In the interest of sound tax administration, a new taxpayer must request advance consent to adopt a method other than one of the safe harbor nonaccrual-experience methods to ensure that the method clearly reflects income and experience.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) and (d) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information contained in these regulations will not have a significant regulatory impact on a substantial number of small entities. This certification is based upon the fact that the estimated burden associated with the information collection averages three hours per respondent. Moreover, for taxpayers that are eligible to use these regulations and that follow these regulations, any burden due to the collection of information in these regulations will be outweighed by the benefit received by accruing less income than would otherwise be required. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is W. Thomas McElroy, Jr. of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.448–2 is added to read as follows:

§1.448–2 Nonaccrual of certain amounts by service providers.

(a) *In general*. This section applies to taxpayers qualified to use a nonaccrual-experience method of accounting provided for in section 448(d)(5) with respect to amounts to be received for the performance of services. A taxpayer that satisfies the requirements of this section is not required to accrue any portion of amounts to be received from the performance of services that, on the basis of the taxpayer's experience, and to the extent determined under the computation or formula used by the taxpayer and allowed under this section, will not be collected. Except as otherwise provided in this section, a taxpayer is qualified to use a nonaccrual-experience method of accounting if the taxpayer uses an accrual method of accounting with respect to amounts to be received for the performance of services by the taxpayer and either—

(1) The services are in fields referred to in section 448(d)(2)(A) and described in §1.448–1T(e)(4) (health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting); or

(2) The taxpayer meets the $5 million annual gross receipts test of section 448(c) and §1.448–1T(f)(2) for all prior taxable years.

(b) *Application of method and treatment as method of accounting*. The rules of section 448(d)(5) and the regulations are applied separately to each taxpayer. For purposes of section 448(d)(5), the term *taxpayer* has the same meaning as the term *person* defined in section 7701(a)(1) (rather than the meaning of the term defined in section 7701(a)(14)). The nonaccrual of amounts to be received for the performance of services is a method of accounting (a nonaccrual-experience method). A change to a nonaccrual-experience method, from one nonaccrual-experience method to another nonaccrual-experience method, or to a periodic system (for example, see Notice 88–51, 1988–1 C.B. 535, and §601.601(d)(2)(ii)(*b*) of this chapter), is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations apply. See also paragraphs (c)(2)(i), (c)(5), (d)(4), and (e)(3)(i) of this section. Except as provided in other published guidance, a taxpayer who wishes to adopt or change to any nonaccrual-experience method other than one of the safe harbor methods described in paragraph (f) of this section must request and receive advance consent from the Commissioner in accordance with the applicable administrative procedures issued under §1.446–1(e)(3)(ii) for obtaining the Commissioner's consent.

(c) *Definitions and special rules*—(1) *Accounts receivable*—(i) *In general*. Accounts receivable include only amounts that are earned by a taxpayer and otherwise recognized in income through the performance of services by the taxpayer. For purposes of determining a taxpayer's nonaccrual-experience under any method provided in this section, amounts described in paragraph (c)(1)(ii) of this section are not taken into account. Except as otherwise provided, for purposes of this section, accounts receivable do not include amounts that are not billed (such as for charitable or pro bono services) or amounts contractually not collectible (such as amounts in excess of a fee schedule agreed to by contract). See paragraph (g) *Examples 1* and *2* of this section for examples of this rule.

(ii) *Method not available for certain receivables*—(A) *Amounts not earned and recognized through the performance of services*. A nonaccrual-experience method of accounting may not be used with respect to amounts that are not earned by a taxpayer and otherwise recognized in income through the performance of services by the taxpayer. For example, a nonaccrual-experience method may not be used with respect to amounts owed to the taxpayer by reason of the taxpayer's activities with respect to lending money, selling goods, or acquiring accounts receivable or other rights to receive payment from other persons (including persons related to the taxpayer) regardless of whether those persons earned the amounts through the provision of services. However, see paragraph (d)(3) of this section for special rules regarding acquisitions of a trade or business or a unit of a trade or business.

(B) *If interest or penalty charged on amounts due*. A nonaccrual-experience method of accounting may not be used with respect to amounts due for which interest is required to be paid or for which there is any penalty for failure to timely pay any amounts due. For this purpose, a taxpayer will be treated as charging interest or penalties for late payment if the contract or agreement expressly provides for the charging of interest or penalties for late payment, regardless of the practice of the parties. If the contract or agreement does not expressly provide for the charging of interest or penalties for late payment, the determination of whether the taxpayer charges interest or penalties for late payment will be made based on all of the facts and circumstances of the transaction, and not merely on the characterization by the parties or the treatment of the transaction under state or local law. However, the offering of a discount for early payment of an amount due will not be regarded as the charging of interest or penalties for late payment under this section, if—

(*1*) The full amount due is otherwise accrued as gross income by the taxpayer at the time the services are provided; and

(*2*) The discount for early payment is treated as an adjustment to gross income in the year of payment, if payment is received within the time required for allowance of the discount. See paragraph (g) *Example 3* of this section for an example of this rule.

(2) *Applicable period*—(i) *In general*. The applicable period is the number of taxable years on which the taxpayer bases its nonaccrual-experience method. A change in the number of taxable years included in the applicable period is a change in method of accounting to which the procedures of section 446 apply. A change in the inclusion or exclusion of the current taxable year in the applicable period is a change in method of accounting to which the procedures of section 446 apply. A change in the number of taxable years included in the applicable period or the inclusion or exclusion of the current taxable year in the applicable period is made on a cut-off basis.

(ii) *Applicable period for safe harbors*. For purposes of the safe harbors under paragraph (f) of this section the applicable period may consist of at least three but not more than six of the immediately preceding consecutive taxable years. Alternatively, the applicable period may con-

sist of the current taxable year and at least two but not more than five of the immediately preceding consecutive taxable years. A period shorter than six taxable years is permissible only if the period contains the most recent preceding taxable years and all of the taxable years in the applicable period are consecutive.

(3) *Bad debts*. Bad debts are accounts receivable determined to be uncollectible and charged off.

(4) *Charge-offs*. Amounts charged off include only those amounts that would otherwise be allowable under section 166(a).

(5) *Determination date*. The determination date in safe harbor 2 provided in paragraph (f)(2) of this section is used as a cut-off date for determining all known data to be taken into account in the computation of the taxable year's uncollectible amount. The determination date may not be later than the earlier of the due date, including extensions, for filing the taxpayer's Federal income tax return for that taxable year or the date on which the taxpayer timely files the return for that taxable year. The determination date may be different in each taxable year. However, once a determination date is selected and used for a particular taxable year, it may not be changed for that taxable year. The choice of a determination date is not a method of accounting.

(6) *Recoveries*. Recoveries are amounts previously excluded from income under a nonaccrual-experience method or charged off that the taxpayer recovers.

(7) *Uncollectible amount*. The uncollectible amount is the portion of any account receivable amount due that, under the taxpayer's nonaccrual-experience method, will be not collected.

(d) *Use of experience to estimate uncollectible amounts*—(1) *In general*. In determining the portion of any amount due that, on the basis of experience, will not be collected, a taxpayer may use any nonaccrual-experience method that clearly reflects the taxpayer's nonaccrual-experience. The determination of whether a nonaccrual-experience method clearly reflects the taxpayer's nonaccrual-experience is made in accordance with the rules under paragraph (e) of this section. Alternatively, the taxpayer may use any one of the five safe harbor nonaccrual-experience methods of accounting provided in paragraphs (f)(1) through (f)(5) of this section, which are presumed to clearly reflect a taxpayer's nonaccrual-experience.

(2) *Application to specific accounts receivable*. The nonaccrual-experience method is applied with respect to each account receivable of the taxpayer that is eligible for this method. With respect to a particular account receivable, the taxpayer determines, in the manner prescribed in paragraphs (d)(1) or (f)(1) through (f)(5) of this section (whichever applies), the uncollectible amount. The determination is required to be made only once with respect to each account receivable, regardless of the term of the receivable. The uncollectible amount is not recognized as gross income. Thus, the amount recognized as gross income is the amount that would otherwise be recognized as gross income with respect to the account receivable, less the uncollectible amount. A taxpayer that excludes an amount from income during a taxable year as a result of the taxpayer's use of a nonaccrual-experience method may not deduct in any subsequent taxable year the amount excluded from income. Thus, the taxpayer may not deduct the excluded amount in a subsequent taxable year in which the taxpayer actually determines that the amount is uncollectible and charges it off. If a taxpayer using a nonaccrual-experience method determines that an amount that was not excluded from income is uncollectible and should be charged off (for example, a calendar-year taxpayer determines on November 1st that an account receivable that was originated on May 1st of the same taxable year is uncollectible and should be charged off), the taxpayer may deduct the amount charged off when it is charged off, but must include any subsequent recoveries in income. The reasonableness of a taxpayer's determination that amounts are uncollectible and should be charged off may be considered on examination. See paragraph (g) *Example 12* of this section for an example of this rule.

(3) *Acquisitions and dispositions*—(i) *Acquisitions*. If a taxpayer acquires the major portion of a trade or business of another person (predecessor) or the major portion of a separate unit of a trade or business of a predecessor, then, for purposes of applying this section for any taxable year ending on or after the acquisition, the experience from preceding taxable years of the predecessor attributable to the portion of the trade or business acquired, if available, must be used in determining the taxpayer's experience.

(ii) *Dispositions*. If a taxpayer disposes of a major portion of a trade or business or the major portion of a separate unit of a trade or business, and the taxpayer furnished the acquiring person the information necessary for the computations required by this section, then, for purposes of applying this section for any taxable year ending on or after the disposition, the experience from preceding taxable years attributable to the portion of the trade or business disposed may not be used in determining the taxpayer's experience.

(iii) *Meaning of terms*. For the meaning of the terms *acquisition*, *separate unit*, and *major portion*, see paragraph (b) of §1.52–2. The term *acquisition* includes an incorporation or a liquidation.

(4) *New taxpayers*. The rules of this paragraph (d)(4) apply to any newly formed taxpayer to which the rules of paragraph (d)(3)(i) of this section do not apply. Any newly formed taxpayer that wants to use a safe harbor nonaccrual-experience method of accounting described in paragraph (f)(1), (f)(2), (f)(3), (f)(4), or (f)(5) of this section applies the methods by using the experience of the actual number of taxable years available in the applicable period. A newly formed taxpayer that wants to use one of the safe harbor nonaccrual-experience methods of accounting described in paragraph (f)(2), (f)(4), or (f)(5) of this section in its first taxable year and does not have any accounts receivable upon formation may not exclude any portion of its year-end accounts receivable from income for its first taxable year. The taxpayer must begin creating its moving average in its second taxable year by tracking the accounts receivable as of the first day of its second taxable year. The use of one of the safe harbor nonaccrual-experience methods of accounting described in paragraph (f)(2), (f)(4), or (f)(5) of this section in a taxpayer's second taxable year in this situation is not a change in method of accounting. Although the taxpayer must maintain the books and records necessary to perform the computations under the adopted safe harbor nonaccrual-experience method, the taxpayer is not required to affirmatively elect the method on its

Federal income tax return for its first taxable year.

