

such section 38 property shall be treated as having ceased to be section 38 property with respect to the taxpayer to the extent of the amount of such reduction in basis (or cost) on the date the refund which results in such reduction in basis (or cost) is received or accrued, except that for purposes of § 1.47-1(a) the actual useful life of the property treated as having ceased to be section 38 property shall be considered to be less than 3 years.

(2) *Example.* Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. (i) On January 1, 1962, A, a cash basis taxpayer, acquired from X Cooperative an item of section 38 property with a basis of \$100 and an estimated useful life of 10 years which he placed in service on such date. The amount of qualified investment with respect to such asset was \$100. For the taxable year 1962 A was allowed under section 38 a credit of \$7 against his liability for tax. On June 1, 1963, A receives a \$10 patronage dividend from X Cooperative with respect to such asset. Under paragraph (c)(2)(i) of § 1.1385-1, the basis of the asset in A's hands is reduced by \$10.

(ii) Under subparagraph (1) of this paragraph, on June 1, 1963, the item of section 38 property ceases to be section 38 property with respect to A to the extent of \$10 of the original \$100 basis.

(d) *Retirements.* A retirement of section 38 property, including a normal retirement (as defined in paragraph (b) of § 1.167(a)-8, relating to definition of normal and abnormal retirements), whether from a single asset account or a multiple asset account, and an abandonment, are dispositions for purposes of paragraph (a) of § 1.47-1.

(e) *Conversion of section 38 property to personal use.* (1) If, for any taxable year subsequent to the credit year—

(i) A deduction for depreciation is allowable to the taxpayer with respect to only a part of section 38 property because such property is partially devoted to personal use, and

(ii) The part of the property (expressed as a percentage of its total basis (or cost)) with respect to which a deduction for depreciation is allowable for such taxable year is less than the part of the property with respect to which a deduction for depreciation was allowable in the credit year,

then such property shall be considered as having ceased to be section 38 property with respect to the taxpayer to such extent. Further, property ceases to be section 38 property with respect to the taxpayer to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to disallowance of certain entertainment, etc., expenses).

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) A, a calendar-year taxpayer, acquired and placed in service on January 1, 1962, an automobile with a basis of \$2,400 and an estimated useful life of four years. In the taxable year 1962 the automobile was used by A 80 percent of the time in his trade or business and was used 20 percent of the time for personal purposes. Thus, for the taxable year 1962 only 80 percent of the basis of the automobile qualified as section 38 property since a deduction for depreciation was allowable to A only with respect to 80 percent of the basis of the automobile. In the taxable year 1963 the automobile is used by A only 60 percent of the time in his trade or business. Thus, for the taxable year 1963 a deduction for depreciation is allowable to A only with respect to 60 percent of the basis of the automobile.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1963, the automobile ceases to be section 38 property with respect to A to the extent of 20 percent (80 percent minus 60 percent) of the \$2,400 basis of the automobile.

Example 2. (i) The facts are the same as in example 1 and in addition for the taxable year 1964 a deduction for depreciation is allowable to A only with respect to 40 percent of the basis of the property.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1964, the automobile ceases to be section 38 property with respect to A to the extent of 20 percent (60 percent minus 40 percent) of the \$2,400 basis of the automobile.

[T.D. 6931, 32 FR 14032, Oct. 10, 1967, as amended by T.D. 7203, 37 FR 17128, Aug. 25, 1972]

§ 1.47-3 Exceptions to the application of § 1.47-1.

(a) *In general.* Notwithstanding the provisions of § 1.47-2, relating to "disposition" and "cessation," paragraph (a) of § 1.47-1 shall not apply if paragraph (b) of this section (relating to transfers by reason of death), paragraph (c) of this section (relating to

property destroyed by casualty), paragraph (d) of this section (relating to reselection of used section 38 property), paragraph (e) of this section (relating to transactions to which section 381(a) applies), paragraph (f) of this section (relating to mere change in form of conducting a trade or business), paragraph (g) of this section (relating to sale-and-leaseback transactions), or paragraph (h) of this section (relating to certain property replaced after Apr. 18, 1969) applies with respect to such disposition or cessation.

