last day of the taxable year of the corporation for purposes of determining the taxable year in which payments (whether or not in cash) that are deductible by the corporation are taken into account by the employee-owner.

(2) *Examples.* The provisions of paragraph (d)(1) of this section may be illustrated by the following examples.

Example (1). Assume that ABC, a calendar year partnership, wishes to elect, for taxable years beginning after December 31, 1985, a 52–53-week taxable year that ends on the Friday nearest to December 31. Assume that A, B, and C, who are individual calendar year taxpayers, are equal partners in ABC. Assume also that A, B, and C agree to treat each of the 52–53-week taxable years of ABC as ending on December 31 for purposes of determining the taxable year in which guaranteed payments and their distributive shares of income, gains, losses, deductions, and credits are taken into account. Assume that, for its taxable year ending January 2, 1987, ABC has net income of $30,000, and that ABC has no other items of income, gain, loss, deduction, or credit for that taxable year. Under paragraph (d)(1)(i) of this section, A, B, and C each must include $10,000 in income for their taxable years ending on December 31, 1986. Similarly, if ABC makes a guaranteed payment to A on January 2, 1987, A must include the payment in income for the taxable year ending December 31, 1986.

Example (2). Assume that X, a calendar year personal service corporation, wishes to elect, for taxable years beginning after December 31, 1985, a 52–53-week taxable year that ends on the Friday nearest to December 31. Assume that all of the employer-owners of X are individual calendar year taxpayers. Assume further that all of the employee-owners agree to treat their taxable year as ending on the last day of X's taxable year for purposes of determining the year in which payments by X are taken into income. Assume that on January 2, 1987, X makes a payment of bonuses of $10,000 to each employee-owner. Under paragraph (d)(1)(v) of this section, each employee-owner must include $10,000 in income for the taxable year ending December 31, 1986.

(e) *Procedural requirements.* In the case of an adoption of or change to a 52–53-week taxable year under §1.441–2(c) (1) or (2), a taxpayer to which any condition in paragraph (d) of this section applies must indicate on the statement required under §1.441–2(c) (1) or (2), or on a separate statement that is attached to the income tax return for the year of adoption or change, that all of the applicable conditions are satisfied. If the due date for that return is before March 9, 1987, the statement required under §1.441–2(c) (1) or (2) (or an amended statement) indicating that the applicable conditions are satisfied must be filed by the later of March 9, 1987 or the due date for the return (determined with regard to extensions). If §1.442–2T or §1.442–3T applies to an adoption of, retention of, or change to or from a 52–53-week taxable year, the procedures set forth in §1.442–2T or §1.442–3T (whichever is applicable) must be followed and the rules set forth in §1.442–2T(f)(3) or §1.442–3T(d) shall apply.

(f) *Effective date*—(1) *In general.* This section shall apply to adoptions of, retentions of, or changes to or from a 52–53-week taxable year if—

(i) The income tax return for the first taxable year for which the election to use or retain the 52–53-week year is made (or, if applicable, the income tax return for the short period involved in the change) is filed after September 29, 1986, and

(ii) The first taxable year for which the election to use or retain the 52–53-week year is made (or the short period involved in the change) ends before January 5, 1987.

(2) *Exceptions.* This section shall not apply if the application required to effect or request the adoption, retention, or change was timely filed before September 30, 1986. In the case of an adoption or change that is effected by filing an income tax return for the first taxable year for which the election is made, this section shall not apply if an application for extension of time for filing that return was filed before September 30, 1986, the application clearly stated the taxpayer's intention to adopt or change to a 52–53-week taxable year, and the income tax return for that taxable year is timely filed (determined with regard to extensions).

[T.D. 8123, 52 FR 3617, Feb. 5, 1987]

§1.441–4T Taxable year of a personal service corporation (temporary).

(a) *Taxable year.* The taxable year of a personal service corporation (as defined in paragraph (d) of this section) is—

(1) The calendar year, or a ''short period'' (as provided in §1.441–1T(b)(1)(i)) ending December 31; or

(2) A fiscal year, or a short period (other than a short period provided in paragraph (a)(1) of this section), if the corporation obtains the approval of the Commissioner (in accordance with paragraph (c) of this section) for using such fiscal year.

