

§ 1.56(g)-1

(v) Untimely election to use simplified inventory method.

(4) Example.

(5) Election to use alternative minimum tax inventories to compute adjusted current earnings.

(s) Adjustment for alternative tax energy preference deduction.

(1) In general.

(2) Example.

[T.D. 8340, 56 FR 11083, Mar. 15, 1991, as amended by T.D. 8454, 57 FR 60476, Dec. 21, 1992]

§ 1.56(g)-1 Adjusted current earnings.

(a) *Adjustment for adjusted current earnings*—(1) *Positive adjustment*. For taxable years beginning after December 31, 1989, the alternative minimum taxable income of any taxpayer described in paragraph (a)(4) of this section is increased by the adjustment for adjusted current earnings. The adjustment for adjusted current earnings is 75 percent of the excess, if any, of—

(i) The adjusted current earnings (as defined in paragraph (a)(6)(ii) of this section) of the taxpayer for the taxable year over.

(ii) The pre-adjustment alternative minimum taxable income (as defined in paragraph (a)(6)(i) of this section) of the taxpayer for the taxable year.

(2) *Negative adjustment*—(i) *In general*. For taxable years beginning after December 31, 1989, the alternative minimum taxable income of any taxpayer is decreased, subject to the limitation of paragraph (a)(2)(ii) of this section, by 75 percent of the excess, if any, of pre-adjustment alternative minimum taxable income (as defined in paragraph (a)(6)(i) of this section), over adjusted current earnings (as defined in paragraph (a)(6)(ii) of this section).

(ii) *Limitation on negative adjustments*. The amount of the negative adjustment for any taxable year is limited to the excess, if any, of—

(A) The aggregate increases in alternative minimum taxable income in prior years under paragraph (a)(1) of this section over

(B) The aggregate decreases in alternative minimum taxable income in prior years under this paragraph (a)(2).

Any excess of pre-adjustment alternative minimum taxable income over adjusted current earnings that is not allowed as a negative adjustment for

the taxable year because of the limitation in this paragraph (a)(2)(ii) is not applied to reduce any positive adjustment in any other taxable year.

(iii) *Example*. The following example illustrates the provisions of this paragraph (a)(2):

(A) Corporation P is a calendar-year taxpayer and has pre-adjustment alternative minimum taxable income and adjusted current earnings in the following amounts for 1990 through 1993:

Year	Pre-adjustment alternative minimum taxable income	Adjusted current earnings
1990 .....	\$800,000	\$700,000
1991 .....	600,000	900,000
1992 .....	500,000	400,000
1993 .....	500,000	100,000

(B) Under these facts, corporation P has the following positive and negative adjustments for adjusted current earnings:

Year	Negative adjustment	Positive adjustment
1990 .....	0	0
1991 .....	0	\$225,000
1992 .....	\$75,000	0
1993 .....	150,000	0

(C) In 1990, P has a potential negative adjustment (before the cumulative limitation) of \$75,000 (75 percent of the \$100,000 excess of pre-adjustment alternative minimum taxable income over adjusted current earnings). Nonetheless, P is not permitted a negative adjustment because P had no prior increases in its alternative minimum taxable income due to an adjustment for adjusted current earnings.

(D) In 1991, P has a positive adjustment of \$225,000 (75 percent of the \$300,000 excess of adjusted current earnings over pre-adjustment alternative minimum taxable income). P is not allowed to use the prior year's excess of pre-adjustment alternative minimum taxable income over adjusted current earnings to reduce its 1991 positive adjustment.

(E) In 1992, P is permitted a negative adjustment of \$75,000, the full amount of 75 percent of the \$100,000 excess of pre-adjustment alternative minimum taxable income over adjusted current earnings for the taxable year. This is

because P's prior cumulative increases in alternative minimum taxable income due to the positive adjustments for adjusted current earnings exceed the negative adjustment for the year.