(b) *Transfers by reason of death*— (1) *General rule.* Notwithstanding the provisions of §1.47-2, relating to “disposition” and “cessation”, paragraph (a) of §1.47-1 shall not apply to a transfer of section 38 property by reason of the death of the taxpayer. Thus, for example, with respect to section 38 property held in joint tenancy, paragraph (a) of §1.47-1 shall not apply to the transfer of the deceased taxpayer’s interest to the surviving joint tenant. If, under §1.48-4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, paragraph (a) of §1.47-1 does not apply if, by reason of the death of the lessee, there is a termination of the lease and transfer of the leased property to the lessor, or there is an assignment of the lease and transfer of the leased property to another person. Moreover, paragraph (a) of §1.47-1 does not apply to the transfer of a partner’s interest in a partnership, a beneficiary’s interest in an estate or trust, or shares of stock of a shareholder of an electing small business corporation (as defined in section 1371(b)) by reason of the death of such partner, beneficiary, or shareholder. Paragraph (a) of §1.47-1 shall not apply to property prior to his death even if the value of such gift is included in his gross estate for estate tax purposes (such as, a gift in contemplation of death under section 2035). The effect of this subparagraph is that any section 38 property held by a taxpayer at the time of his death is deemed to have been held by him for its entire estimated useful life.

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example 1. (i) A, an individual, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of \$10,000 and an estimated useful life of eight years. On April 28, 1963, A dies and, as a result of A’s death, his interest in such item of section 38 property is transferred to a testamentary trust pursuant to A’s will, and on February 1, 1967, the trust is terminated and the item of section 38 property is transferred to the beneficiaries of the trust.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of §1.47-1 does not apply to the transfer, as a result of A’s death, of his interest in such item of section 38 property to the testamentary trust. Moreover, paragraph (a) of §1.47-1 does not apply to the February 1, 1967, transfer of such item of section 38 property by the trust to its beneficiaries.

Example 2. (i) X Corporation, an electing small business corporation (as defined in section 1371(b)) which makes its returns on the basis of a calendar year, acquired and placed in service during 1962 an item of section 38 property. On December 31, 1962, X Corporation had 10 shares of stock outstanding which were owned as follows: A owned eight shares and B owned two shares. On December 31, 1962, 80 percent of the basis of the item of section 38 property was apportioned to A and 20 percent to B. On June 1, 1964, A dies and, as a result of A’s death, his eight shares of stock in X Corporation are transferred to his wife. On July 10, 1965, X Corporation sells the item of section 38 property to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of §1.47-1 does not apply to the transfer, as a result of A’s death, of his eight shares of stock in X Corporation to his wife. Moreover, with respect to the July 10, 1965, sale paragraph (a) of §1.47-1 applies only to the 20 percent of the basis of the item of section 38 property which was apportioned to B.

(c) *Property destroyed by casualty*— (1) *Dispositions after April 18, 1969.* Notwithstanding the provisions of §1.47-2, relating to “disposition” and “cessation”, paragraph (a) of §1.47-1 shall not apply to property which, after April 18, 1969, and before August 16, 1971, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of its theft.

(2) *Dispositions before April 19, 1969.* (i) In the case of property which, before

April 19, 1969, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck or other casualty, or by reason of its theft, paragraph (a) of § 1.47-1 shall apply except to the extent provided in subdivisions (ii) and (iii) of this subparagraph.

(ii) Paragraph (a) of § 1.47-1 shall not apply if—

(a) Section 38 property is placed in service by the taxpayer to replace (within the meaning of paragraph (h) of § 1.46-3) the destroyed, damaged, or stolen property, and

(b) The basis (or cost) of the section 38 property which is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property is reduced under paragraph (h) of § 1.46-3.