(5) *Recoveries.* Regardless of the nonaccrual-experience method of accounting used by a taxpayer under this section, the taxpayer must take recoveries into account. If, in a subsequent taxable year, a taxpayer recovers an amount previously excluded from income under a nonaccrual-experience method or charged off, the taxpayer must include the recovered amount in income in that subsequent taxable year. See paragraph (g) *Example 13* of this section for an example of this rule.

(6) *Request to exclude taxable years from applicable period.* A period shorter than the applicable period generally is permissible only if the period consists of consecutive taxable years and there is a change in the type of a substantial portion of the outstanding accounts receivable such that the risk of loss is substantially increased. A decline in the general economic conditions in the area, which substantially increases the risk of loss, is a relevant factor in determining whether a shorter period is appropriate. However, approval to use a shorter period will not be granted unless the taxpayer supplies evidence that the accounts receivable outstanding at the close of the taxable years for the shorter period requested are more comparable in nature and risk to accounts receivable outstanding at the close of the current taxable year. A substantial increase in a taxpayer's bad debt experience is not, by itself, sufficient to justify the use of a shorter period. If approval is granted to use a shorter period, the experience for the excluded taxable years may not be used for any subsequent taxable year. A request for approval to exclude the experience of a prior taxable year must be made in accordance with the applicable procedures for requesting a letter ruling and must include a statement of the reasons the experience should be excluded. A request will not be considered unless it is sent to the Commissioner at least 30 days before the close of the first taxable year for which the approval is requested.

(7) *Short taxable years.* A taxpayer with a short taxable year that uses a nonaccrual-experience method that compares accounts receivable balance to total bad debts during the taxable year should make appropriate adjustments.

(8) *Record keeping requirements*—(i) A taxpayer using a nonaccrual-experience method of accounting must keep sufficient books and records to establish the amount of any exclusion from gross income under section 448(d)(5) for the taxable year, including books and records demonstrating—

(A) The nature of the taxpayer's nonaccrual-experience method;

(B) Whether, for any particular taxable year, the taxpayer qualifies to use its nonaccrual-experience method (including the self-testing requirements of paragraph (e) of this section (if applicable));

(C) The taxpayer's determination that amounts are uncollectible;

(D) The proper amount that is excludable under the taxpayer's nonaccrual-experience method; and

(E) The taxpayer's determination date under paragraph (c)(5) of this section (if applicable).

(ii) If a taxpayer does not maintain records of the data that are sufficient to establish the amount of any exclusion from gross income under section 448(d)(5) for the taxable year, the Internal Revenue Service may change the taxpayer's method of accounting on examination. See §1.6001–1 for rules regarding records.

(e) *Requirements for nonaccrual method to clearly reflect experience*—(1) *In general.* A nonaccrual-experience method clearly reflects the taxpayer's experience if the taxpayer's nonaccrual-experience method meets the self-test requirements described in this paragraph (e). If a taxpayer is using one of the safe harbor nonaccrual-experience methods described in paragraphs (f)(1) through (f)(4) of this section, its method is deemed to clearly reflect its experience and is not subject to the self-testing requirements in paragraphs (e)(2) and (e)(3) of this section.

(2) *Requirement to self-test*—(i) *In general.* A taxpayer using, or desiring to use, a nonaccrual-experience method must self-test its nonaccrual-experience method for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method (first-year self-test) and every three taxable years thereafter (three-year self-test). Each self-test must be performed by comparing the uncollectible amount (under the taxpayer's nonaccrual-experience method) with the taxpayer's actual experience. A taxpayer using the safe harbor under paragraph (f)(5) of this section must self-test using the safe harbor comparison method in paragraph (e)(3) of this section.

(ii) *First-year self-test.* The first-year self-test must be performed by comparing the uncollectible amount with the taxpayer's actual experience for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method. If the uncollectible amount for the first-year self-test is less than or equal to the taxpayer's actual experience for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method, the taxpayer's nonaccrual-experience method is treated as clearly reflecting its experience for the first taxable year. If, as a result of the first-year self-test, the uncollectible amount for the test period is greater than the taxpayer's actual experience, then—

(A) The taxpayer's nonaccrual-experience method is treated as not clearly reflecting its experience;

(B) The taxpayer is not permitted to use that nonaccrual-experience method in that taxable year; and

(C) The taxpayer must change to (or adopt) for that taxable year either—

(*1*) Another nonaccrual-experience method that clearly reflects experience, that is, a nonaccrual-experience method that meets the first-year self-test requirement; or

(*2*) A safe harbor nonaccrual-experience method described in paragraphs (f)(1) through (f)(5) of this section.

(iii) *Three-year self-test*—(A) *In general.* The three-year self-test must be performed by comparing the sum of the uncollectible amounts for the current taxable year and prior two taxable years (cumulative uncollectible amount) with the sum of the taxpayer's actual experience for the current taxable year and prior two taxable years (cumulative actual experience amount).

(B) *Recapture.* If the cumulative uncollectible amount for the test period is greater than the cumulative actual experience amount for the test period, the taxpayer's uncollectible amount is limited to the cumulative actual experience amount for the test period. Any excess of the taxpayer's cumulative uncollectible amount over the taxpayer's cumulative actual nonaccrual-experience amount ex-

cluded from income during the test period must be recaptured into income in the third taxable year of the three-year self-test period.

(C) *Determination of whether method is permissible or impermissible*. If the cumulative uncollectible amount is less than 110 percent of the cumulative actual experience amount, the taxpayer's nonaccrual-experience method is treated as a permissible method and the taxpayer may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement of this paragraph (e)(2)(iii). If the cumulative uncollectible amount is greater than or equal to 110 percent of the cumulative actual experience amount, the taxpayer's nonaccrual-experience method is treated as impermissible in the taxable year subsequent to the three-year self-test year and does not clearly reflect its experience. The taxpayer must change to another nonaccrual-experience method that clearly reflects experience, including, for example, one of the safe harbor nonaccrual-experience methods described in paragraphs (f)(1) through (f)(5) of this section, for the subsequent taxable year. A change in method of accounting from an impermissible method under this paragraph (e)(2)(iii)(C) to a permissible method in the taxable year subsequent to the three-year self-test year is made on a cut-off basis.

(iv) *Determination of taxpayer's actual experience*. Reserved.

(3) *Safe harbor comparison method*—(i) *In general*. A taxpayer using, or desiring to use, a nonaccrual-experience method under the safe harbor in paragraph (f)(5) of this section must self-test its nonaccrual-experience method for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method (first-year self-test) and every three taxable years thereafter (three-year self-test). A nonaccrual-experience method under the safe harbor in paragraph (f)(5) of this section is deemed to clearly reflect experience provided all the requirements of the safe harbor comparison method of this paragraph (e)(3) are met. Each self-test must be performed by comparing the uncollectible amount (under the taxpayer's nonaccrual-experience method) with the uncollectible amount that would have resulted from use of one of the safe harbor methods described in paragraph (f)(1), (f)(2), (f)(3), or (f)(4) of this section. A change from a nonaccrual-experience method that uses the safe harbor comparison method for self-testing to a nonaccrual-experience method that does not use the safe harbor comparison method for self-testing, and vice versa, is a change in method of accounting to which the provisions of sections 446 and 481 and the regulations apply. A change solely to use or discontinue use of the safe harbor comparison method for purposes of determining whether the nonaccrual-experience method clearly reflects experience must be made on a cut-off basis and without audit protection.

(ii) *Requirements to use safe harbor comparison method*—(A) *First-year self-test*. The first-year self-test must be performed by comparing the uncollectible amount with the uncollectible amount determined under any of the safe harbor methods described in paragraph (f)(1), (f)(2), (f)(3), or (f)(4) of this section (safe harbor uncollectible amount) for its first taxable year for which the taxpayer uses, or desires to use, that nonaccrual-experience method. If the uncollectible amount for the first-year self-test is less than or equal to the safe harbor uncollectible amount, then the taxpayer's nonaccrual-experience method is treated as clearly reflecting its experience for the first taxable year. If, as a result of the first-year self-test, the uncollectible amount for the test period is greater than the safe harbor uncollectible amount, then—

(*1*) The taxpayer's nonaccrual-experience method is treated as not clearly reflecting its experience;

(*2*) The taxpayer is not permitted to use that nonaccrual-experience method in that taxable year; and

(*3*) The taxpayer must change to (or adopt) for that taxable year either—

(*i*) Another nonaccrual-experience method that clearly reflects experience, that is, a nonaccrual-experience method that meets the first-year self-test requirement; or

(*ii*) A safe harbor nonaccrual-experience method described in paragraphs (f)(1) through (f)(5) of this section.

(B) *Three-year self-test*. The three-year self-test must be performed by comparing the sum of the uncollectible amounts for the current taxable year and prior two taxable years (cumulative uncollectible amount) with the sum of the uncollectible amount determined under any of the safe harbor methods described in paragraph (f)(1), (f)(2), (f)(3), or (f)(4) of this section for the current taxable year and prior two taxable years (cumulative safe harbor uncollectible amounts). If the cumulative uncollectible amount for the three-year self-test is less than or equal to the cumulative safe harbor uncollectible amount for the test period, then the taxpayer's nonaccrual-experience method is treated as clearly reflecting its experience for the test period and the taxpayer may continue to use that nonaccrual-experience method, subject to a requirement to self-test again after three taxable years. If the cumulative uncollectible amount for the test period is greater than the cumulative safe harbor uncollectible amount for the test period, the taxpayer's uncollectible amount is limited to the cumulative safe harbor uncollectible amount for the test period. Any excess of the taxpayer's cumulative uncollectible amount over the taxpayer's cumulative safe harbor uncollectible amount excluded from income during the test period must be recaptured into income in the third taxable year of the three-year self-test period. If the cumulative uncollectible amount is less than 110 percent of the cumulative safe harbor uncollectible amount, the taxpayer's nonaccrual-experience method is treated as a permissible method and the taxpayer may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement of this paragraph (e)(3)(ii)(B). If the cumulative uncollectible amount is greater than or equal to 110 percent of the cumulative safe harbor uncollectible amount, the taxpayer's nonaccrual-experience method is treated as impermissible in the taxable year subsequent to the three-year self-test year and does not clearly reflect its experience. The taxpayer must change to another nonaccrual-experience method that clearly reflects experience, including, for example, one of the safe harbor nonaccrual-experience methods described in paragraphs (f)(1) through (f)(5) of this section, for the subsequent taxable year. A change in method of accounting from an impermissible method under this paragraph (e)(3)(ii)(B) to a permissible method in the taxable year subsequent to

the three-year self-test year is made on a cut-off basis.

(4) *Methods that do not clearly reflect experience*. [Reserved.]

(5) *Contemporaneous documentation*. For purposes of this paragraph (e), including the safe harbor comparison method of paragraph (e)(3) of this section, a taxpayer must document in its books and records, in the taxable year any first-year or three-year self-test is performed, the method used to conduct the self-test, including appropriate documentation and computations that resulted in the determination that the taxpayer's nonaccrual-experience method clearly reflected the taxpayer's nonaccrual-experience for the applicable test period.

