

(iii) If, within the taxpayer's taxable year within which such items are accrued by the taxpayer and 2 1/2 months after the close thereof, the amount of such items is not paid and the amount of such items is not otherwise (under the rules of constructive receipt) includible in the gross income of the payee.

(2) The provisions of section 267(a)(2) and this paragraph do not otherwise affect the general rules governing the allowance of deductions under an accrual method of accounting. For example, if the accrued expenses or interest are paid after the deduction has become disallowed under section 267(a)(2), no deduction would be allowable for the taxable year in which payment is made, since an accrual item is deductible only in the taxable year in which it is properly accruable.

(3) The expenses and interest specified in section 267(a)(2) and this paragraph shall be considered as paid for purposes of that section to the extent of the fair market value on the date of issue of notes or other instruments of similar effect received in payment of such expenses or interest if such notes or other instruments were issued in such payment by the taxpayer within his taxable year or within 2 1/2 months after the close thereof. The fair market value on the date of issue of such notes or other instruments of similar effect is includible in the gross income of the payee for the taxable year in which he receives the notes or other instruments.

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

Example. A, an individual, is the holder and owner of an interest-bearing note of the M Corporation, all the stock of which was owned by him on December 31, 1956. A and the M Corporation make their income tax returns for a calendar year. The M Corporation uses an accrual method of accounting. A uses a combination of accounting methods permitted under section 446(c)(4) in which he uses the cash receipts and disbursements method in respect of items of gross income. The M Corporation does not pay any interest on the note to A during the calendar year 1956 or within 2 1/2 months after the close of that year, nor does it credit any interest to A's account in such a manner that it is subject to his unqualified demand and thus is constructively received by him. M Corpora-

tion claims a deduction for the year 1956 for the interest accruing on the note in that year. Since A is on the cash receipts and disbursements method in respect of items of gross income, the interest is not includible in his return for the year 1956. Under the provisions of section 267(a)(2) and this paragraph, no deduction for such interest is allowable in computing the taxable income of the M Corporation for the taxable year 1956 or for any other taxable year. However, if the interest had actually been paid to A on or before March 15, 1957, or if it had been made available to A before that time (and thus had been constructively received by him), the M Corporation would be allowed to deduct the amount of the payment in computing its taxable income for 1956.

(c) *Scope of section.* Section 267(a) requires that deductions for losses or unpaid expenses or interest described therein be disallowed even though the transaction in which such losses, expenses, or interest were incurred was a bona fide transaction. However, section 267 is not exclusive. No deduction for losses or unpaid expenses or interest arising in a transaction which is not bona fide will be allowed even though section 267 does not apply to the transaction.

§ 1.267(a)-2T Temporary regulations; questions and answers arising under the Tax Reform Act of 1984 (temporary).

(a) *Introduction*—(1) *Scope.* This section prescribes temporary question and answer regulations under section 267(a) and related provisions as amended by section 174 of the Tax Reform Act of 1984, Pub. L. No. 98-369.

(2) *Effective date.* Except as otherwise provided by *Answer 2* or *Answer 3* in paragraph (c) of this section, the effective date set forth in section 174(c) of the Tax Reform Act of 1984 applies to this section.

(b) *Questions applying section 267(a)(2) and (b) generally.* The following questions and answers deal with the application of section 267(a)(2) and (b) generally:

Question 1: Does section 267(a)(2) ever apply to defer the deduction of an otherwise deductible amount if the person to whom the payment is to be made properly uses the completed contract method of accounting with respect to such amount?

Answer 1: No. Section 267(a)(2) applies only if an otherwise deductible amount is owed to a related person under whose method of accounting such amount is not includible in income unless paid to such person. Regardless of when payment is made, an amount owed to a contractor using the completed contract method of accounting is includible in the income of the contractor in accordance with §1.451-3(d) in the year in which the contract is completed or in which certain disputes are resolved.

Question 2: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible original issue discount as defined in sections 163(e) and 1271 through 1275 (“the OID rules”)?

Answer 2: No. Regardless of when payment is made, an amount owed to a lender that constitutes original issue discount is included in the income of the lender periodically in accordance with the OID rules. Similarly, section 267(a)(2) does not apply to defer an otherwise deductible amount to the extent section 467 or section 7872 requires periodic inclusion of such amount in the income of the person to whom payment is to be made, even though payment has not been made.

Question 3: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible unstated interest determined to exist under section 483?

Answer 3: Yes. If section 483 recharacterizes any amount as unstated interest and the other requirements of section 267(a)(2) are met, a deduction for such unstated interest will be deferred under section 267.