(iii) If property which would be section 38 property but for section 49 is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property, then the provisions of paragraph (h) of this section (other than the requirement that the replacement take place within 6 months after the disposition) shall apply.

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

Example 1. (i) A acquired and placed in service on January 1, 1962, machine No. 1 which qualified as section 38 property with a basis of \$30,000 and an estimated useful life of 6 years. The amount of qualified investment with respect to such machine was \$20,000. For the taxable year 1962 A's credit earned of \$1,400 was allowed under section 38 as a credit against its liability for tax. On January 1, 1963, machine No. 1 is completely destroyed by fire. On January 1, 1963, the adjusted basis of machine No. 1 in A's hands is \$24,500. A receives \$23,000 in insurance proceeds as compensation for the destroyed machine, and on February 15, 1964, A acquires and places in service machine No. 2, which qualifies as section 38 property, with a basis of \$41,000 and an estimated useful life of 6 years to replace machine No. 1.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply with respect to machine No. 1 since machine No. 2 is placed in service to replace machine No. 1 and the \$41,000 basis of machine No. 2 is reduced, under paragraph (h) of § 1.46-3, by \$23,000. (See example 1 of paragraph (h)(3) of § 1.46-3.)

Example 2. (i) The facts are the same as in example 1 except that A receives only \$19,000 in insurance proceeds as compensation for the destroyed machine.

(ii) Although machine No. 2 is placed in service to replace machine No. 1, subparagraph (1) of this paragraph does not apply with respect to machine No. 1 since the basis of machine No. 2 is not reduced under paragraph (h) of § 1.46-3. Paragraph (a) of § 1.47-1 applies with respect to the January 1, 1963, destruction of machine No. 1. The actual useful life of machine No. 1 is 1 year. The recomputed qualified investment with respect to such machine is zero (\$30,000 basis multiplied by zero applicable percentage) and A's recomputed credit earned for the taxable year 1962 is zero. The income tax imposed by chapter 1 of the Code on A for the taxable year 1963 is increased by \$1,400.

(d) *Reselection of used section 38 property—(1) Reselection.* If—

(i) Used section 38 property (as defined in § 1.48-3) the cost of which was taken into account in computing the taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing such qualified investment, and

(ii) For the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, the sum of (a) the cost of used section 38 property placed in service by the taxpayer, and (b) the cost of used section 38 property apportioned to such taxpayer exceeded \$50,000,

then such taxpayer may treat the cost of any used section 38 property (regardless of its estimated useful life) which was not originally selected, under paragraph (c)(4) of § 1.48-3, to be taken into account in computing qualified investment for such taxable year (or previously reselected under this subparagraph) as having been selected (in accordance with the principles of paragraph (c)(4)(ii) of § 1.48-3) in place of the cost of the used section 38 property described in subdivision (i) of this subparagraph. Hereinafter such reselected property is referred to as "newly selected used section 38 property". For purposes of this subparagraph, the cost of used section 38 property apportioned to a taxpayer means the sum of the cost of used section 38 property apportioned to him by a trust, estate, or

electing small business corporation (as defined in section 1371(b)), and his share of the cost of partnership used section 38 property, with respect to the taxable year of such trust, estate, corporation or partnership ending with or within such taxpayer's taxable year. In the case of a taxpayer to whom paragraph (c)(2) of § 1.48-3 applied for the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, a \$25,000 amount shall be substituted for the \$50,000 amount referred to in subdivision (ii)(b) of this subparagraph, and in the case of a member of an affiliated group (as defined in subparagraph (6) of § 1.48-3(e)) the amount apportioned to such member under paragraph (e) of § 1.48-3 shall be substituted for such \$50,000 amount.