(F) In 1993, P has a potential negative adjustment (before the cumulative limitation) of \$300,000 (75 percent of the \$400,000 excess of pre-adjustment alternative minimum taxable income over adjusted current earnings). P's net cumulative increases in alternative minimum taxable income due to the adjustment for adjusted current earnings are \$150,000 (\$225,000 increase in 1991, less \$75,000 decrease in 1992). Thus, P's negative adjustment in 1993 is limited to \$150,000. P may not use the remaining portion (\$150,000) of the negative adjustment for 1993 to reduce positive adjustments in other taxable years.

(3) *Negative amounts.* In determining whether an excess exists under paragraph (a)(1) or (a)(2) of this section, a positive amount exceeds a negative amount by the sum of the absolute numbers, and a smaller negative amount exceeds a larger negative amount by the difference between the absolute numbers. Thus, for example, a positive amount of adjusted current earnings of \$30 exceeds a negative amount (or loss) of pre-adjustment AMTI of \$10 by the sum of the absolute numbers, or \$40 (30+10). Accordingly, the adjustment for adjusted current earnings would be 75 percent of \$40, or \$30. In contrast, a negative amount of adjusted current earnings of \$10 exceeds a negative amount (or loss) of pre-adjustment alternative minimum taxable income of \$30 by the difference between the absolute numbers, or \$20 (30-10). Accordingly, the adjustment for adjusted current earnings would be 75 percent of \$20, or \$15.

(4) *Taxpayers subject to adjustment for adjusted current earnings.* The adjustment for adjusted current earnings applies to any corporation other than—

- (i) An S corporation as defined in section 1361,
- (ii) A regulated investment company as defined in section 851,
- (iii) A real estate investment trust as defined in section 856, or
- (iv) A real estate mortgage investment conduit as defined in section 860A.

(5) *General rule for applying Internal Revenue Code provisions in determining adjusted current earnings—(i) In general.* Except as otherwise provided by regulations or other guidance issued by the Internal Revenue Service, all Internal Revenue Code provisions that apply in determining the regular taxable income of a taxpayer also apply in determining adjusted current earnings. For example, the rules of part V of subchapter P (relating to original issue discount and similar matters) of the Code apply in determining the amount (and the timing) of any interest income included in adjusted current earnings under this section. In applying Code provisions, however, the adjustments of section 56(g) and this section are also taken into account. For example, in applying the capitalization provisions of section 263A, the amount of depreciation to be capitalized is based on the amount of depreciation allowed in computing adjusted current earnings.

(ii) *Example.* The following example illustrates the provisions of this paragraph (a)(5):

*Example.* (A) Corporation N is a calendar year manufacturer of golf clubs. N places new manufacturing equipment in service in 1990. The regular tax depreciation allowable for this equipment is \$80,000; the pre-adjustment alternative minimum taxable income depreciation is \$60,000; and the adjusted current earnings depreciation is \$40,000. All of the golf clubs N produces in 1990 are unsold and are in ending inventory.

(B) Pursuant to section 263A and § 1.263A-1(e)(3)(ii)(I), N must capitalize the depreciation allowed for the year for the new manufacturing equipment in the ending inventory of golf clubs. Thus, when N sells the golf clubs (or is deemed to have sold them under its normal method of accounting), the cost of goods sold attributable to the capitalized depreciation will be \$80,000 in computing regular taxable income; \$60,000 in computing pre-adjustment alternative minimum taxable income; and \$40,000 in computing adjusted current earnings.

(6) *Definitions.* The following terms have the following meanings for purpose of this section.

(i) *Pre-adjustment alternative minimum taxable income.* Pre-adjustment alternative minimum taxable income is the alternative minimum taxable income of the taxpayer for the taxable year, determined under section 55(b)(2), but without the adjustment for adjusted current earnings under section 56(g)

and this section, without the alternative tax net operating loss deduction under section 56(a)(4), and without the alternative tax energy preference deduction under section 56(h).