(f) *Safe harbors*—(1) *Safe harbor 1: revenue-based moving average method*. A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (revenue-based moving average percentage). The revenue-based moving average percentage is computed by dividing the total bad debts sustained, adjusted by recoveries received, throughout the applicable period by the total revenue resulting in accounts receivable earned throughout the applicable period. See paragraph (g) *Example 4* of this section for an example of this method. Thus, the uncollectible amount under the revenue-based moving average method is computed:

$$\frac{\text{Bad debts sustained, adjusted by recoveries received, during the applicable period}}{\text{Total revenue resulting in accounts receivable during the applicable period}} \times \text{Accounts receivable at end of current taxable year}$$

(2) *Safe harbor 2: actual experience method*—(i) *Option A: single determination date*. A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (moving average nonaccrual-experience percentage) and then increasing the resulting amount by 5 percent. See paragraph (g) *Example 5* of this section for an example of safe harbor 2 in general, and paragraph (g) *Example 6* of this section for an example of the single determination date option of safe harbor 2. The taxpayer's moving average nonaccrual-experience percentage is computed by dividing the total bad debts sustained, adjusted by recoveries that are allocable to the bad debts, by the determination date of the current taxable year related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period by the sum of the accounts receivable at the beginning of the each taxable year during the applicable period. Thus, the uncollectible amount under Option A of the actual experience method is computed:

$$\frac{\text{Bad debts sustained, adjusted by recoveries received that are allocable to the bad debts, by the determination date of the current taxable year related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period}}{\text{Sum of accounts receivable at the beginning of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year} \times 1.05$$

(ii) *Option B: multiple determination dates*. Alternatively, in computing its bad debts related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period, a taxpayer may use the original determination date for each taxable year during the applicable period. That is, the taxpayer may use bad debts sustained, adjusted by recoveries received that are allocable to the bad debts, by the determination date of each taxable year during the applicable period rather than the determination date of the current taxable year. See paragraph (g) *Example 7* of this section for an example of the multiple determination date option of safe harbor 2. Thus, the uncollectible amount under Option B of the actual experience method is computed:

$$\frac{\text{Sum of, for each taxable year during the applicable period, bad debts sustained, adjusted by recoveries received that are allocable to the bad debts, by that taxable year's determination date and related to the taxpayer's accounts receivable balance at the beginning of the taxable year}}{\text{Sum of accounts receivable at the beginning of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year} \times 1.05$$

(iii) *Tracing of recoveries*—(A) *In general*. Bad debts related to the taxpayer's accounts receivable balance at the beginning of each taxable year during the applicable period must be adjusted by the portion, if any, of recoveries received that are properly allocable to the bad debts.

(B) *Specific tracing*. If a taxpayer, without undue burden, can trace all recoveries to their corresponding charge-offs, the taxpayer must specifically trace all recoveries.

(C) *Recoveries cannot be traced without undue burden*. If a taxpayer has any recoveries that cannot, without undue burden, be traced to corresponding charge-offs, the taxpayer may allocate those or all recoveries between charge-offs of amounts in the relevant beginning accounts receivable balances and other charge-offs using an allocation method that is reasonable under all of the facts and circumstances.

(*1*) *Reasonable allocations*. An allocation method is reasonable if there is a cause and effect relationship between the allocation base or ratio and the recoveries. A taxpayer may elect to trace recoveries that are traceable and allocate all untraceable recoveries to charge-offs of amounts in the relevant beginning accounts receivable balances. Such an allocation method will be deemed to be reasonable under all the facts and circumstances.

(*2*) *Allocations that are not reasonable*. Allocation methods that generally will not be considered reasonable include, for example, methods in which there is not a cause and effect relationship between the allocation base or ratio and methods in which receivables for which the nonaccrual-experience method is not allowed to be used are included in the allocation. See paragraph (c)(1)(ii) of this section for examples of receivables for which the nonaccrual-experience method is not allowed.

(3) *Safe harbor 3: modified Black Motor method*. A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (modified Black Motor moving average percentage) and then reducing the resulting amount by the bad debts written off during the current taxable year relating to accounts receivable generated during the current taxable year. The modified Black Motor moving average percentage is computed by dividing the total bad debts sustained, adjusted by recoveries received, during the applicable period by the sum of accounts receivable at the end of each taxable year during the applicable period. See paragraph (g) *Example 8* of this section for an example of this method. Thus, the uncollectible amount under the modified Black Motor method is computed:

$$\frac{\text{Bad debts sustained, adjusted by recoveries received, during the applicable period}}{\text{Sum of accounts receivable at the end of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year} - \text{Bad debts written off during the current taxable year relating to accounts receivable generated during the current taxable year}$$

(4) *Safe harbor 4: modified moving average method*. A taxpayer may use a nonaccrual-experience method under which the taxpayer determines the uncollectible amount by multiplying its accounts receivable balance at the end of the current taxable year by a percentage (modified moving average percentage). The modified moving average percentage is computed by dividing the total bad debts sustained, adjusted by recoveries received, during the applicable period other than bad debts that were written off in the same taxable year the related accounts receivable were generated by the sum of accounts receivable at the beginning of each taxable year during the applicable period. See paragraph (g) *Example 9* of this section for an example of this method. Thus, the uncollectible amount under the modified moving average method is computed:

$$\frac{\text{(Bad debts sustained, adjusted by recoveries received, during the applicable period} - \text{Bad debts written off in same taxable year accounts receivable generated)}}{\text{Sum of accounts receivable at the beginning of each taxable year during the applicable period}} \times \text{Accounts receivable at end of current taxable year}$$

(5) *Safe harbor 5: alternative nonaccrual-experience method*. A taxpayer may use an alternative nonaccrual-experience method that clearly reflects the taxpayer's actual nonaccrual-experience, provided the taxpayer's alternative nonaccrual-experience method meets the self-test requirements described in paragraph (e)(3) of this section.

(g) *Examples*. The following examples illustrate the provisions of this section. In each example, the taxpayer uses a calendar year for Federal income tax purposes and an accrual method of accounting, does not require the payment of interest or penalties with respect to past due accounts receivable (except in the case of *Example 3*) and, in the case of *Examples 5* through *7*, selects an appropriate determination date for each taxable year. The examples are as follows:

Example 1. Contractual allowance or adjustment. B, a healthcare provider, performs a medical procedure on individual C, who has health insurance coverage with IC, an insurance company. B bills IC and C for $5,000, B's standard charge for this medical procedure. However, B has a contract with IC that obligates B to accept $3,500 as full payment for the medical procedure if the procedure is provided to a patient insured by IC. Under the contract, only $3,500 of the $5,000 billed by B is legally collectible

from IC and C. The remaining $1,500 represents a contractual allowance or contractual adjustment. Under paragraph (c)(1)(i) of this section, the remaining $1,500 is not a contractually collectible amount for purposes of this section and B may not use a nonaccrual-experience method with respect to this portion of the receivable.

Example 2. Charitable or pro bono services. D, a law firm, agrees to represent individual E in a legal matter and to provide services to E on a pro bono basis. D normally charges $500 for these services. Because D provides its services to E pro bono, D's services are never billed or intended to result in revenue. Thus, under paragraph (c)(1)(i) of this section, the $500 is not a collectible amount for purposes of this section and D may not use a nonaccrual-experience method with respect to this portion of the receivable.

Example 3. Charging interest and/or penalties. Z has two billing methods for the amounts to be received from Z's provision of services described in paragraph (a)(1) of this section. Under one method, for amounts that are more than 90 days past due, Z charges interest at a market rate until the amounts (together with interest) are paid. Under the other billing method, Z charges no interest for amounts past due. Under paragraph (c)(1)(ii) of this section, A may not use a nonaccrual-experience method of accounting with respect to any of the amounts billed under the method that charges interest on amounts that are more than 90 days past due. Z may, however, use the nonaccrual-experience method with respect to the amounts billed under the method that does not charge interest for amounts past due.

Example 4. Safe harbor 1: Revenue-based moving average method. (i) F uses the revenue-based moving average method described in paragraph (f)(1) of this section with an applicable period of six taxable years. F's total accounts receivable and bad debt experience for the 2006 taxable year and the five immediately preceding consecutive taxable years are as follows:

Taxable year	Total accounts receivable earned during the taxable year	Bad debts (adjusted for recoveries)
2001	$40,000	$5,700
2002	40,000	7,200
2003	40,000	11,000
2004	60,000	10,200
2005	70,000	14,000
2006	80,000	16,800
Total	$330,000	$64,900

(ii) F's revenue-based moving average percentage is 19.67% ($64,900/$330,000). If $49,300 of accounts receivable remains outstanding as of the close of that taxable year (2006), F's uncollectible amount using the revenue-based moving average safe harbor method is computed by multiplying $49,300 by the revenue-based moving average percentage of 19.67%, or $9,697. Thus, F may exclude $9,697 from gross income for 2006.

Example 5. Safe harbor 2: Actual experience method. (i) G is eligible to use a nonaccrual-experience method and wishes to adopt the actual experience method of paragraph (f)(2) of this section. G elects to use a three-year applicable period consisting of the current and two immediately preceding consecutive taxable years. G determines that its actual accounts receivable collection experience is as follows:

Taxable year	Total A/R balance at beginning of taxable year	Bad debts, adjusted for recoveries, related to A/R balance at beginning of taxable year
2006	$1,000,000	$35,000
2007	760,000	75,000
2008	1,975,000	65,000
Total	$3,735,000	$175,000

(ii) G's ending A/R Balance on December 31, 2008, is $880,000. In 2008, G computes its uncollectible amount by using a three-year moving average under paragraph (f)(2) of this section. G's moving average nonaccrual-experience percentage is 4.7%, determined by dividing the sum of the amount of G's accounts receivable outstanding on January 1 of 2006, 2007, and 2008, that were determined to be bad debts (adjusted for recoveries allocable to the bad debts) on or before the corresponding determination date(s), by the sum of the amount of G's accounts receivable outstanding on January 1 of 2006, 2007, and 2008 ($175,000/$3,735,000 or 4.7%). G's uncollectible amount for 2008 is determined by multiplying this percentage by the balance of G's accounts receivable on December 31, 2008 ($880,000 x 4.7% = $41,360), and increasing this amount by 105% ($41,360 x 105% = $43,428). G may exclude $43,428 from gross income for 2008.

Example 6. Safe harbor 2: Single determination date (Option A). H is eligible to use a nonaccrual-experience method and wishes to adopt the actual experience method of paragraph (f)(2) of this section. H elects to use a six-year applicable period consisting of the current and five immediately preceding taxable years. H also elects to use a single determination date in accordance with paragraph (f)(2)(i) of this section. H selects December 31, its taxable year-end, as its determination date. Since H is using a single determination date from the current taxable year, its determination date for the 2001–2006 applicable period is December 31, 2006. H has a $800 charge-off in 2003 of an account receivable in the 2003 beginning accounts receivable balance. In 2005, H has a recovery of $100 which is traceable, without undue burden, to the $800 charge-off in 2003. Since the $100 recovery occurred prior to H's December 31, 2006, determination date, it reduces the amount of H's bad debts in the numerator of the formula for purposes of determining H's moving average nonaccrual-experience percentage. In addition, H must include the $100 recovery in income in 2005 (see paragraph (d)(5) of this section regarding recoveries).