(2) *Application of paragraph (a) of § 1.47-1.* (i) If a taxpayer treats, under subparagraph (1) of this paragraph, the cost of any used section 38 property which was not originally selected as having been selected in place of the cost of used section 38 property described in subparagraph (1)(i) of this paragraph, then, notwithstanding the provisions of § 1.47-2 (relating to "disposition" and "cessation"), paragraph (a) of § 1.47-1 shall not apply to the property described in subparagraph (1)(i) of this paragraph to the extent of the cost of the newly selected used section 38 property.

(ii) If the cost of the used section 38 property described in subparagraph (1)(i) of this paragraph exceeds the cost of the newly selected used section 38 property, then the property described in subparagraph (1)(i) of this paragraph shall cease to be section 38 property with respect to the taxpayer to the extent of such excess.

(iii) If the newly selected used section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life of the property described in subparagraph (1)(i) of this paragraph, then, unless he reselects other used section 38 property, paragraph (a) of § 1.47-1 shall apply with respect to such newly selected used section 38 property. For purposes of recomputing qualified investment with respect to such newly

selected used section 38 property the actual useful life shall be deemed to be the period beginning with the date on which the property described in subparagraph (1)(i) of this paragraph was placed in service by the taxpayer and ending with the date of the disposition or cessation with respect to such newly selected used section 38 property. See paragraph (c) of § 1.47-1, relating to date placed in service and date of disposition or cessation.

(3) *Information requirement.* (i) If in any taxable year this paragraph applies to a taxpayer, such taxpayer shall attach to his income tax return for such taxable year a statement containing the information required by subdivision (ii) of this subparagraph.

(ii) The statement referred to in subdivision (i) of this subparagraph shall contain the following information:

(a) The taxpayer's name, address and taxpayer account number; and

(b) With respect to the originally selected used section 38 property and the newly selected used section 38 property, the month and year placed in service, cost, and estimated useful life.

(4) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation purchased and placed in service on January 1, 1962, machines No. 1 and No. 2, which qualified as used section 38 property, each with a cost of \$50,000 and an estimated useful life of eight years. The aggregate cost of used section 38 property taken into account by X Corporation in computing its qualified investment for the taxable year 1962 could not exceed \$50,000; therefore, under paragraph (c)(4) of § 1.48-3, X selected the \$50,000 cost of machine No. 1 to be taken into account in computing its qualified investment for the taxable year 1962. The qualified investment with respect to machine No. 1 was \$50,000. For the taxable year 1962 X's credit earned of \$3,500 was allowed under section 38 as a credit against its liability for tax. On January 2, 1965, X Corporation sells machine No. 1 to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the \$50,000 cost of machine No. 2 as having been selected to be taken into account in computing its qualified investment for the taxable year 1962 in place of the \$50,000 cost of machine No. 1. Therefore, under subparagraph (2)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 2, 1965, disposition of machine No. 1.

Example 2. (i) The facts are the same as in example 1 and in addition X Corporation, on December 2, 1966, sells machine No. 2 to Z Corporation.

(ii) Under subparagraph (2)(iii) of this paragraph, paragraph (a) of § 1.47-1 applies with respect to the December 2, 1966, disposition of machine No. 2. The actual useful life of machine No. 2 is four years and eleven months (that is, the period beginning on January 1, 1962, and ending on December 2, 1966). The recomputed qualified investment with respect to machine No. 2 is \$16,667 (\$50,000 cost multiplied by 33⅓ percent applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is \$1,167. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1966 is increased by the \$2,333 decrease in its credit earned for the taxable year 1962 (that is, \$3,500 original credit earned minus \$1,167 recomputed credit earned).

Example 3. (i) The facts are the same as in example 1 except that machine No. 2 had a cost of \$30,000.