(b) *Change in taxable year required*—(1) *In general.* For any taxable year beginning after December 31, 1986, a taxpayer that is a personal service corporation for such taxable year must—

(i) Use a taxable year described in paragraph (a) of this section; or

(ii) Change to such a taxable year by using a short taxable year that ends on the last day of a taxable year described in paragraph (a) of this section.

(2) *Approval not required for change to a calendar year*—(i) *In general.* A personal service corporation may change its taxable year to the calendar year without the approval of the Commissioner. In such cases, however, the taxpayer should notify the Internal Revenue Service of the change in accordance with the provisions of the applicable revenue procedure. See, for example, section 5.02(1) of Rev. Proc. 87–32, 1987–28 I.R.B. 14.

(ii) *Special rule for 52–53-week taxable year ending with reference to the month of December.* For purposes of this section, a 52–53-week taxable year of a personal service corporation ending with reference to the month of December shall be treated as the calendar year. In order to assist in the processing of the retention or change in taxable year, taxpayers should refer to this special rule by either typing or legibly printing the following statement at the top of page 1 of the income tax return: ''FILED UNDER §1.441–4T(b)(2)(ii).'' See §1.441–2T(e) for special rules regarding 52–53-week taxable years for personal service corporations.

(3) *Examples.* The provisions of paragraph (b) of this section may be illustrated by the following examples.

Example (1). X corporation's last taxable year beginning before January 1, 1987, ends on January 31, 1987. In addition, X is a personal service corporation for its taxable year beginning February 1, 1987, and does not obtain the approval of the Commissioner for using a fiscal year. Thus, under paragraph (b)(1) of this section, X is required to change its taxable year to the calendar year by using a short taxable year that begins on February 1, 1987, and ends on December 31, 1987. Under paragraph (b)(2)(i) of this section, X may change its taxable year without the consent of the Commissioner, but should notify the Internal Revenue Service of the change in accordance with section 5.02(1) of Rev. Proc. 87–32.

Example (2). Assume the same facts as in example (1), except that for its taxable year beginning February 1, 1987, X obtains the approval of the Commissioner to change its annual accounting period to a fiscal year ending September 30. Under paragraph (b)(1) of this section, X must file a tax return for the short period from February 1, 1987, through September 30, 1987.

Example (3). Assume the same facts as in example (1), except that the first taxable year for which X is a personal service corporation is the taxable year that begins on February 1, 1990. Thus, for taxable years ending before that date, this section does not apply with respect to X. For its taxable year beginning on February 1, 1990, however, X will be required to comply with paragraph (b) of this section. If X does not obtain the approval of the Commissioner to use a fiscal year, X will be required to change its taxable year to the calendar year by using a short taxable year that ends on December 31, 1990.

Example (4). Assume the same facts as in example (1), except that X desires to change to a 52–53-week taxable year ending with reference to the month of December. Pursuant to paragraphs (b)(2)(i) and (b)(2)(ii) of this section, X may change its taxable year to a 52–53-week taxable year ending with reference to the month of December without the consent of the Commissioner, but should notify the Internal Revenue Service of the change in accordance with paragraph (b)(2)(ii) of this section.

(c) *Approval of a fiscal year.* A personal service corporation must establish to the satisfaction of the Commissioner a business purpose for using a fiscal year under paragraph (a)(2) of this section. Business purpose is established to the satisfaction of the Commissioner in the case of a personal service corporation that—

(1) Requests to use, or is using, a fiscal year that coincides with its natural business year, as defined in section 4.01(1) of Rev. Proc. 87–32, or successor revenue procedures, or

(2) Receives permission from the Commissioner to use the fiscal year by establishing a business purpose for the fiscal year under section 6.01 of Rev.

Proc. 87–32, or successor revenue procedures. See also Rev. Rul. 87–57, 1987–28 I.R.B. 7. See Announcement 87–82 for modifications to Rev. Proc. 87–32 regarding due dates for personal service corporations filing applications and income tax returns for certain short taxable years beginning after December 31, 1986.

(d) *Personal service corporation for a taxable year*—(1) *In general.* For purposes of this section, a taxpayer is a personal service corporation for a taxable year only if—

(i) The taxpayer is a C corporation (as defined in section 1361(a)(2)) for the taxable year;

(ii) The principal activity of the taxpayer during the testing period for the taxable year is the performance of personal services;

(iii) During the testing period for the taxable year, such services are substantially performed by employee-owners; and

(iv) Employee-owners, as defined in paragraph (h) of this section, own (as determined under the attribution rules of section 318, except that ''any'' shall be substituted for ''50 percent'' in section 318(a)(2)(C)) more than 10 percent of the fair market value of the outstanding stock in the taxpayer on the last day of the testing period for the taxable year.