Question 4: Does section 267(a)(2) ever apply to defer the deduction of otherwise deductible cost recovery, depreciation, or amortization?

Answer 4: Yes, in certain cases. In general, section 267(a)(2) does not apply to defer the deduction of otherwise deductible cost recovery, depreciation, or amortization. Notwithstanding this general rule, if the other requirements of section 267(a)(2) are met, section 267(a)(2) does apply to defer deductions for cost recovery, depreciation, or amortization of an amount owed to a related person for interest or rent or for the performance or nonperformance of services, which amount the taxpayer payor capitalized or treated as a de-

ferred expense (unless the taxpayer payor elected to capitalize or defer the amount and section 267(a)(2) would not have deferred the deduction of such amount if the taxpayer payor had not so elected). Amounts owed for services that may be subject to this provision include, for example, amounts owed for acquisition, development, or organizational services or for covenants not to compete. In applying this rule, payments made between persons described in any of the paragraphs of section 267(b) (as modified by section 267(e)) will be closely scrutinized to determine whether they are made in respect of capitalized costs (or costs treated as deferred expenses) that are subject to deferral under section 267(a)(2), or in respect of other capitalized costs not so subject.

Question 5: If a deduction in respect of an otherwise deductible amount is deferred by section 267(a)(2) and, prior to the time the amount is includible in the gross income of the person to whom payment is to be made, such person and the payor taxpayer cease to be persons specified in any of the paragraphs of section 267(b) (as modified by section 267(e)), is the deduction allowable as of the day on which the relationship ceases?

Answer 5: No. The deduction is not allowable until the day as of which the amount is includible in the gross income of the person to whom payment of the amount is made, even though the relationship ceases to exist at an earlier time.

Question 6: Do references in other sections to persons described in section 267(b) incorporate changes made to section 267(b) by section 174 of the Tax Reform Act of 1984?

Answer 6: Yes. References in other sections to persons described in section 267(b) take into account changes made to section 267(b) by section 174 of the Tax Reform Act of 1984 (without modification by section 267(e)(1)). For example, a transfer after December 31, 1983 (the effective date of the new section 267(b)(3) relationship added by the Tax Reform Act of 1984) of section 1245 class property placed in service before January 1, 1981, from one corporation to another corporation, 11 percent of the stock of which is owned by the first

corporation, will not constitute recovery property (as defined in section 168) in the hands of the second corporation by reason of section 168(e)(4) (A)(i) and (D).

(c) *Questions applying section 267(a) to partnerships.* The following questions and answers deal with the application of section 267(a) to partnerships:

Question 1: Does section 267(a) disallow losses and defer otherwise deductible amounts at the partnership (entity) level?

Answer 1: Yes. If a loss realized by a partnership from a sale or exchange of property is disallowed under section 267(a)(1), that loss shall not enter into the computation of the partnership's taxable income. If an amount that otherwise would be deductible by a partnership is deferred by section 267(a)(2), that amount shall not enter into the computation of the partnership's taxable income until the taxable year of the partnership in which falls the day on which the amount is includible in the gross income of the person to whom payment of the amount is made.

Question 2: Does section 267(a)(1) ever apply to disallow a loss if the sale or exchange giving rise to the loss is between two partnerships even though the two partnerships are not persons specified in any of the paragraphs of section 267(b)?

Answer 2: Yes. If the other requirements of section 267(a)(1) are met, section 267(a)(1) applies to such losses arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) as follows, and § 1.267(b)-1(b) does not apply. If the two partnerships have one or more common partners (*i.e.*, if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the selling partnership's loss will be disallowed under section 267(a)(1). The amount disallowed under this rule is the greater of: (1) The amount that would be disallowed if the transaction giving rise to the loss had

occurred between the selling partnership and the separate partners of the purchasing partnership (in proportion to their respective interests in the purchasing partnership); or (2) the amount that would be disallowed if such transaction had occurred between the separate partners of the selling partnership (in proportion to their respective interests in the selling partnership) and the purchasing partnership. Notwithstanding the general rule of this paragraph (c) *Answer 2*, no disallowance shall occur if the amount that would be disallowed pursuant to the immediately preceding sentence is less than 5 percent of the loss arising from the sale or exchange.

Question 3: Does section 267(a)(2) ever apply to defer an otherwise deductible amount if the taxpayer payor is a partnership and the person to whom payment of such amount is to be made is a partnership even though the two partnerships are not persons specified in any of the paragraphs of section 267(b) (as modified by section 267(e))?