(ii) *Adjusted current earnings.* Adjusted current earnings is the pre-adjustment alternative minimum taxable income of the taxpayer for the taxable year, adjusted as provided in section 56(g) and this section. To the extent an amount is included (or deducted) in computing pre-adjustment alternative minimum taxable income for the taxable year (whether because an adjustment is made under section 56 or 58, because of a tax preference item under section 57, or because the item is reflected in taxable income), that amount is not again included (or deducted) in computing adjusted current earnings for the taxable year.

(iii) *Earnings and profits.* Earnings and profits means current earnings and profits within the meaning of section 316(a)(2), that is, earnings and profits for the taxable year computed as of the close of the taxable year of the corporation without diminution by reason of any distributions made during the taxable year.

(7) *Application to foreign corporations.* See paragraph (m) of this section for rules relating to the application of this section to foreign corporations.

(b) *Depreciation allowed.* The depreciation deduction allowed in computing adjusted current earnings is determined under the rules of this paragraph (b). Generally, the rules for computing the adjusted current earnings depreciation deduction differ depending on the taxable year in which the property is placed in service and the method used in computing the depreciation deduction for taxable income purposes. See § 1.168(i)-1(k) for an election to use general asset accounts.

(1) *Property placed in service after 1989.* The depreciation deduction for property placed in service in a taxable year beginning after December 31, 1989, is the amount determined by using the alternative depreciation system of section 168(g). This paragraph (b)(1) does not apply to property to which paragraph (b)(4) of this section applies (relating to certain property described in sections 168 (f)(1) through (f)(4)).

(2) *Property subject to new ACRS—(i) In general.* This paragraph (b)(2) provides the rules for computing the depreciation deduction for property to which the amendments made by section 201 of the Tax Reform Act of 1986 (new ACRS) apply (generally property placed in service after December 31, 1986), and that is placed in service in a taxable year beginning before January 1, 1990. This paragraph (b)(2) does not apply to property described in paragraph (b)(4) of this section (relating to certain property described in sections 168 (f)(1) through (f)(4)) or to property described in paragraph (b)(5)(i) of this section (relating to certain churning transactions described in section 168(f)(5)).

(ii) *Rules for computing the depreciation deduction.* The depreciation deduction for property described in this paragraph (b)(2) is the amount determined by using—

(A) The adjusted basis of the property as determined in computing alternative minimum taxable income as of the close of the last taxable year beginning before January 1, 1990,

(B) The straight-line method, and

(C) The recovery period that consists of the remainder of the recovery period applicable to the property under the alternative depreciation system of section 168(g).

Thus, the recovery period begins on the first day of the first taxable year beginning after December 31, 1989, and ends on the last day of the recovery period that would have applied had the recovery period for the property originally been determined under section 168(g). In determining the recovery period that would have applied, the property is deemed placed in service on the date it was considered placed in service under the depreciation convention that would have applied to the property under section 168(d).

(iii) *Example.* The following example illustrates the provisions of this paragraph (b)(2).

*Example.* Corporation X, a calendar-year taxpayer, purchases and places in service on August 1, 1987, computer-based telephone central office switching equipment. This is the only item of depreciable property X places in service during 1987. Thus, the applicable convention under section 168(d) is the half-year convention. As of December 31,

1989, the adjusted basis of the property used in computing alternative minimum taxable income is \$42,000. The recovery period that would have applied to the property under section 168(g)(2) is 9.5 years (from July 1, 1987 to December 31, 1996). Thus, the recovery period for computing adjusted current earnings under section 56(g)(4)(A)(ii) and this paragraph (b)(2) begins on January 1, 1990, and ends on December 31, 1996. X's 1990 depreciation deduction for computing adjusted current earnings is \$6,000, determined under the straight-line method by dividing \$42,000 (adjusted basis) by 7 (recovery period).