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the \$30,000 cost of machine No. 2 as having been selected to be taken into account in computing its qualified investment for the taxable year 1962 in place of the \$50,000 cost of machine No. 1. Therefore, under subparagraph (2)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 2, 1965, disposition of machine No. 1 to the extent of \$30,000 of the \$50,000 cost of machine No. 1. However, under subparagraph (2)(ii) of this paragraph, paragraph (a) of § 1.47-1 applies to the January 2, 1965, disposition of machine No. 1 to the extent of \$20,000 (that is, \$50,000 cost of machine No. 1 minus \$30,000 cost of machine No. 2). The actual useful life of such \$20,000 portion of machine No. 1 is three years (that is, the period beginning on January 1, 1962, and ending on January 2, 1965). The recomputed qualified investment with respect to the \$20,000 portion of the cost of machine No. 1 is zero (\$20,000 portion of the cost multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is \$2,100 (7 percent of \$30,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the \$1,400 decrease in its credit earned for the taxable year 1962 (that is, \$3,500 original credit earned minus \$2,100 recomputed credit earned).

(e) *Transactions to which section 381(a) applies—(1) General rule.* Notwithstanding the provisions of § 1.47-2, relating to “disposition” and “cessation”, paragraph (a) of § 1.47-1 shall not apply to a disposition of section 38

property in a transaction to which section 381(a) (relating to carryovers in certain corporate acquisitions) applies. If the section 38 property described in the preceding sentence is disposed of, or otherwise ceases to be section 38 property with respect to the acquiring corporation, before the close of the estimated useful life which was taken into account in computing the transferor corporation's qualified investment, then paragraph (a) of § 1.47-1 shall apply to the acquiring corporation with respect to such section 38 property. For purposes of recomputing qualified investment with respect to such property its actual useful life shall be the period beginning with the date on which it was placed in service by the transferor corporation and ending with the date of the disposition by, or cessation with respect to, the acquiring corporation.

(2) *Examples.* This paragraph may be illustrated by the following examples:

Example 1. (i) X Corporation, a wholly owned subsidiary of Y Corporation, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of \$12,000 and an estimated useful life of eight years. Both X and Y make their returns on the basis of a calendar year. The qualified investment with respect to such item was \$12,000. For the taxable year 1962 X Corporation's credit earned of \$840 was allowed under section 38 as a credit against its liability for tax. On January 15, 1967, X Corporation is liquidated under section 332 and all of its properties, including the item of section 38 property, are transferred to Y Corporation. The bases of the properties in the hands of Y Corporation are determined under section 334(b)(1).

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 15, 1967, transfer to Y Corporation.

Example 2. (i) The facts are the same as in example 1 and in addition on February 2, 1968, Y Corporation sells the item of section 38 property to Z Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 15, 1967, transfer to Y Corporation. However, paragraph (a) of § 1.47 applies to the February 2, 1968, sale of the property by Y Corporation. The actual useful life of the property is six years and one month (that is, the period beginning on January 1, 1962, and ending on February 2, 1968).

(f) *Mere change in form of conducting a trade or business—(1) General rule.* (i)

Notwithstanding the provisions of § 1.47-2, relating to “disposition” and “cessation”, paragraph (a) of § 1.47-1 shall not apply to section 38 property which is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer’s qualified investment by reason of a mere change in the form of conducting the trade or business in which such section 38 property is used provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:

(a) The section 38 property described in subdivision (i) of this subparagraph is retained as section 38 property in the same trade or business,

(b) The transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of such section 38 property retains a substantial interest in such trade or business,

(c) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred to the transferee to whom such section 38 property is transferred, and

(d) The basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor. This subparagraph shall not apply to the transfer of section 38 property if paragraph (e) of this section, relating to transactions to which section 381 applies, applies with respect to such transfer.

(2) *Substantial interest.* For purposes of this paragraph, a transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) shall be considered as having retained a substantial interest in the trade or business only if, after the change in form, his interest in such trade or business—

(i) Is substantial in relation to the total interest of all persons, or

(ii) Is equal to or greater than his interest prior to the change in form.

Thus, where a taxpayer owns a 5-percent interest in a partnership, and, after the incorporation of that partnership, the taxpayer retains at least a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form.