Answer 3: Yes. If the other requirements of section 267(a)(2) are met, section 267(a)(2) applies to such amounts arising as a result of transactions entered into after December 31, 1984 between partnerships not described in any of the paragraphs of section 267(b) (as modified by section 267(e)) as follows, and § 1.267(b)-1(b) does not apply. If the two partnerships have one or more common partners (*i.e.*, if any person owns directly, indirectly, or constructively any capital or profits interest in each of such partnerships), or if any partner in either partnership and one or more partners in the other partnership are persons specified in any of the paragraphs of section 267(b) (without modification by section 267(e)), a portion of the payor partnership's otherwise allowable deduction will be deferred under section 267(a)(2). The amount deferred under this rule is the greater of: (1) The amount that would be deferred if the transaction giving rise to the otherwise allowable deduction had occurred between the payor partnership and the separate partners of the payee partnership (in proportion to their respective interests in the payee partnership); or (2) the amount

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that would be deferred if such transaction had occurred between the separate partners of the payor partnership (in proportion to their respective interests in the payor partnership) and the payee partnership. Notwithstanding the general rule of this paragraph (c) *Answer 3*, no deferral shall occur if the amount that would be deferred pursuant to the immediately preceding sentence is less than 5 percent of the otherwise allowable deduction.

Example. On May 1, 1985, partnership AB enters into a transaction whereby it accrues an otherwise deductible amount to partnership AC. AC is on the cash receipts and disbursements method of accounting. A holds a 5 percent capital and profits interest in AB and a 49 percent capital and profits interest in AC, and A's interest in each item of the income, gain, loss, deduction, and credit of each partnership is 5 percent and 49 percent, respectively. B and C are not related. Notwithstanding that AB and AC are not persons specified in section 267(b), 49 percent of the deduction in respect of such amount will be deferred under section 267(a)(2). The result would be the same if A held a 49 percent interest in AB and a 5 percent interest in AC. However, if A held more than 50 percent of the capital or profits interest of either AB or AC, the entire deduction in respect of such amount would be deferred under section 267(a)(2).

Question 4: What does the phrase *incurred at an annual rate not in excess of 12 percent* mean as used in section 267(e)(5)(C)(ii)?

Answer 4: The phrase refers to interest that accrues but is not includible in the income of the person to whom payment is to be made during the taxable year of the payor. Thus, in determining whether the requirements of section 267(e)(5) (providing an exception to certain provisions of section 267 for certain expenses and interest of partnerships owning low income housing) are met with respect to a transaction, the requirement of section 267(e)(5)(C)(ii) will be satisfied, even though the total interest (both stated and unstated) paid or accrued in any taxable year of the payor taxpayer exceeds 12 percent, if the interest in excess of 12 percent per annum, compounded semi-annually, on the outstanding loan balance (principal and accrued but unpaid interest) is includible in the income of the person to whom payment is to be

made no later than the last day of such taxable year of the payor taxpayer.

(98 Stat. 704, 26 U.S.C. 267; 98 Stat. 589, 26 U.S.C. 706; 68A Stat. 367, 26 U.S.C. 1502; 68A Stat. 917, 26 U.S.C. 7805)

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§ 1.267(a)-3 Deduction of amounts owed to related foreign persons.

(a) *Purpose and scope.* This section provides rules under section 267(a) (2) and (3) governing when an amount owed to a related foreign person that is otherwise deductible under Chapter 1 may be deducted. Paragraph (b) of this section provides the general rules, and paragraph (c) of this section provides exceptions and special rules.

(b) *Deduction of amount owed to related foreign person—(1) In general.* Except as provided in paragraph (c) of this section, section 267(a)(3) requires a taxpayer to use the cash method of accounting with respect to the deduction of amounts owed to a related foreign person. An amount that is owed to a related foreign person and that is otherwise deductible under Chapter 1 thus may not be deducted by the taxpayer until such amount is paid to the related foreign person. For purposes of this section, a related foreign person is any person that is not a United States person within the meaning of section 7701(a)(30), and that is related (within the meaning of section 267(b)) to the taxpayer at the close of the taxable year in which the amount incurred by the taxpayer would otherwise be deductible. Section 267(f) defines *controlled group* for purposes of section 267(b) without regard to the limitations of section 1563(b). An amount is treated as paid for purposes of this section if the amount is considered paid for purposes of section 1441 or section 1442 (including an amount taken into account pursuant to section 884(f)).

(2) *Amounts covered.* This section applies to otherwise deductible amounts that are of a type described in section 871(a)(1) (A), (B) or (D), or in section 881(a) (1), (2) or (4). The rules of this section also apply to interest that is from sources outside the United States. Amounts other than interest that are from sources outside the United States, and that are not income of a related