(3) *Property subject to original ACRS—*

(i) *In general.* This paragraph (b)(3) provides the rules for computing the depreciation deduction for property to which section 168 as in effect on the day before the date of enactment of the Tax Reform Act of 1986 (original ACRS) applies and that is placed in service in a taxable year beginning before January 1, 1990 (generally property that was placed in service after December 31, 1980 and before January 1, 1987). In determining whether original ACRS applies to property, the fact that the unadjusted basis of the property is reduced or eliminated under section 168(d)(4)(A)(i) of original ACRS is not taken into account. This paragraph (b)(3) does not apply to property described in paragraph (b)(4) or (b)(5)(i) of this section (relating to certain section 168(f) property).

(ii) *Rules for computing the depreciation deduction.* The depreciation deduction for property described in this paragraph (b)(3) is the amount determined by using—

(A) The adjusted basis of the property as determined in computing taxable income as of the close of the last taxable year beginning before January 1, 1990,

(B) The straight-line method, and

(C) The recovery period that consists of the remainder of the recovery period applicable to the property under the alternative depreciation system of section 168(g). Thus, the recovery period begins on the first day of the first taxable year beginning after December 31, 1989, and ends on the last day of the recovery period that would have applied had the recovery period for the property originally been determined under section 168(g)(2). In determining the recovery period that would have applied,

the property is deemed placed in service on the date it was considered placed in service under the depreciation convention that would have applied to the property under section 168(d) (without regard to section 168(d)(3)).

(iii) *Example.* The following example illustrates the provisions of this paragraph (b)(3).

*Example.* Corporation Y, a calendar-year taxpayer, purchases and places in service on December 1, 1986, computer-based telephone central office switching equipment. The depreciation convention that would have applied to this property under section 168(d) (without regard to section 168(d)(3)) is the half-year convention. As of December 31, 1989, the adjusted basis of the property used in computing taxable income is \$21,000. The recovery period for the property under section 168(g)(2) is 9.5 years (from July 1, 1986 to December 31, 1995). Thus, the recovery period for computing adjusted current earnings under section 56(g)(4)(A)(iii) and this paragraph (b)(3) begins on January 1, 1990, and ends on December 31, 1995. Y's 1990 depreciation deduction for computing adjusted current earnings is \$3,500, determined under the straight-line method by dividing \$21,000 (adjusted basis) by 6 (recovery period).

(4) *Special rule for certain section 168(f) property.* The depreciation or amortization deduction for property described in section 168(f) (1) through (4) is determined in the same manner as used in computing taxable income, without regard to when the property is placed in service.

(5) *Certain property not subject to ACRS.* The depreciation or amortization deduction for property not described in paragraphs (b) (1) through (4) of this section is determined in the same manner as used in computing taxable income. Thus, this paragraph (b)(5) applies to—

(i) Property placed in service after December 31, 1980, in a taxable year beginning before January 1, 1990, and that is excluded from the application of original ACRS or new ACRS by section 168(e)(4) of original ACRS or section 168(f)(5)(A)(i) of new ACRS, and

(ii) Property placed in service before January 1, 1981.

(c) *Inclusion in adjusted current earnings of items included in earnings and profits—*(1) *In general.* Except as otherwise provided in paragraph (c)(4) of this

section, adjusted current earnings includes all income items that are permanently excluded from (*i.e.*, not taken into account in determining) pre-adjustment alternative minimum taxable income but that are taken into account in determining earnings and profits. An income item is considered taken into account in determining pre-adjustment alternative minimum taxable income without regard to the timing of its inclusion. Thus, this paragraph (c)(1) does not apply to any income item that is, has been, or will be included in pre-adjustment alternative minimum taxable income. For example, a taxpayer eligible to use the completed contract method of accounting for long-term construction contracts does not take income (or expenses) into account in determining pre-adjustment alternative minimum taxable income for taxable years before the taxable year the contract is completed. The taxpayer is required under section 312(n)(6) to include income (and expenses) in earnings and profits throughout the term of the contract under the percentage of completion method. This paragraph (c)(1) does not require the income on the contract to be included in adjusted current earnings, however, because the income will be taken into account in the taxable year the contract is completed and therefore is considered to be taken into account in determining pre-adjustment alternative minimum taxable income.