(3) *Property held for the production of income.* Subparagraph (1)(i) of this paragraph applies to section 38 property held for the production of income (within the meaning of section 167(a)(2)) as well as to section 38 property used in a trade or business.

(4) *Leased property.* In a case where a lessor of new section 38 property made a valid election, under § 1.48-4, to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, in determining whether subparagraph (1)(i) of this paragraph applies to an assignment of the lease and transfer of possession of such property, the condition contained in subparagraph (1)(ii) (d) of this paragraph is not applicable.

(5) *Disposition or cessation.* (i) If section 38 property described in subparagraph (1)(i) of this paragraph is disposed of by the transferee, or otherwise ceases to be section 38 property with respect to the transferee, before the close of the estimated useful life which was taken into account in computing the qualified investment of the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the qualified investment of the partners, beneficiaries, or shareholders) then under paragraph (a) of § 1.47-1 such property ceases to be section 38 property with respect to the transferor (or such partners, beneficiaries, or shareholders), and a recapture determination shall be made with respect to such property. For purposes of recomputing qualified investment with respect to such property, the actual useful life shall be the period beginning with the date on which it was placed in service by the transferor and ending with the date of the disposition by, or cessation with respect to, the transferee.

(ii) If in any taxable year the transferor (or in a case where the transferor is a partnership, estate, trust, or electing small business corporation, the partner, beneficiary, or shareholder) of the section 38 property described in subparagraph (1)(i) of this paragraph does not retain a substantial interest in the trade or business directly or indirectly (through ownership in other entities provided that such other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the transferor) then, under paragraph (a) of § 1.47-1, such property ceases to be section 38 property with respect to the transferor and he (or the partner, beneficiary, or shareholder) shall make a recapture determination. For purposes of recomputing qualified investment with respect to property described in this subdivision, its actual useful life shall be the period beginning with the date on which it was placed in service by the transferor and ending with the first date on which the transferor (or the partner, beneficiary, or shareholder) does not retain a substantial interest in the trade or business. Any taxpayer who seeks to establish his interest in a trade or business under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in such trade or business after any such transfer or transfers.

(iii) In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations with respect to the transferor in connection with the same property.

(iv) Notwithstanding subparagraph (1) of this paragraph and subdivision (ii) of this subparagraph in the case of a mere change in the form of a trade or business, if the interest of a taxpayer in the trade or business is reduced but such taxpayer has retained a substantial interest in such trade or business, paragraph (a)(2) of § 1.47-4 (relating to electing small business corporations), paragraph (a)(2) of § 1.47-5 (relating to estates or trusts) or paragraph (a)(2) of § 1.47-6 (relating to partnerships) shall apply, as the case may be.

(6) *Examples.* This paragraph may be illustrated by the following examples

in each of which it is assumed that the transfer satisfies the conditions of subparagraphs (1)(ii) (a), (c), and (d) of this paragraph.

Example 1. (i) On January 1, 1962, A, an individual, acquired and placed in service in his sole proprietorship an item of section 38 property with a basis of \$12,000 and an estimated useful life of eight years. The qualified investment with respect to such item was \$12,000. For the taxable year 1962 A's credit earned of \$840 was allowed under section 38 as a credit against his liability for tax. On March 15, 1963, A transfers all of the assets used in his sole proprietorship to X Corporation, a newly formed corporation, in exchange for 45 percent of the stock of X Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the March 15, 1963, transfer to X Corporation.

Example 2. (i) The facts are the same as in example 1 and in addition on February 2, 1964, X Corporation sells the item of section 38 property to Y Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the March 15, 1963, transfer to X Corporation. However, under subparagraph (5)(i) of this paragraph, paragraph (a) of § 1.47-1 applies to the February 2, 1964, sale of the item of section 38 property by X Corporation to Y Corporation. The actual useful life of the property is two years and one month (that is, the period beginning on January 1, 1962, and ending on February 2, 1964). The recomputed qualified investment with respect to such property is zero (\$12,000 basis multiplied by zero applicable percentage) and A's recomputed credit earned for the taxable year 1962 is zero. The income tax imposed by chapter 1 of the Code on A for 1964 is increased by the \$840 decrease in his credit earned for the taxable year 1962 (that is, \$840 credit earned minus zero recomputed credit earned).