(2) *Testing period*—(i) *In general.* Except as otherwise provided in paragraph (d)(2)(ii) of this section, the testing period for a taxable year is the taxable year preceding such taxable year.

(ii) *New corporations.* The testing period for a taxpayer's first taxable year is the period beginning on the first day of such taxable year and ending on the earlier of—

(A) The last day of such taxable year; or

(B) The last day of the calendar year in which such taxable year begins.

(3) *Examples.* The provisions of paragraph (d)(2) of this section may be illustrated by the following examples.

Example (1). Corporation A has been in existence since 1980 and has used a January 31 taxable year for all taxable years beginning before 1987. For purposes of determining whether A is a personal service corporation for the taxable year beginning February 1, 1987, A's testing period under paragraph (d)(2)(i) of this section is the taxable year ending January 31, 1987.

Example (2). B corporation's first taxable year begins on June 1, 1987, and B desires to use a September 30 taxable year. However, if B is a personal service corporation, it must obtain the Commissioner's approval to use a September 30 taxable year. Pursuant to paragraph (d)(2)(ii) of this section, B's testing period for its first taxable year beginning June 1, 1987, is the period June 1, 1987 through September 30, 1987. Thus, if, based upon such testing period, B is a personal service corporation, B must obtain the Commissioner's permission to use a September 30 taxable year.

Example (3). The facts are the same as in Example (2), except that B desires to use a March 31 taxable year. Pursuant to paragraph (d)(2)(ii) of this section, B's testing period for its first taxable year beginning June 1, 1987, is the period June 1, 1987, through December 31, 1987. Thus, if, based upon such testing period, B is a personal service corporation, B must obtain the Commissioner's permission to use a March 31 fiscal year.

(e) *Determination of whether an activity during the testing period is treated as the performance of personal services*—(1) *Activities described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer described in section 448(d)(2)(A) or the regulations thereunder will be treated as the performance of personal services. Therefore, any activity of the taxpayer that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (as such fields are defined in the regulations interpreting section 448) will be treated as the performance of personal services for purposes of this section.

(2) *Activities not described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer not described in section 448(d)(2)(A) or the regulations thereunder will not be treated as the performance of personal services.

(f) *Principal activity*—(1) *General rule.* For purposes of this section, the principal activity of a corporation for any testing period will be considered to be the performance of personal services if the cost of the corporation's compensation (the ''compensation cost'') for such testing period that is attributable to its activities that are treated as the performance of personal services under paragraph (e) of this section exceeds 50

percent of the corporation's total compensation cost for such testing period.

(2) *Compensation cost.* For purposes of this section, the compensation cost of a corporation for a taxable year is equal to the sum of the following amounts allowable as a deduction, allocated to a long-term contract, or otherwise chargeable to a capital account by the corporation during such taxable year—

(i) Wages and salaries, and

(ii) Any other amounts attributable to services performed for or on behalf of the corporation by a person who is an employee of the corporation (including an owner of the corporation who is treated as an employee under paragraph (h)(2) of this section) during the testing period. Such amounts include, but are not limited to, amounts attributable to deferred compensation, commissions, bonuses, compensation includible in income under section 83, compensation for services based on a percentage of profits, and the cost of providing fringe benefits that are includible in income.

However, for purposes of this section, compensation cost does not include amounts attributable to a plan qualified under section 401(a) or 403(a), or to a simplified employee pension plan defined in section 408(k).

(3) *Attribution of compensation cost to personal service activity*—(i) *Employees involved only in the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are treated as personal services under paragraph (e) of this section, or employees involved only in supporting the work of such employees, shall be considered to be attributable to the corporation's personal service activity.

(ii) *Employees involved only in activities that are not treated as the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are not treated as personal services under paragraph (e) of this section, or for employees involved only in supporting the work of such employees, shall not be considered to be attributable to the corporation's personal service activity.