Example 7. Safe harbor 2: Multiple determination dates (Option B). The facts are the same as in *Example 6*, except H elects to use multiple determination dates in accordance with paragraph (f)(2)(ii) of this section. Consequently, H's determination date is December 31, 2001, for its calculations of the portion of the numerator relating to the 2001 taxable year, December 31, 2002, for its calculations of the portion of the numerator relating to the 2002 taxable year, and so on through the final taxable year (2006), which has a determination date of December 31, 2006. Since the $100 recovery did not occur until after December 31, 2003 (the determination date for the 2003 taxable year), it does not reduce the amount of H's bad debts in the numerator of the formula for purposes of determining H's moving average nonaccrual-experience percentage. However, H still must include the $100 recovery in income in 2005 (see paragraph (d)(5) of this section regarding recoveries).

Example 8. Safe harbor 3: Modified Black Motor method. (i) J uses the modified Black Motor method described in paragraph (f)(3) of this section and a six-year applicable period. J's total accounts receivable and bad debt experience for the 2006 taxable year and the five immediately preceding consecutive taxable years are as follows:

Taxable year	Total accounts receivable earned during the taxable year	Bad debts (adjusted for recoveries)
2001	$130,000	$9,100
2002	140,000	7,000
2003	140,000	14,000
2004	160,000	14,400
2005	170,000	20,400
2006	180,000	10,800
Total	$920,000	$75,700

(ii) J's modified Black Motor moving average percentage is 8.228% ($75,700/$920,000). If the accounts receivable generated and written off during the current taxable year are $3,600, J's uncollectible amount is $11,210, computed by multiplying J's accounts receivable on December 31, 2006 ($180,000) by the modified Black Motor moving average percentage of 8.228% and reducing the resulting amount by $3,600 (J's accounts receivable generated and written off during the 2006 taxable year). J may exclude $11,210 from gross income for 2006.

Example 9. Safe harbor 4: Modified moving average method. (i) The facts are the same as in *Example 8*, except that the balances represent accounts receivable at the beginning of the taxable year, and J uses the modified moving average method described in paragraph (f)(4) of this section and a six-year applicable period. Furthermore, the accounts receivable that were written off in the same taxable year they were generated, adjusted for recoveries of bad debts during the period are as follows:

Taxable year	Accounts receivable written off in same taxable year as generated (adjusted for recoveries)
2001	$3,033
2002	2,333
2003	4,667
2004	4,800
2005	6,800
2006	3,600
Total	$25,233

(ii) J's modified moving average percentage is 5.486% (($75,700 - $25,233)/$920,000). J's uncollectible amount is $9,875, computed by multiplying J's accounts receivable on December 31, 2006 ($180,000) by the modified moving average percentage of 5.486%. J may exclude $9,875 from gross income for 2006.

Example 10. First-year self-test. Beginning in 2006, K is eligible to use a nonaccrual-experience method and wants to adopt an alternative nonaccrual-experience method under paragraph (f)(5) of this section, and consequently is subject to the safe harbor comparison method of self-testing under paragraph (e)(3) of this section. K elects to self-test against safe harbor 1 for purposes of conducting its first-year self-test. K's uncollectible amount for 2006 is $22,000. K's safe harbor uncollectible amount under safe harbor 1 is $21,000. Because K's uncollectible amount for 2006 ($22,000) is greater than the safe harbor uncollectible amount ($21,000), K's alternative nonaccrual-experience method is treated as not clearly reflecting its nonaccrual experience for 2006. Accordingly, K must adopt either another nonaccrual-experience method that clearly reflects experience (subject to the self-testing requirements of paragraph (e)(2)(ii) of this section, or a safe harbor nonaccrual-experience method described in paragraph (f)(1) (revenue-based moving average), (f)(2) (actual experience method), (f)(3) (modified Black Motor method), (f)(4) (modified moving average method) of this section, or another alternative nonaccrual-experience method under paragraph (f)(5) of this section that meets the self-testing requirements of paragraph (e)(3) of this section.

Example 11. Three-year self-test. The facts are the same as in *Example 10*, except that K's safe harbor uncollectible amount under safe harbor 1 for 2006 is also $22,000. Consequently, K meets the first-year self-test requirement and may use its alternative nonaccrual-experience method. Subsequently, K's cumulative uncollectible amount for 2007 through 2009 is $300,000. K's safe harbor uncollectible amount for 2007 through 2009 under its chosen safe harbor method for self-testing (safe harbor 1) is $295,000. Because K's cumulative uncollectible amount for the three-year test period (taxable years 2007 through 2009) is greater than its safe harbor uncollectible amount for the three-year test period ($295,000), under paragraph (e)(3)(ii)(B) of this section, the $5,000 excess of K's cumulative uncollectible amount over K's safe harbor uncollectible amount for the three-year test period must be recaptured into income in 2009 in accordance with paragraph (e)(3)(ii)(B) of this section. Since K's cumulative uncollectible amount for the three-year test period ($300,000) is less than 110% of its safe harbor uncollectible amount ($295,000 x 110% = $324,500), under paragraph (e)(3)(ii)(B) of this section, K may continue to use its alternative nonaccrual-experience method, subject to the three-year self-test requirement.

Example 12. Subsequent worthlessness of year-end receivable. The facts are the same as in *Example 4*, except that one of the accounts receivable outstanding at the end of 2002 was for $8,000, and in 2003, under section 166, the entire amount of this receivable becomes wholly worthless. Because F does not accrue as income $1,573 of this account receivable ($8,000 x .1967) under the nonaccrual-experience method in 2002, under paragraph (d)(2) of this section F may not deduct this portion of the account receivable as a bad debt deduction under section 166 in 2003. F may deduct the remaining balance of the receivable in 2003 as a bad debt deduction under section 166 ($8,000 - $1,574 = $6,426).

Example 13. Subsequent collection of year-end receivable. The facts are the same as in *Example 4*. In 2007, F collects in full an account receivable of $1,700 that was outstanding at the end of 2006. Under paragraph (d)(5) of this section, F must recognize additional gross income in 2007 equal to the portion of this receivable that F excluded from gross income in the prior taxable year ($1,700 x .1967 = $334). That amount ($334) is a recovery under paragraph (d)(5) of this section.

(h) *Effective date*. This section is applicable for taxable years ending on or after August 31, 2006.

§1.448–2T [Removed]

Par. 3. Section 1.448–2T is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 4. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 5. In §602.101, paragraph (b) is amended by adding an entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described		Current OMB control No.
* * * * *		
1.448–2	....	1545–1855
* * * * *		

Steven T. Miller,
Acting Deputy Commissioner for Services and Enforcement.

Approved August 30, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on August 31, 2006, 1:53 p.m., and published in the issue of the Federal Register for September 6, 2006, 71 F.R. 52430)

Section 467.—Certain Payments for the Use of Property or Services

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 468.—Special Rules for Mining and Solid Waste Reclamation and Closing Costs

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 482.—Allocation of Income and Deductions Among Taxpayers

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 483.—Interest on Certain Deferred Payments

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 642.—Special Rules for Credits and Deductions

Federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 807.—Rules for Certain Reserves

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 846.—Discounted Unpaid Losses Defined

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 1274.—Determination of Issue Price in the Case of Certain Debt Instruments Issued for Property

(Also Sections 42, 280G, 382, 412, 467, 468, 482, 483, 642, 807, 846, 1288, 7520, 7872.)

Federal rates; adjusted federal rates; adjusted federal long-term rate and the long-term exempt rate. For purposes of sections 382, 642, 1274, 1288, and other sections of the Code, tables set forth the rates for October 2006.

Rev. Rul. 2006–50

This revenue ruling provides various prescribed rates for federal income tax purposes for October 2006 (the current month). Table 1 contains the short-term, mid-term, and long-term applicable federal rates (AFR) for the current month for purposes of section 1274(d) of the Internal Revenue Code. Table 2 contains the short-term, mid-term, and long-term adjusted applicable federal rates (adjusted AFR) for the current month for purposes of section 1288(b). Table 3 sets forth the adjusted federal long-term rate and the long-term tax-exempt rate described in section 382(f). Table 4 contains the appropriate percentages for determining the low-income housing credit described in section 42(b)(2) for buildings placed in service during the current month. Finally, Table 5 contains the federal rate for determining the present value of an annuity, an interest for life or for a term of years, or a remainder or a reversionary interest for purposes of section 7520.

REV. RUL. 2006–50 TABLE 1

Applicable Federal Rates (AFR) for October 2006

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term				
AFR	5.00%	4.94%	4.91%	4.89%
110% AFR	5.50%	5.43%	5.39%	5.37%
120% AFR	6.02%	5.93%	5.89%	5.86%
130% AFR	6.52%	6.42%	6.37%	6.34%
Mid-term				
AFR	4.82%	4.76%	4.73%	4.71%
110% AFR	5.31%	5.24%	5.21%	5.18%
120% AFR	5.79%	5.71%	5.67%	5.64%
130% AFR	6.29%	6.19%	6.14%	6.11%
150% AFR	7.27%	7.14%	7.08%	7.04%
175% AFR	8.50%	8.33%	8.25%	8.19%
Long-term				
AFR	5.02%	4.96%	4.93%	4.91%
110% AFR	5.53%	5.46%	5.42%	5.40%
120% AFR	6.04%	5.95%	5.91%	5.88%
130% AFR	6.55%	6.45%	6.40%	6.36%

REV. RUL. 2006–50 TABLE 2

Adjusted AFR for October 2006

Period for Compounding

	Annual	*Semiannual*	*Quarterly*	*Monthly*
Short-term adjusted AFR	3.50%	3.47%	3.46%	3.45%
Mid-term adjusted AFR	3.69%	3.66%	3.64%	3.63%
Long-term adjusted AFR	4.22%	4.18%	4.16%	4.14%

REV. RUL. 2006–50 TABLE 3

Rates Under Section 382 for October 2006

Adjusted federal long-term rate for the current month	4.22%
Long-term tax-exempt rate for ownership changes during the current month (the highest of the adjusted federal long-term rates for the current month and the prior two months.)	4.52%

REV. RUL. 2006–50 TABLE 4

Appropriate Percentages Under Section 42(b)(2) for October 2006

Appropriate percentage for the 70% present value low-income housing credit	8.15%
Appropriate percentage for the 30% present value low-income housing credit	3.49%

REV. RUL. 2006–50 TABLE 5	
Rate Under Section 7520 for October 2006	
Applicable federal rate for determining the present value of an annuity, an interest for life or a term of years, or a remainder or reversionary interest	5.8%

Section 1288.—Treatment of Original Issue Discount on Tax-Exempt Obligations

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 7520.—Valuation Tables

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Section 7872.—Treatment of Loans With Below-Market Interest Rates

The adjusted applicable federal short-term, mid-term, and long-term rates are set forth for the month of October 2006. See Rev. Rul. 2006-50, page 672.

Part III. Administrative, Procedural, and Miscellaneous

Phase-Out of Credit for New Qualified Hybrid Motor Vehicles and New Advanced Lean Burn Technology Motor Vehicles

Notice 2006–78

SECTION 1. PURPOSE

This notice announces the credit phase-out schedule for advanced lean burn technology motor vehicles and hybrid passenger automobiles and light trucks manufactured by Toyota Motor Corporation.