Example 3. (i) On January 1, 1962, partnership ABC, which makes its returns on the basis of a calendar year, acquired and placed in service on item of section 38 property with a basis of \$20,000 and an estimated useful life of eight years. Partnership ABC has 10 partners who make their returns on the basis of a calendar year and share partnership profits equally. Each partner's share of the basis of such item of section 38 property is 10 percent, that is, \$2,000. On March 15, 1963, partnership ABC transfers all of the assets used in its trade or business to the X Corporation, a newly formed corporation, in exchange for all of the stock of X Corporation and immediately thereafter transfers 10 percent of such stock to each of the 10 partners.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply

to the March 15, 1963 transfer by the ABC Partnership to X Corporation.

Example 4. (i) The facts are the same as in example 3 except that partnership ABC transfers 10 percent of the stock in X Corporation to each of 8 partners, 20 percent to partner A, and cash to partner B.

(ii) Under subparagraph (1)(i) of this paragraph, with respect to all of the partners (including partner A) except partner B, paragraph (a) of §1.47-1 does not apply to the March 15, 1963, transfer by the ABC Partnership to X Corporation. Paragraph (a) of §1.47-1 applies with respect to partner B's \$2,000 share of the item of section 38 property. See paragraph (a)(1) of §1.47-6.

Example 5. (i) X Corporation operates a manufacturing business and a separate personal service business. On January 1, 1962, X acquired and placed in service a truck, which qualified as section 38 property, in its manufacturing business. The truck had a basis of \$10,000 and an estimated useful life of 8 years. On February 10, 1965, X transfers all the assets used in its manufacturing business to Partnership XY in exchange for a 50-percent interest in such partnership.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of §1.47-1 does not apply to the February 10, 1965, transfer to Partnership XY.

(g) *Sale-and-leaseback transactions*—(1) *In general.* Notwithstanding the provisions of §1.47-2, relating to “disposition” and “cessation”, paragraph (a) of §1.47-1 shall not apply where section 38 property is disposed of and as part of the same transaction is leased back to the vendor even though gain or loss is recognized to the vendor-lessee and the property ceases to be subject to depreciation in his hands. If paragraph (a) of §1.47-1 applies with respect to such property subsequent to the transaction, the actual useful life shall begin with the date on which such property was first placed in service by the vendor-lessee as owner.

(2) *Special rule for progress expenditure property.* The sale and leaseback (or agreement or contract to leaseback) of progress expenditure property (including any contract rights to the property), in general, will be treated as a cessation described in section 47(a)(3)(A) with respect to the seller-lessee. However, a sale and leaseback (or agreement or contract to leaseback) will not be treated as a cessation to the extent qualified investment passed through to the lessee under section 48(d) in the year the property is

placed in service equals or exceeds qualified progress expenditures for the property taken into account by the lessee. If a sale-leaseback transaction is treated as a cessation, qualified investment must be reduced and the credit recomputed, beginning with the most recent credit year (*i.e.*, the most recent year property is taken into account in computing qualified investment under §1.46-3 or 1.46-5). The amount of the reduction is the amount, if any, by which qualified progress expenditures taken into account by the lessee in all prior years exceeds qualified investment passed through to the lessee under section 48(d). This paragraph (g)(2) does not apply to any progress expenditure property that has been placed in service by a vendor-lessee (as described in paragraph (g)(1) of this section) prior to a sale-leaseback of that property in a transaction described in paragraph (g)(1) of this section.