(iii) *Other employees.* The compensation cost for any employee who is not described in either paragraph (f)(3)(i) or paragraph (f)(3)(ii) of this section (''a mixed activity employee'') shall be allocated as follows—

(A) *Compensation cost attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is attributable to the corporation's personal service activity equals the compensation cost for such employee multiplied by the percentage of the total time worked for the corporation by such employee during the year that is attributable to activities of the corporation that are treated as the performance of personal services under paragraph (e) of this section. Such percentage shall be determined by the taxpayer in any reasonable and consistent manner. Time logs are not required unless maintained for other purposes;

(B) *Compensation cost not attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that shall not be considered to be attributable to the corporation's personal service activity is the compensation cost for such employee less the amount determined in paragraph (f)(3)(iii)(A) of this section.

(g) *Services substantially performed by employee-owners*—(1) *General rule.* Personal services are substantially performed during the testing period by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost for such period attributable to its activities that are treated as the performance of personal services (within the meaning of paragraph (e) of this section), is attributable to personal services performed by employee-owners.

(2) *Compensation cost attributable to personal services.* For purposes of paragraph (g)(1) of this section—

(i) The corporation's compensation cost attributable to its activities that are treated as the performance of personal services shall be determined under paragraph (f)(3) of this section; and

(ii) The portion of the amount determined under paragraph (g)(2)(i) of this section that is attributable to personal services performed by employee-owners

shall be determined by the taxpayer in any reasonable and consistent manner.

(3) *Examples.* The provisions of paragraph (g) of this section may be illustrated by the following examples.

Example (1). For its taxable year beginning February 1, 1987, Corporation A's testing period is the taxable year ending January 31, 1987. During such testing period, A's only activity was the performance of personal services. The total compensation cost of A (including compensation cost attributable to employee-owners) for the testing period was $1,000,000. The total compensation cost attributable to employee-owners of A for the testing period was $210,000. Pursuant to paragraph (g)(1) of this section, the employee-owners of A substantially performed the personal services of A during the testing period because the compensation cost of A's employee-owners was more than 20 percent of the total compensation cost for all of A's employees (including employee-owners).

Example (2). Corporation B has the same facts as corporation A in example (1), except that during the taxable year ending January 31, 1987, B also participated in an activity that would not be characterized as the performance of personal services under this section. The total compensation cost of B (including compensation cost attributable to employee-owners) for the testing period was $1,500,000 ($1,000,000 attributable to B's personal service activity and $500,000 attributable to B's other activity). The total compensation cost attributable to employee-owners of B for the testing period was $250,000 ($210,000 attributable to B's personal service activity and $40,000 attributable to B's other activity). Pursuant to paragraph (g)(1) of this section, the employee-owners of B substantially performed the personal services of B during the testing period because more than 20 percent of B's compensation cost during the testing period attributable to its personal service activities was attributable to personal services performed by employee-owners ($210,000).

(h) *Employee-owner defined*—(1) *General rule.* For purposes of this section, a person is an employee-owner of a corporation for a testing period if—

(i) The person is an employee of the corporation on any day of the testing period, and

(ii) The person owns any outstanding stock of the corporation on any day of the testing period.

(2) *Special rule for independent contractors who are owners.* Any person who is an owner of the corporation within the meaning of paragraph (h)(1)(ii) of this section and who performs personal services for or on behalf of the corporation shall be treated as an employee for purposes of this section, even if the legal form of that person's relationship to the corporation is such that he or she would be considered an independent contractor for other purposes.

(i) *Special rules for affiliated group filing consolidated return*—(1) *In general.* For purposes of applying this section to the members of an affiliated group of corporations filing a consolidated return for the taxable year—

(i) The members of the affiliated group shall be treated as a single corporation;

(ii) The employees of the members of the affiliated group shall be treated as employees of such single corporation; and

(iii) All of the stock, of the members of the affiliated group, that is not owned by any other member of the affiliated group shall be treated as the outstanding stock of such corporation.

(2) *Examples.* The provisions of this paragraph (i) may be illustrated by the following examples.