(2) *Certain amounts not taken into account in determining whether an item is permanently excluded.* The fact that proceeds from an income item may eventually be reflected in pre-adjustment alternative minimum taxable income of another taxpayer on the liquidation or disposal of a business, or similar circumstances, is not taken into account in determining whether the item is permanently excluded from pre-adjustment alternative minimum taxable income. Thus, for example, a corporation's adjusted current earnings include interest excluded from pre-adjustment alternative minimum taxable income under section 103 even though the interest might eventually be reflected in the pre-adjustment alternative minimum taxable income of a

corporate shareholder as gain on the liquidation of the corporation.

(3) *Allowance of offsetting deductions.* In determining adjusted current earnings under this paragraph (c), a deduction is allowed for all items that relate to income required to be included in adjusted current earnings under this paragraph (c) and that would be deductible in computing pre-adjustment alternative minimum taxable income if the income items to which the items of deduction relate were included in pre-adjustment alternative minimum taxable income for any taxable year. For example, deductions disallowed under section 265(a)(2) for the costs of carrying tax-exempt obligations, the interest on which is excluded from pre-adjustment alternative minimum taxable income under section 103 but is included in adjusted current earnings under this paragraph (c), are generally allowed as deductions in computing adjusted current earnings. Amounts deductible under this paragraph (c)(3) are taken into account using the taxpayer's method of accounting and are subject to any provisions or limitations of the Code that would have applied if the amounts had been deductible in determining pre-adjustment alternative minimum taxable income. For example, section 267(a)(2) may affect the timing of a deduction otherwise disallowed under section 265(a)(2).

(4) *Special rules.* Adjusted current earnings does not include the following amounts.

(i) *Income from the discharge of indebtedness.* Amounts that are excluded from gross income under section 108 of the Internal Revenue Code of 1986 or any corresponding provision of prior law (including the Bankruptcy Tax Act of 1980, case law, income tax regulations and administrative pronouncements).

(ii) *Federal income tax refunds.* Refunds of federal income taxes.

(iii) *Income earned on behalf of states and municipalities.* Amounts that are excluded from gross income under section 115.

(5) *Treatment of life insurance contracts—(i) In general.* This paragraph (c)(5) addresses the treatment of life insurance contracts in determining adjusted current earnings. These rules

apply to life insurance contracts as defined in section 7702. Generally, death benefits under a life insurance contract are included in adjusted current earnings, and all other distributions (including surrenders) are taxed in accordance with the principles of section 72(e), taking into account the taxpayer's basis in the contract for purposes of adjusted current earnings. If the adjusted basis in the contract for purposes of adjusted current earnings exceeds the amount of death benefits received or the amount received when the contract is surrendered (increased by the amount of any outstanding policy loan), the resulting loss is allowed as a deduction under paragraph (c)(3) of this section in computing adjusted current earnings for the taxable year. In addition, undistributed income on the contract is included in adjusted current earnings as provided in paragraph (c)(5)(ii) of this section. Paragraph (c)(5)(vi)(A) of this section provides special rules for term insurance that has no net surrender value.