(h) *Certain property replaced after April 18, 1969*—(1) *In general.* (i) If section 38 property is disposed of and property which is, for purposes of section 1033 and the regulations thereunder, similar or related in service or use to the property disposed of and which would be section 38 property but for the application of section 49 is placed in service to replace the property disposed of, the increase in income tax and adjustment of investment credit carryovers and carrybacks resulting from the recomputation under paragraph (a) of §1.47-1 shall be reduced (but not below zero) by the credit that would be allowed for the qualified investment of the replacement property (determined as if such property were section 38 property). The preceding sentence shall not apply unless the replacement takes place within 6 months after the disposition. If property otherwise qualifies as replacement property, it is immaterial that it is placed in service (for example, to undergo testing) before the replaced property is disposed of. The assignment by the taxpayer in his return of an estimated useful life to the replacement property in computing its qualified investment will be considered a representation by the taxpayer that he expects to retain the replacement property for its entire estimated useful

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life. If such property is disposed of before the end of such life, then the circumstances surrounding the replacement will be examined to determine whether the taxpayer's representation was in good faith and, if appropriate, the qualified investment of the replacement property will be recomputed for the year of replacement using the actual useful life of such property.

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On January 1, 1967, A, a calendar year taxpayer, acquired and placed in service a new machine with a basis of \$100 and an estimated useful life of 8 years. A's qualified investment was \$100 and his credit earned was \$7, which was allowed as a credit against tax for 1967. On January 15, 1971, A disposed of the machine and replaced it with a similar new machine costing \$75 and having an estimated useful life of 8 years. The new machine would be section 38 property but for section 49. Since the actual useful life of the original machine was at least 4 but less than 6 years, the recomputed qualified investment of the machine is \$33.33 (33⅓ percent of \$100) and under paragraph (a) of § 1.47-1 the amount of recapture tax would be \$4.67 (\$7, the original credit earned, minus \$2.33, the recomputed credit earned). However, under the provisions of this paragraph, the recapture tax is reduced (but not below zero) by the credit that would be allowed for the replacement property (determined as if such property were section 38 property). Under these facts the recapture tax is zero (\$4.67, the recapture tax with respect to the original machine, minus \$5.25, the credit that would be allowed on the new machine).

(2) *Leased property.* Property disposed of may be replaced with property leased from another, provided (i) an election with respect to the newly leased property could be made under section 48(d) but for section 49, and (ii) the lessee obtains the lessor's written statement that he will not claim such property as replacement property under this paragraph. The statement of the lessor shall contain the information specified in subdivisions (i) through (vii) of § 1.48-4(f)(1) and the statement (or a copy thereof) shall be retained in the records of the lessor and the lessee for a period of at least 3

years after the property is transferred to the lessee.

[T.D. 6931, 32 FR 14033, Oct. 10, 1967, as amended by T.D. 7126, 36 FR 11192, June 10, 1971; T.D. 7203; 37 FR 17128, Aug. 25, 1972; T.D. 8183, 53 FR 6625, Mar. 2, 1988]

§ 1.47-4 Electing small business corporation.

(a) *In general—(1) Disposition or cessation in hands of corporation.* If an electing small business corporation (as defined in section 1371(b)) or a former electing small business corporation disposes of any section 38 property (or if any section 38 property otherwise ceases to be section 38 property in the hands of the corporation) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each shareholder who is treated, under § 1.48-5, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the pro rata share of the basis (or cost) of such property taken into account by such shareholder in computing his qualified investment. For purposes of each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the electing small business corporation and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the shareholder in connection with the same property. For definition of "recapture determination" see paragraph (a)(1) of § 1.47-1.

(2) *Disposition of shareholder's interest.*

(i) If—

(a) The basis (or cost) of section 38 property is apportioned, under § 1.48-5, to a shareholder of an electing small business corporation who takes such basis (or cost) into account in computing his qualified investment, and

(b) After the end of the shareholder's taxable year in which such apportionment was taken into account and before the close of the estimated useful