SECTION 2. BACKGROUND

Section 30B(a)(2) of the Internal Revenue Code provides for a credit determined under § 30B(c) for certain new advanced lean burn technology motor vehicles. Section 30B(a)(3) provides for a credit determined under § 30B(d) for certain new qualified hybrid motor vehicles. Both the new advanced lean burn technology motor vehicle credit and the new qualified hybrid motor vehicle credit begin to phase out for a manufacturer's passenger automobiles and light trucks in the second calendar quarter after the calendar quarter in which at least 60,000 of the manufacturer's passenger automobiles and light trucks that qualify for either credit have been sold for use or lease in the United States (determined on a cumulative basis for sales after December 31, 2005). Taxpayers purchasing the manufacturer's vehicles during the first two calendar quarters of the phase-out period may claim only 50 percent of the otherwise allowable credit. Taxpayers purchasing the manufacturer's vehicles during the third and fourth quarters of the phase-out period may claim only 25 percent of the otherwise allowable credit. No credit is available for vehicles purchased after the last day of the fourth quarter of the phase-out period.

Notice 2006–9, 2006–6 I.R.B. 413, provides procedures for a vehicle manufacturer (or, in the case of a foreign vehicle manufacturer, its domestic distributor) to certify to the Internal Revenue Service (Service) both (1) that a particular make, model, and model year of vehicle qualifies for either the new advanced lean burn technology motor vehicle credit or the new qualified hybrid motor vehicle credit and (2) the amount of the credit allowable with respect to that vehicle.

Section 5.05 of Notice 2006–9 requires a manufacturer (or, in the case of a foreign vehicle manufacturer, its domestic distributor) that has received from the Service an acknowledgement of its certification for a particular make, model, and model year of vehicle to submit to the Service a report of the number of qualified vehicles sold by the manufacturer (or, in the case of a foreign vehicle manufacturer, its domestic distributor) to retail dealers during the calendar quarter. A qualified vehicle is defined for this purpose as any passenger automobile or light truck that is a new advanced lean burn technology motor vehicle or a new qualified hybrid motor vehicle.

In accordance with the section 5.05 of Notice 2006–9, Toyota Motor Sales, U.S.A., Inc. has submitted quarterly reports that indicate that its cumulative sales of qualified vehicles to retail dealers reached the 60,000-vehicle limit during the calendar quarter ending June 30, 2006. Accordingly, the credit for all new advanced lean burn technology motor vehicles or new qualified hybrid passenger automobiles or light trucks manufactured by Toyota Motor Corporation will begin to phase out on October 1, 2006.

SECTION 3. SCOPE OF NOTICE

This notice applies to any make, model, or model year of new advanced lean burn technology motor vehicle or new qualified hybrid passenger automobile or light truck that is—

(1) manufactured by Toyota Motor Corporation; and

(2) purchased for use or lease in the United States on or after October 1, 2006.

SECTION 4. Credit Amount

.01 *In general*. If a new advanced lean burn technology motor vehicle or new qualified hybrid passenger automobile or light truck manufactured by Toyota Motor Corporation is purchased for use or lease after September 30, 2006, the allowable credit is as follows:

(1) For vehicles purchased for use or lease on or after October 1, 2006, and on or before March 31, 2007, the credit is 50 percent of the otherwise allowable amount determined under § 30B(c) or (d) (whichever is applicable);

(2) For vehicles purchased for use or lease on or after April 1, 2007, and on or before September 30, 2007, the credit is 25 percent of the otherwise allowable amount determined under § 30B(c) or (d) (whichever is applicable); and

(3) For vehicles purchased for use or lease on or after October 1, 2007, no credit is allowable.

.02 Certified Vehicles. The following tables set forth the credit available on or after October 1, 2006, for hybrid motor vehicles for which Toyota Motor Sales, U.S.A., Inc. received an acknowledgement of its certification from the Service on or before September 19, 2006:

Table 1

October 1, 2006 — March 31, 2007		
Model Year	**Model**	**Credit Amount**
2005	Prius	$1,575
2006	Prius	$1,575
2006	Highlander 4WD Hybrid	$1,300
2006	Highlander 2WD Hybrid	$1,300
2006	Lexus RX400h 2WD	$1,100
2006	Lexus RX400h 4WD	$1,100
2007	Camry Hybrid	$1,300
2007	Lexus GS 450h	$775

Table 2

April 1, 2007 — September 30, 2007		
Model Year	**Model**	**Credit Amount**
2005	Prius	$787.50
2006	Prius	$787.50
2006	Highlander 4WD Hybrid	$650
2006	Highlander 2WD Hybrid	$650
2006	Lexus RX400h 2WD	$550
2006	Lexus RX400h 4WD	$550
2007	Camry Hybrid	$650
2007	Lexus GS 450h	$387.50

Table 3

On or after October 1, 2007		
Model Year	**Model**	**Credit Amount**
2005	Prius	$0.00
2006	Prius	$0.00
2006	Highlander 4WD Hybrid	$0.00
2006	Highlander 2WD Hybrid	$0.00
2006	Lexus RX400h 2WD	$0.00
2006	Lexus RX400h 4WD	$0.00
2007	Camry Hybrid	$0.00
2007	Lexus GS 450h	$0.00

The principal author of this notice is Nicole R. Cimino of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Ms. Cimino at (202) 622–3120 (not a toll-free call).

Guidance on the Application of Section 911 to U.S. Individuals Working at Guantanamo Bay

Notice 2006–84

This notice provides guidance regarding the application of section 911 of the Internal Revenue Code to U.S. citizens and residents earning income from performing services at the U.S. Naval Base at Guantanamo Bay.

Section 911(a) of the Code allows a qualified individual to elect to exclude from gross income his or her foreign earned income (as defined in section 911(b)) and housing cost amount. Section 911(d)(1) generally defines a "qualified individual" as a U.S. citizen or resident whose tax home is in a foreign country and who meets certain requirements of residence or presence in a foreign country. Section 1.911–3(a) of the Income Tax Regulations defines foreign earned income as earned income from sources within a foreign country (as defined in section 1.911–2(h) of the regulations) that is earned during a period for which the individual qualifies under section 1.911–2(a) to make an election. Earned income is from sources within a foreign country if it is attributable to services performed by an individual in a foreign country or countries. Section 1.911–2(h) provides, in part, that the term "foreign country" when used in a geographical sense includes any territory under the sovereignty of a government other than that of the United States. Section 911(b)(1)(B) excludes from the definition of foreign earned income certain amounts, including amounts paid by the United States or an agency thereof to an employee of the United States or an agency thereof.

Section 911(d)(8)(A) of the Code provides, generally, that if travel (or any transaction in connection with such travel) with respect to any foreign country is proscribed by certain regulations during any period, then: (1) foreign earned income does not include income from sources within that country attributable to services performed during that period; (2) housing expenses do not include any expenses allocable to such period for housing in that country, or for housing of the taxpayer's spouse or dependents in another country while the taxpayer is present in that country; and (3) an individual is not treated as a *bona fide* resident of, or as present in, a foreign country for any day during which the individual was present in that country during that period. The regulations identified in section 911(d)(8)(A) are those promulgated pursuant to the Trading With the Enemy Act ("TWEA"), 50 U.S.C. App. 1 *et seq*., or the International Emergency Economic Powers Act, 50 U.S.C. 1701 *et seq*., that include provisions generally prohibiting U.S. citizens and residents from engaging in transactions related to travel to, from, or within certain foreign countries. Section 911(d)(8)(B). Section 911(d)(8)(C), however, provides that the limitations of section 911(d)(8)(A) do not apply to any individual during any period in which such individual's activities are not in violation of these regulations.

In 1963, the Department of the Treasury's Office of Foreign Assets Control ("OFAC") issued the Cuban Assets Control Regulations (the "CACR"), 31 C.F.R. part 515. The CACR were issued pursuant to TWEA. Section 515.201(b)(1) of the CACR prohibits persons subject to United States jurisdiction from all dealings in any property in which Cuba or a Cuban national has or has had an interest since July 8, 1963, unless authorized by OFAC. OFAC interprets this prohibition to include a prohibition on all transactions related to travel to, from, and within Cuba. *See, e.g.*, § 515.560 of the CACR, which authorizes certain transactions related to travel to, from, and within Cuba for participation in certain activities.

Section 911(d)(8) of the Code was enacted as part of the Tax Reform Act of 1986 (Pub. L. No. 99–514, 1986–3 C.B. 1, 481). The Report of the Senate Committee on Finance (S. Rep. No. 99–313, 99th Cong., 2d Sess. 389 (1986)) listed Cuba as one of the countries for which Treasury regulations proscribed transactions related to travel of U.S. citizens and residents. Section 911(d)(8) continues to apply to Cuba. See, Rev. Rul. 2005–3, 2005–1 C.B. 334.

After consultations with OFAC, the IRS and Treasury have determined that for purposes of section 911(d)(8) of the Code, the CACR do not proscribe transactions related to travel, to, from, or within the U.S. Naval Base at Guantanamo Bay. For purposes of determining whether an individual's earned income is from sources within a foreign country for the purpose of section 911(b) and section 1.911–3(a) of the regulations, however, the individual who is performing services at the U.S. Naval Base at Guantanamo Bay is performing services within a foreign country. See section 1.911–2(h).

Accordingly, under section 911(d)(8)(C) of the Code, the limitations of section 911(d)(8)(A) do not apply to qualified individuals who are performing services at the U.S. Naval Base at Guantanamo Bay. Therefore, such individuals are eligible for the exclusion under section 911 provided that they meet the other requirements of that section.

The principal author of this notice is Kate Y. Hwa of the Office of Associate Chief Counsel (International). For further information regarding this notice, contact Kate Y. Hwa at (202) 622–3840 (not a toll-free call).

Treatment Under Section 367(b) of Property Used to Purchase Parent Stock in Certain Triangular Reorganizations

Notice 2006–85

SECTION 1. OVERVIEW

This notice announces that the Internal Revenue Service (IRS) and the Treasury Department (Treasury) will issue regulations under section 367(b) of the Internal Revenue Code that address certain triangular reorganizations under section 368(a) involving one or more foreign corporations. This notice is issued in response to comments and specific requests for guidance regarding certain transactions that are designed to avoid U.S. income tax, including tax on the repatriation of a subsidiary's earnings. The transactions generally involve a subsidiary purchasing its parent's stock for property and then transferring the stock in exchange for the stock or assets of a corporation in a triangular reorganization under section 368(a). In general, and as described below, the regulations issued pursuant to this notice will apply to transactions occurring on or after September 22, 2006.

The IRS and Treasury recently finalized §1.367(b)–4(b)(1)(ii), which may apply to

certain (but not all) of the triangular reorganizations described in this notice. That final regulation under section 367(b) appropriately addressed the treatment of the majority of relevant triangular reorganizations. While the IRS and Treasury were aware of the transactions covered by this notice at that time, the decision was made to address these transactions comprehensively in separate guidance.

The following definitions apply for purposes of this notice. A "triangular reorganization" is a forward triangular merger, a triangular C reorganization, a reverse triangular merger, or a triangular B reorganization, as those terms are defined in §1.358–6(b)(2)(i) through (iv), respectively, or a reorganization described in section 368(a)(1)(G) and (a)(2)(D). In addition, P, S, and T are corporations described in §1.358–6(b)(1)(i) through (iii), respectively. Finally, the term "property" means money, securities, and any other property, except that the term does not include stock in S.