Example (1). The affiliated group AB, consisting of corporation A and its wholly owned subsidiary B, filed a consolidated Federal income tax return for the taxable year ending January 31, 1987, and AB is attempting to determine whether it is affected by this section for its taxable year beginning February 1, 1987. During the testing period (i.e., the taxable year ending January 31, 1987), A did not perform personal services while B's only activity was the performance of personal services. On the last day of the testing period, employees of A did not own any stock in A while some of B's employees own stock in A. In the aggregate, B's employees own 9 percent of A's stock on the last day of the testing period. Pursuant to paragraph (i)(1) of this section, this section is effectively applied on a consolidated basis to members of an affiliated group filing a consolidated Federal income tax return. Since the only employee-owners of AB are the employees of B and since B's employees do not own more than 10 percent of AB on the last day of the testing period, AB is not subject to the provisions of this section. Thus, AB is not required to determine on a consolidated basis whether, during the testing period, (a) its principal activity is the providing of personal services, or (b) the personal services are substantially performed by employee-owners.

Example (2). The facts are the same as in example (1), except that on the last day of the testing period A owns only 80 percent of

B. The remaining 20 percent of B is owned by employees of B. The fair market value of A, including its 80 percent interest in B, as of the last day of the testing period, is $1,000,000. In addition, the fair market value of the 20 percent interest in B owned by B's employees is $5,000 as of the last day of the testing period. Pursuant to paragraph (d)(1)(iv) and paragraph (i)(1) of this section, AB must determine whether the employee-owners of A and B (*i.e.*, B's employees) own more than 10 percent of the fair market value of A and B as of the last day of the testing period. Since the $14,000 [($100,000.09)+ $5,000] fair market value of the stock held by B's employees is greater than 10 percent of the $105,000 ($100,000+$5,000) aggregate fair market value of A and B as of the last day of the testing period, AB may be subject to this section if, on a consolidated basis during the testing period, (a) the principal activity of AB is the performance of personal services and (b) the personal services are substantially performed by employee-owners.

(j) *Effective date*. This section applies to taxable years beginning after December 31, 1986.

[T.D. 8167, 52 FR 48528, Dec. 23, 1987]

§ 1.442–1 Change of annual accounting period.

(a) *Manner of effecting such change*—(1) *In general*. If a taxpayer wishes to change his annual accounting period (as defined in section 441(c)) and adopt a new taxable year (as defined in section 441(b)), he must obtain prior approval from the Commissioner by application, as provided in paragraph (b) of this section, or the change must be authorized under the Income Tax Regulations. A new taxpayer who adopts an annual accounting period as provided in section 441 and §§1.441–1 or 1.441–2 need not secure the permission of the Commissioner under section 442 and this section. However, see subparagraph (2) of this paragraph. For adoption of and changes to or from a 52–53-week taxable year, see section 441(f) and §1.441–2; for adoption of and changes in the taxable years of partners and partnerships, see paragraph (b)(2) of this section, section 706(b) and paragraph (b) of §1.706–1; for special rules relating to certain corporations, subsidiary corporations, and newly married couples, see paragraphs (c), (d), and (e), respectively, of this section. For special rules relating to real estate investment trusts, see section 859.

(2) *Taxpayers to whom section 441(g) applies*. Section 441(g) provides that if a taxpayer keeps no books, does not have an annual accounting period, or has an accounting period which does not meet the requirements for a fiscal year, his taxable year shall be the calendar year. If section 441(g) applies to a taxpayer, the adoption of a fiscal year will be treated as a change in his annual accounting period under section 442. Therefore, such fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner. Approval of any such change will be denied unless the taxpayer agrees in his application to establish and maintain accurate records of his taxable income for the short period involved in the change and for the fiscal year proposed. The keeping of records which adequately and clearly reflect income for the taxable year constitutes the keeping of books within the meaning of section 441(g) and paragraph (g) of §1.441–1.

(b) *Prior approval of the Commissioner*—(1) *In general*. In order to secure prior approval of a change of a taxpayer's annual accounting period, the taxpayer must file an application on Form 1128 with the Commissioner of Internal Revenue, Washington, D.C. 20224, to effect the change of accounting period. If the short period involved in the change ends after December 31, 1973, such form shall be filed on or before the 15th day of the second calendar month following the close of such short period; if such short period ends before January 1, 1974, such form shall be filed on or before the last day of the first calendar month following the close of such short period. Approval will not be granted unless the taxpayer and the Commissioner agree to the terms, conditions, and adjustments under which the change will be effected. In general, a change of annual accounting period will be approved where the taxpayer established a substantial business purpose for making the change. In determining whether a taxpayer has established a substantial business purpose for making the change, consideration