SECTION 2. TRANSACTIONS AT ISSUE

The IRS and Treasury are aware that certain taxpayers are engaging in triangular reorganizations involving foreign corporations that result in a tax-advantaged transfer of property from S to P. The transaction is often structured as a triangular B reorganization, but could also be structured as a triangular C reorganization or another type of triangular reorganization. For example, assume P, a domestic corporation, owns 100 percent of S, a foreign corporation, and S1, a domestic corporation. S1 owns 100 percent of T, a foreign corporation. S purchases P stock for either cash or a note, and provides the P stock to S1 in exchange for all the T stock in a triangular B reorganization.

Taxpayers take the position that (i) when P sells its stock to S for cash or a note, P recognizes no gain or loss on the sale under section 1032, (ii) S takes a cost basis in the P shares under section 1012, and (iii) S recognizes no gain under §1.1032–2(c) upon the transfer of the P shares immediately thereafter because the basis and fair market value of the shares are equal. Thus, taxpayers take the position that the cash or note used by S to acquire the P stock does not result in a distribution under section 301. Furthermore, taxpayers do not include in income amounts under section 951(a)(1)(B) because S acquires and disposes of the P stock before the close of a quarter of the taxable year, which is the time at which to measure P's share of the average amount of United States property held by S. *See* section 956(a)(1)(A). Finally, under §1.367(b)–4(b)(1)(ii), S1 does not include in income as a deemed dividend the section 1248 amount attributable to the T stock that S1 exchanges.

The IRS and Treasury believe that the taxpayers' characterization of these transactions raises significant policy concerns, particularly when either P or S (or both) is a foreign corporation (regardless of whether T is related to P and S before the transaction). For example, when P is domestic and S is foreign, as in the example described above, the transaction could have the effect of repatriating foreign earnings of S to P without a corresponding dividend to P that would be subject to U.S. income tax. Similarly, where P is foreign and S is domestic, the transaction could have the effect of repatriating S's U.S. earnings to its foreign parent in a manner that is not subject to U.S. withholding tax. This variation of the transaction also raises U.S. earnings stripping issues where S uses a note to purchase all or a portion of the P stock. Moreover, where both P and S are foreign, the transactions may have the effect of avoiding income inclusions to certain U.S. shareholders of P that would be subject to U.S. income tax under the subpart F provisions, absent the application of an exception, such as under section 954(c)(6). In addition, foreign-to-foreign transactions of this type can be used to facilitate the subsequent repatriation of foreign earnings to U.S. shareholders without U.S. income tax.

SECTION 3. BACKGROUND

.01 Triangular reorganizations

Section 368 defines the term "reorganization." Sections 368(a)(1)(B), 368(a)(1)(C), 368(a)(1)(G), 368(a)(2)(D), and 368(a)(2)(E) describe certain reorganizations in which P stock may be used by S as the consideration issued in exchange for T's stock or assets, as applicable.

Section 1032 provides that no gain or loss will be recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation. Section 1.1032–2(b) provides that in the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization, P stock provided by P to S, or directly to T or T's shareholders on behalf of S, pursuant to the plan of reorganization is treated as a disposition by P of shares of its own stock. However, §1.1032–2(c) provides that S must recognize gain or loss in the above transactions on its exchange of P stock for T stock or assets if S did not receive the P stock from P pursuant to the plan of reorganization. Section 361 provides that S does not recognize gain or loss on the P stock that it exchanges for T stock in a reverse triangular merger.

Section 361(a) provides that no gain or loss shall be recognized by T if it exchanges property in pursuance of the plan of reorganization solely for stock or securities in P. Section 361(c) provides that no gain or loss shall be recognized to T on the distribution to its shareholders of P stock received from P in pursuance of the plan of reorganization.

Section 354 provides that no gain or loss shall be recognized by T shareholders if stock or securities in T are, in pursuance of the plan of reorganization, exchanged solely for stock or securities of P. Section 356 applies to T shareholders in cases where they receive other property in addition to the property permitted to be received under section 354.

Section 358 provides rules for determining the T shareholders' bases in their P stock following triangular reorganizations. Sections 1.358–6 and 1.367(b)–13 provide rules for determining P's basis in its S or T stock, as applicable. If P files a consolidated return with S or T, other basis rules apply. *See* Treas. Reg. §1.1502–30 or 1.1502–31.

.02 Section 367

Section 367(a)(1) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be

a corporation. The Secretary has broad authority under section 367(a)(2), (3), and (6) to provide that section 367(a)(1) will not apply to certain transfers described therein.

In the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), section 367(b)(1) provides that a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing, among other things, the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to basis of stock or securities.

.03 Distributions of property

Section 301(c)(1) provides that a distribution of property by a corporation to its shareholder with respect to its stock is included in the shareholder's gross income to the extent the distribution constitutes a dividend under section 316. Section 316 defines a dividend as a distribution out of a corporation's current and accumulated earnings and profits. To the extent the distribution is not a dividend, the shareholder reduces basis in the distributing corporation's stock, and any amount of the distribution in excess of the shareholder's basis is treated as gain from the sale or exchange of the corporation's stock. *See* section 301(c)(2) and (3).

Certain transactions that are exchanges in form can be treated as distributions for tax purposes. Section 304 generally provides that when a shareholder transfers stock of a controlled corporation to another controlled corporation in exchange for property, the two legs of the exchange are bifurcated and the receipt of the property by the shareholder is treated as a distribution. Section 304, by its terms, does not apply to the transfer by a shareholder of its own stock to a controlled corporation in exchange for property, even though the economic effect of that transaction is essentially identical.

Other transactions may result in deemed distribution treatment in certain circumstances. For example, a shareholder that exchanges common stock of a corporation for common stock and property pursuant to a recapitalization will be treated as receiving a distribution of property with respect to its stock under section 301 if in substance the distribution is a separate transaction. *See* Treas. Reg. §1.301–1(l); *see also*, *Bazley v. Comm'r*, 331 U.S. 737 (1947).

.04 Distributions involving foreign corporations or foreign shareholders

The treatment of a distribution varies depending upon whether the corporation or shareholder is domestic or foreign. A distribution from a foreign corporation to a shareholder that is a U.S. person resulting in a dividend under sections 301(c)(1) and 316, or gain from the sale or exchange of property under section 301(c)(3), generally is subject to U.S. income tax, with potential offset by foreign tax credits.

A distribution from a domestic corporation to a shareholder that is not a U.S. person resulting in a dividend is generally taxable under section 871 or 881 at a rate of 30 percent, subject to reduction under an applicable treaty, and the domestic corporation is responsible for withholding tax under section 1441 or 1442. To the extent such a distribution results in gain from the sale or exchange of property to the foreign shareholder under section 301(c)(3), such amounts are subject to U.S. income tax under section 897(a) if the distributing corporation had been a United States real property holding corporation (as defined in section 897(c)(2)) within the past five years. In such a case, the gain is subject to U.S. income tax as income effectively connected with the conduct of a trade or business within the United States.

Finally, a distribution from a foreign corporation to a shareholder that is a controlled foreign corporation, within the meaning of section 957, resulting in a dividend or gain from the sale or exchange of property to the foreign shareholder under section 301(c)(3) may also be subject to U.S. income tax. For example, such amounts may constitute subpart F income and therefore result in an income inclusion under section 951(a)(1)(A) to U.S. shareholders, within the meaning of section 951(b), of the controlled foreign corporation, subject to certain exceptions. *See, e.g.*, section 954(c)(6).

SECTION 4. APPLICATION OF SECTION 367(b)

Congress enacted section 367(b) to ensure that international tax considerations are adequately addressed when the subchapter C provisions apply to certain nonrecognition exchanges involving foreign corporations. This provision was necessary because the subchapter C provisions were enacted largely to address transactions involving domestic corporations and shareholders that are United States persons. As a result, the subchapter C provisions do not fully account for international tax concerns that arise when the provisions apply to transactions involving foreign corporations or shareholders that are not U.S. persons.

In enacting section 367(b), Congress noted that "it is essential to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings...." H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975). In addition, because determining the proper interaction of the Code's international and subchapter C provisions is "necessarily highly technical," Congress granted the Secretary broad regulatory authority to provide the "necessary or appropriate" rules to prevent the avoidance of Federal income taxes, rather than enacting a more comprehensive statutory regime. *Id.* This broad grant of authority has been exercised on numerous occasions to address a wide range of international policy concerns. *See, e.g.*, Treas. Reg. §§1.367(b)–4(b)(1) (preserving section 1248 amounts), (b)(2) (addressing trafficking in foreign tax credits by use of preferred stock), –5(b)(1)(ii) (ensuring section 311(b) gain is recognized by a domestic corporation when it distributes stock of a controlled foreign corporation to an individual distributee under section 355), and –7 (addressing the carryover of tax attributes in a foreign-to-foreign section 381 transaction).

In a triangular reorganization, the exchange by the T shareholders of their T stock for P stock is described in section 354 or 356. As a result, a triangular reorganization involving a foreign corporation is described in section 367(b) and, therefore, may be subject to regulations issued under the broad regulatory authority granted therein. It is on this basis that regulations will be issued to address the triangular reorganizations covered by this notice.

SECTION 5. REGULATIONS TO BE ISSUED UNDER SECTION 367(b)

The IRS and Treasury will issue regulations under section 367(b) to address certain triangular reorganizations involving foreign corporations. The regulations will apply to triangular reorganizations where P or S (or both) is foreign and, pursuant to the reorganization, S acquires from P, in exchange for property, all or a portion of the P stock that is used to acquire the stock or assets of T (T could be either related or unrelated to P and S before the transaction). In such a case, the regulations under section 367(b) will make adjustments with respect to P and S such that the property transferred from S to P in exchange for P stock will have the effect of a distribution of property from S to P under section 301(c) that is treated as separate from the transfer by P of the P stock to S pursuant to the reorganization. The adjustments will be made notwithstanding the fact that section 1032 otherwise applies to the reorganization. Therefore, the regulations will require, as appropriate, an inclusion in P's gross income as a dividend, a reduction in P's basis in its S or T stock, and the recognition of gain by P from the sale or exchange of property. The regulations will also provide for appropriate corresponding adjustments to be made, such as a reduction of S's earnings and profits as a result of the distribution (consistent with the principles of section 312). The regulations will also address similar transactions in which S acquires the P stock used in the reorganization from a related party that purchased the P stock in a related transaction.

SECTION 6. EFFECTIVE DATE

In general, the regulations to be issued under section 367(b) that are described in section 5 of this notice will apply to transactions occurring on or after September 22, 2006. The regulations described in this notice will not, however, apply to a transaction that was completed on or after September 22, 2006, provided the transaction was entered into pursuant to a written agreement which was (subject to customary conditions) binding before September 22, 2006 and all times thereafter.

No inference is intended as to the treatment of transactions described herein under current law, and the IRS may, where appropriate, challenge such transactions under applicable provisions or judicial doctrines.

SECTION 7. COMMENTS

The IRS and Treasury request comments on the regulations to be issued under this notice. Specifically, comments are requested as to whether in certain cases it is appropriate to provide an exception from the treatment described in this notice. In addition, comments are requested as to the source and timing of the adjustments to be made with respect to P and S under the regulations to be issued.

The IRS and Treasury also request comments regarding transactions that are not described in section 5 of this notice. For example, comments are requested on transactions where S or P is foreign and S purchases P stock from a person unrelated to P (for example, from the public on the open market), or where S acquires the P stock in a transaction that is unrelated to the triangular reorganization. Finally, the IRS and Treasury request comments on the treatment of transactions similar to those described in this notice that do not qualify as reorganizations (for example, because S issues minimal consideration to T in a transaction that would otherwise qualify as a reorganization under section 368(a)(1)(B)). Any regulations issued to address transactions that are not described in section 5 of this notice will apply prospectively.

SECTION 8. DRAFTING INFORMATION

The principal authors of this notice are Daniel McCall of the Office of Associate Chief Counsel (International) and Sean McKeever of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury participated in its development. For further information regarding this notice, contact Mr. McCall at (202) 622–3860 (not a toll-free call). For comments or questions regarding subchapter C issues, contact Mr. McKeever at (202) 622–7750.

"Tie-breaking" Rule for Two or More Taxpayers Claiming a Child as a Qualifying Child

Notice 2006–86

PURPOSE

This notice provides interim guidance under § 152(c)(4) of the Internal Revenue Code, the rule for determining which taxpayer may claim a qualifying child when two or more taxpayers claim the same child under any of the following provisions: (1) head of household filing status under § 2(b), (2) the child and dependent care credit under § 21, (3) the child tax credit under § 24, (4) the earned income credit under § 32, (5) the exclusion for dependent care assistance under § 129 (which incorporates by reference the definition of qualifying child or other qualifying individual under § 21), and (6) the dependency deduction under § 151. This notice clarifies that, unless the special rule in § 152(e) applies, the tie-breaking rule in § 152(c)(4) applies to these provisions as a group, rather than on a section-by-section basis.

Section 152 was amended by § 201 of the Working Families Tax Relief Act of 2004 (WFTRA), Pub. L. No. 108–311, 118 Stat. 1169, effective for taxable years beginning after December 31, 2004. The Internal Revenue Service and Treasury Department intend to issue regulations consistent with the guidance contained in this notice. The guidance in this notice applies until those regulations are effective.

BACKGROUND

Definition of a qualifying child

Section 151 allows a taxpayer a deduction of the exemption amount for each individual who is a dependent (as defined in § 152) of the taxpayer for the taxable year.

Under § 152(a), a dependent is a qualifying child or qualifying relative.

Section 152(c)(1) defines a qualifying child as an individual who (A) bears a certain relationship to the taxpayer (child, brother, sister, stepbrother, stepsister or descendant of any of those relatives), (B) has the same principal place of abode as the taxpayer for more than one-half of the taxable year, (C) meets certain age requirements, and (D) does not provide over one-half of the child's own support for the calendar year in which the taxable year of the taxpayer begins.

WFTRA establishes a uniform definition of a qualifying child under § 152(c) for determining whether a taxpayer qualifies for head of household filing status, the child and dependent care credit, the child tax credit, the earned income credit, and the dependency deduction. *See* §§ 2(b)(1)(A)(i), 21(b)(1)(A), 24(c), 32(c)(3), and 151, respectively, and H.R. Conf. Rep. No. 696, 108th Cong., 2d Sess. 55–65 (2004). The uniform definition also applies in determining whether a taxpayer qualifies for the income exclusion under § 129, which defines dependent care assistance by reference to employment-related expenses (as defined in § 21(b)(2)) for the care of a qualifying child or other qualifying individual.

"Tie-breaking" rule

Section 152(c)(4) provides a tie-breaking rule for determining which taxpayer may claim a qualifying child as a qualifying child when two or more taxpayers claim the same child for a taxable year beginning in the same calendar year. The general rule of § 152(c)(4)(A) applies if one or no taxpayer claiming the child is the child's parent. Under § 152(c)(4)(A), the child is treated as the qualifying child of (i) the taxpayer who is the child's parent, or (ii) if none of the taxpayers is the child's parent, the taxpayer with the highest adjusted gross income for that taxable year.

The rule of § 152(c)(4)(B) applies if both taxpayers claiming the child as a qualifying child are the child's parents who do not file a joint return together. Under § 152(c)(4)(B), the child is treated as the qualifying child of the parent with whom the child resides for the longer period of time during the taxable year. If the child resides with both parents for the same amount of time during the taxable year, the child is treated as the qualifying child of the parent with the higher adjusted gross income for that taxable year.

Special rule for certain noncustodial parents

Notwithstanding the rule of §152(c)(4)(B), a child may be treated as the qualifying child of the noncustodial parent, for certain purposes, under the special rule of § 152(e). The noncustodial parent may claim the child as a qualifying child under § 152(e), if:

(1) the child is in the custody of one or both parents for more than one-half of the calendar year;

(2) the child receives over one-half of the child's support during the calendar year from the child's parents;

(3) the parents—

(a) are divorced or 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; and

(4) the custodial parent releases the claim to the exemption to the noncustodial parent in a written declaration that the noncustodial parent attaches to the noncustodial parent's tax return.

Section 152(e)(4) defines "custodial parent" as the parent having custody of the child for the greater portion of the calendar year, and "noncustodial parent" as the parent who is not the custodial parent.

The special rule of § 152(e) allows a noncustodial parent to claim the child as a qualifying child only for purposes of the child tax credit under § 24 and the dependency deduction under § 151. Section 152(e) does not apply to determinations under §§ 2(b), 21(b) and 129 (see § 21(e)(5)), and 32(c)(3).

APPLICATION

Except to the extent that § 152(e) applies, under § 152(c)(4), when more than one taxpayer claims a child as a qualifying child, the child is treated as the qualifying child of only one taxpayer for all the provisions that employ the uniform definition of a qualifying child (head of household filing status under § 2(b), the child and dependent care credit under § 21, the child tax credit under § 24, the earned income credit under § 32, the exclusion for dependent care assistance under § 129, and the dependency deduction under § 151). This rule is applied to these provisions as a group, rather than on a section-by-section basis.

If § 152(e) applies, a child may be treated as the qualifying child of two taxpayers. A noncustodial parent may claim the child as a qualifying child under § 152(e) only for purposes of the child tax credit under § 24 and the dependency deduction under § 151. However, the noncustodial parent may not claim the child as a qualifying child under § 152(e) in determining head of household filing status under § 2(b), the earned income credit under § 32, the child and dependent care credit under § 21, or the exclusion from income for dependent care assistance under § 129. Only the custodial parent (or other eligible taxpayer) may claim the child as a qualifying child for those purposes.

EXAMPLES

In the examples below, each individual is a citizen of the United States and uses a calendar taxable year, and the child is a qualifying child (as defined in § 152(c)) of each taxpayer. Unless otherwise indicated, these examples assume that each individual meets the other requirements for claiming a benefit described in the example.

Example 1. (i) A child, mother, and grandmother share the same principal place of abode. The mother is not married and is not the qualifying child of the grandmother, and the grandmother is not the mother's dependent.

(ii) The mother claims the child as a qualifying child for purposes of the earned income credit under § 32.

(iii) The child is treated as the qualifying child of the mother for purposes of the earned income credit. Because the mother claims the child as a qualifying child for purposes of the earned income credit, under § 152(c)(4)(A), the child may not be treated as the qualifying child of the grandmother for any purpose.

(iv) If, however, the mother does not claim the child as a qualifying child for any purpose, the child may be treated as the qualifying child of the grandmother for purposes of the earned income credit under § 32 as well as head of household filing status under § 2(b), the dependency deduction under § 151, the child tax credit under § 24, the child and dependent care credit under § 21, and the exclusion from income for dependent care assistance under § 129, if applicable, assuming that no other taxpayer claims the child as a qualifying child.

Example 2. (i) The facts are the same as in *Example 1*, except that the mother and father of the child are divorced, the father is the noncustodial parent, the

mother has released the claim to the exemption to the father in a written declaration under § 152(e), and the father attaches the written declaration to his return and claims the child as a qualifying child for purposes of the dependency deduction and the child tax credit.

(ii) Under § 152(e), the child is treated as the qualifying child of the father for purposes of the dependency deduction and the child tax credit. The child is treated as the qualifying child of the mother for purposes of the earned income credit and, if applicable, head of household filing status, the child and dependent care credit, and the exclusion from income for dependent care assistance. The child may not be treated as the qualifying child of the grandmother for any purpose.

Example 3. (i) The father and mother of a child are married to each other. The father, mother, and child share the same principal place of abode for the first 8 months of the year. For the last 4 months of the year, the parents live apart from each other, and the mother and child share the same principal place of abode. The parents file separate tax returns for the taxable year. Consequently, neither parent may claim head of household filing status, an earned income credit, or a child and dependent care credit, because in general § 2(b) applies only to unmarried individuals, while §§ 32(d) and 21(e)(2), respectively, require married individuals to file a joint return.

(ii) The father claims the child as a qualifying child for purposes of the dependency deduction under § 151 and the exclusion for dependent care assistance under § 129. The mother claims the child as a qualifying child for purposes of the dependency deduction under § 151, the child tax credit under § 24, and the exclusion for dependent care assistance under § 129.

(iii) Under the tie-breaking rule of § 152(c)(4)(B), the child is treated as the qualifying child of the mother because the child resided with the mother for the longer period of time during the taxable year. Therefore, the child is the qualifying child of the mother for purposes of the dependency deduction, the child tax credit, and the exclusion for dependent care assistance. Section 152(e) does not apply because the mother and father are not divorced or separated under a decree of separate maintenance or written separation agreement at the end of the taxable year and did not live apart for the last 6 months of the calendar year. Therefore, the child may not be treated as the qualifying child of the father for any purpose.

(iv) If, however, the mother does not claim the child as a qualifying child for any purpose, the child is treated as the qualifying child of the father for purposes of the dependency deduction under § 151 and the exclusion for dependent care assistance under § 129.

Example 4. (i) The facts are the same as in *Example 3*, except that the mother and father are separated under a written separation agreement at the end of the taxable year, the mother is the custodial parent and has released the claim to the exemption to the father in a written declaration under § 152(e), and the father attaches the Form 8332 to his return and claims the child as a qualifying child for purposes of the dependency deduction, the child tax credit, and the exclusion for dependent care assistance under § 129.

(ii) Because § 152(e) applies, the child is treated as the qualifying child of the father for purposes of the dependency deduction and the child tax credit. The child is not treated as the qualifying child of the father for purposes of the exclusion for dependent care assistance because the father is the noncustodial parent and, under § 21(e)(5), only the custodial parent may claim the child as a qualifying child for purposes of the exclusion for dependent care assistance. Therefore, the tie-breaking rule of § 152(c)(4)(B) applies, and the child is treated as the qualifying child of the mother for purposes of the exclusion for dependent care assistance.

Example 5. (i) The father and mother of two children are married to each other. The father, mother, and both children share the same principal place of abode for the entire year. The father and mother file separate tax returns for the taxable year. Consequently, neither parent may claim head of household filing status, an earned income credit, or a child and dependent care credit, because in general § 2(b) applies only to unmarried individuals, while §§ 32(d) and 21(e)(2), respectively, require married individuals to file a joint return.

(ii) The father claims the older child as a qualifying child for purposes of the child tax credit, dependency deduction, and exclusion for dependent care assistance. The mother claims the younger child as a qualifying child for purposes of the child tax credit, dependency deduction, and exclusion for dependent care assistance.

(iii) The older child is treated as the qualifying child of the father and the younger child is treated as the qualifying child of the mother. The tie-breaking rule of § 152(c)(4)(B) does not apply because no two taxpayers are claiming the same child as a qualifying child for any of the benefits.

EFFECTIVE DATE

This notice applies to taxable years beginning after December 31, 2004.

DRAFTING INFORMATION

The principal author of this notice is Victoria Driscoll of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this notice, contact Ms. Driscoll at (202) 622–4920.

Part IV. Items of General Interest

Notice of Proposed Rulemaking and Notice of Public Hearing

Section 1221(a)(4) Capital Asset Exclusion for Accounts and Notes Receivable

REG–109367–06

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that clarify the circumstances in which accounts or notes receivable are "acquired . . . for services rendered" within the meaning of section 1221(a)(4) of the Internal Revenue Code. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by November 6, 2006. Outlines of topics to be discussed at the public hearing scheduled for November 7, 2006, must be received by October 17, 2006.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–109367–06), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday, between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–109367–06), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically via the IRS Internet site at *www.irs.gov/regs* or via the Federal eRulemaking Portal at *www.regulations.gov/* (IRS–REG–109367–06). The public hearing will be held in the New Carrollton Auditorium, 5000 Ellin Road, Lanham, Maryland.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, K. Scott Brown (202) 622–3920 (not a toll-free number); concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, email: *Kelly.D.Banks@irscounsel.treas.gov.*

SUPPLEMENTAL INFORMATION:

Background and Explanation of Provisions

I. Section 1221(a)(4) Language, Legislative History, and Regulations

Section 1221 defines a capital asset as all property held by a taxpayer unless specifically excepted. Section 1221(a)(4) treats accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in section 1221(a)(1) as ordinary assets.

Congress enacted section 1221(a)(4) in 1954 to correct a character mismatch problem. Before its enactment, the value of accounts or notes receivable acquired for rendering services or selling inventory was taken into account by a taxpayer as ordinary income, but gain or loss on a later disposition of the receivables was given capital treatment. Section 1221(a)(4) corrected this mismatch by treating the accounts or notes receivable as ordinary assets.

The legislative history confirms this limited focus by referring explicitly to accounts and notes receivable acquired "in payment for" inventory or services rendered by the holder. The specific problem being addressed by the enactment of section 1221(a)(4) was described in the House Report:

> Paragraph (4) is a new provision which excepts from the definition of capital assets accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1), that is, stock in trade or inventory or property held for sale to customers in the ordinary course of trade or business. This will change present law treatment, for example, as follows: If a taxpayer acquires a note or account receivable in payment for inventory or services rendered, reports it as income and sells it at a discount, then this amendment will provide ordinary loss treatment. Under present law such loss treatment is only allowed if the taxpayer is also, in effect, a dealer in such accounts or notes. Alternatively, the taxpayer may sell the account or note for something more than the discounted value that was originally reported. Under present law this difference would be capital gain unless the taxpayer is such a dealer. The amendment will cause such gain to be ordinary income.

H. R. Rep. No. 1337, 83d Cong., 2d Sess., A273–74 (1954).

The longstanding regulation interpreting section 1221(a)(4) also confirms this limited focus. Section 1.1221–1(a) of the Income Tax Regulations states that the term *capital assets* includes all classes of property not specifically excluded by section 1221. Section 1.1221–1(d), which addresses the section 1221(a)(4) exclusion, repeats the statutory language of section 1221(a)(4) and then interprets it to apply as follows:

> Thus, if a taxpayer acquires a note receivable for services rendered, reports the fair market value of the note as income, and later sells the note for less than the amount previously reported, the loss is an ordinary loss. On the other hand, if the taxpayer later sells the note for more than the amount originally reported, the excess is treated as ordinary income.

II. Expansion of Section 1221(a)(4)

Notwithstanding the above, section 1221(a)(4) has been applied more expansively. The initial expansion occurred with respect to notes obtained in loan originations. In *Burbank Liquidating Corp. v. Commissioner*, 39 T.C. 999 (1963), *acq. sub nom. United Assocs., Inc.*, 1965–1 C.B. 3, *aff'd. in part and rev'd. in part on other grounds*, 335 F.2d 125 (9th Cir. 1964), the Tax Court held that mortgage loans originated by a savings and loan association in the ordinary course of its business were, in the hands of that association, ordinary assets under section 1221(a)(4) because they were notes receivable acquired for the service of making loans. In addition to acquiescing to the decision, the Service relied upon *Burbank Liquidating*

in a series of revenue rulings treating loans made by commercial lenders (including banks and REITs) as ordinary assets under section 1221(a)(4) when held by the original lender. See Rev. Rul. 72–238, 1972–1 C.B. 65; Rev. Rul. 73–558, 1973–2 C.B. 298; Rev. Rul. 80–56, 1980–1 C.B. 154; Rev. Rul. 80–57, 1980–1 C.B. 157. See §601.601(d)(2) of this chapter.

Historically, a lending transaction was sometimes thought of as rendering a service to the borrower. See Rev. Rul. 70–540, 1970–2 C.B. 101; Rev. Rul. 69–188, 1969–1 C.B. 54; Rev. Rul. 68–6, 1968–1 C.B. 325. That characterization, however, does not justify treating notes acquired by an originator in a lending transaction as ordinary assets under section 1221(a)(4). That treatment strains the language of the statute because the notes are not issued by borrowers solely or even predominantly for services rendered. Rather, the notes are, for the most part, issued by the borrower to the lender in exchange for money.

Subsequently, the Tax Court further extended the application of section 1221(a)(4) in *Federal National Mortgage Association v. Commissioner*, 100 T.C. 541 (1993) (*FNMA*), by applying that provision to notes that were purchased in transactions that the court considered closely associated with the process of origination. Although FNMA was not an originator, the court used the *Burbank Liquidating* analysis to extend section 1221(a)(4) treatment to mortgages purchased by FNMA. The court justified this result by pointing out that FNMA's purchasing activity was undertaken in accordance with its statutorily defined purpose "to provide supplementary assistance to the secondary market for home mortgages by providing a degree of liquidity for mortgage investments." *FNMA*, 100 T.C. at 545 (quoting the Housing Act of 1954, ch. 649, title II, section 201, 12 U.S.C. 1716(a)). Because of this purpose, the court concluded that the purchases were "a service to the mortgage lending business and the members thereof." *Id.* at 578.

The expansion of section 1221(a)(4) cannot be reconciled with Congress' stated purpose for enacting the statute. Acquisition of notes or mortgages using consideration other than services or section 1221(a)(1) property generally does not trigger current ordinary income and so does not create a potential for the character mismatch that concerned Congress when it enacted section 1221(a)(4).

The proposed regulation reflects a conclusion by the Treasury Department and the IRS that the extension of section 1221(a)(4) to notes acquired by a creditor in a lending transaction or to notes purchased in the secondary market is inconsistent with Congressional intent and is unsound as a matter of tax policy. In addition, the interpretation of section 1221(a)(4) set forth in *Burbank Liquidating* and *FNMA* impedes effective administration of the tax laws by causing the status of the notes to hinge on judgments as to whether the lending transaction or a subsequent secondary market purchase of the notes provides a service to the borrower or the mortgage lending industry. Reliance on judgments such as this fosters uncertainty and disputes.

Accordingly, the proposed regulation clarifies that an account or note receivable is not described in section 1221(a)(4) if, in exchange for the account or note receivable, the taxpayer provides more than *de minimis* consideration other than services or property described in section 1221(a)(1), or if the account or note receivable is not issued by the party acquiring the services or property described in section 1221(a)(1). In particular, a note is not acquired for services within the meaning of section 1221(a)(4) on the grounds that the taxpayer's act of acquiring (including originating) the account or note receivable constitutes, or includes, the provision of a service or services to the issuer of the account or note receivable, to the secondary market in which accounts or notes receivable of this sort may trade, or to the participants in that market.

Effect on Other Documents

Rev. Rul. 72–238 and Rev. Rul. 73–558 are not determinative with respect to future transactions because these rulings apply to taxable years beginning before July 12, 1969, and were superseded by section 582(c) of the Internal Revenue Code of 1986. Accordingly, simultaneously with the publication of these proposed regulations, those rulings are being declared obsolete. When final regulations are published, the IRS will determine whether Rev. Rul. 80–56 and 80–57 should similarly be declared obsolete.

Proposed Effective Date

These regulations are proposed to apply to accounts or notes receivable acquired after the date the final regulations are published in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entitles, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and IRS invite comments on the proposed effective date, on the impact of the proposed regulation on hedging practices of lending institutions or other taxpayers to which section 582(c) does not apply, and on appropriate measures to deal with that impact. Comments are specifically requested from taxpayers in the acceptance finance, debt collection, factoring and personal finance industries on any impact that the proposed regulation may have. The Treasury Department and the IRS also specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for November 7, 2006, beginning at 10 a.m. in the New Carrollton Auditorium, 5000

Ellin Road, Lanham, Maryland. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written or electronic comments and an outline of the topics to be discussed and the time to be devoted to each topic (a signed original and eight (8) copies) by October 17, 2006. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is K. Scott Brown, Office of the Associate Chief Counsel (Financial Institutions and Products). However, other personnel from the IRS and Treasury Department participated in their development.

* * * * *

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1221–1 is amended as follows:

1. Paragraph (e) is redesignated as (f).

2. A new paragraph (e) is added.

The addition reads as follows:

§1.1221–1 Meaning of terms.

* * * * *

(e)(1) An account or note receivable is not described in section 1221(a)(4) if—

(i) In acquiring the account or note receivable, the taxpayer provides more than *de minimis* consideration other than services or property described in section 1221(a)(1); or

(ii) The obligor under the account or note receivable is a person other than the person acquiring the services or property described in section 1221(a)(1).

(2) In particular, an account or note receivable is not described in section 1221(a)(4) on the grounds that the taxpayer's act of acquiring (including originating) the account or note receivable constitutes, or includes, the provision of a service or services to the issuer of the account or note receivable, to the secondary market in which accounts or notes receivable of this sort may trade, or to the participants in that market. If a lender, however, separately invoiced reasonable fees for services that the lender rendered to the borrower in connection with a lending transaction and if the lender received as evidence of the obligation to make payment of those fees an account or note receivable that is separate from the debt instrument that was originated in the lending transaction, then this paragraph (e)(2) does not prevent the separate account or note receivable from being described in section 1221(a)(4).

(3) This paragraph (e) applies to accounts or notes receivable acquired after the date the final regulations are published in the **Federal Register**.

* * * * *

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

(Filed by the Office of the Federal Register on August 4, 2006, 8:45 a.m., and published in the issue of the Federal Register for August 7, 2006, 71 F.R. 44600)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D. —Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z —Corporation.

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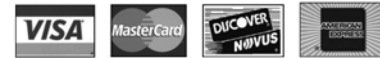

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