(ii) *Inclusion of inside buildup.* Income on a life insurance contract with respect to a taxable year (or any shorter period either ending or beginning with the date of a distribution from the contract) is included in adjusted current earnings for the taxable year. Thus, income on the contract is calculated from the beginning of a taxable year to the date of any distribution, from immediately after any distribution to the date of the next distribution, and from the last distribution during the taxable year through the end of the taxable year. Income on a life insurance contract is not included in adjusted current earnings for any taxable year in which the insured dies or the contract is completely surrendered for its entire net surrender value. Solely for purposes of computing adjusted current earnings, the taxpayer's adjusted basis in the contract (as determined under section 72(e)(6)) is increased to reflect any positive income on the contract included in adjusted current earnings under this paragraph (c)(5)(ii). The manner in which the income on the contract is determined for adjusted current earnings purposes is prescribed in paragraph (c)(5)(iii) of this section. If the income on the contract deter-

mined under paragraph (c)(5)(iii) of this section is a negative amount, income on the contract is not included in adjusted current earnings and no deduction from adjusted current earnings is allowed for the negative amount.

(iii) *Calculation of income on the contract.* For purposes of determining adjusted current earnings, the income on a life insurance contract for any period, including a taxable year, is the excess, if any, of—

(A) The sum of the contract's net surrender value (as defined in section 7702(f)(2)(B)) at the end of the period, and any distributions under the contract during the period that, in accordance with the principles of section 72(e), are not taxed because they represent recoveries of the taxpayer's basis in the contract for adjusted current earnings, over

(B) The sum of the contract's net surrender value at the end of the preceding period, and any premiums paid under the contract during the period.

(iv) *Treatment of distributions under the life insurance contract.* Any distribution under a life insurance contract (whether a partial withdrawal or an amount received on complete surrender of the contract) is included in adjusted current earnings in accordance with the principles of section 72(e), taking into account the taxpayer's basis in the contract for purposes of computing adjusted current earnings. The taxpayer's basis in the contract is equal to the basis at the end of the immediately preceding period plus any premiums paid before the distribution. The taxpayer's basis in the contract for purposes of adjusted current earnings is reduced, in accordance with the principles of section 72(e), to the extent that the distribution is not included in adjusted current earnings because it represents a recovery of that basis.

(v) *Treatment of death benefits.* The excess of the contractual death benefit of a life insurance contract over the taxpayer's adjusted basis in the contract for purposes of computing adjusted current earnings at the time of the insured's death is included in adjusted current earnings as provided by paragraph (c)(6)(i) of this section. The amount of the death benefit that is

taken into account for adjusted current earnings includes the amount of any outstanding policy loan treated as forgiven or discharged by the insurance company upon the death of the insured.

(vi) *Other rules*—(A) *Term life insurance contract without net surrender values.* Except as provided in this paragraph (c)(5)(vi), the requirements of paragraph (c)(5) of this section do not apply to term life insurance contracts that provide no net surrender value. Adjusted current earnings are reduced by any premiums paid under such a contract that are allocable to the taxable year. Any premiums paid that are not allocable to the taxable year must be included in the basis of the contract. The death benefit under such a term insurance contract is included in adjusted current earnings as provided by paragraph (c)(5)(v) of this section.

(B) *Life insurance contracts involving divided ownership.* If the ownership of a life insurance contract is divided between different persons (for example, a split-dollar arrangement), the requirements of paragraph (c)(5) of this section apply to the separate ownership interests as though each interest were a separate contract.

(vii) *Examples.* The following examples illustrate the provisions of this paragraph (c)(5).

*Example 1.* (i) On January 1, 1987, corporation X, a calendar year taxpayer, purchased a flexible premium life insurance contract with a death benefit of \$100,000 and planned annual gross premiums of \$2,200 payable on January 1 of each year. The net surrender value of the contract at the end of 1987 and subsequent years, together with the cumulative premiums for the contract at the end of each year, are set forth in the following table:

Year	Cumulative premiums paid	Year-end net surrender value
1987 .....	\$2,200	\$2,420
1988 .....	4,400	5,082
1989 .....	6,600	8,010
1990 .....	8,800	11,231
1991 .....	11,000	14,774

(ii) Under paragraph (c)(5)(ii) of this section, X must include \$1,021 in adjusted current earnings for 1990. The inclusion is computed by subtracting from the net surrender value of the contract at the end of the taxable year (\$11,231) the sum of the net surrender value of the contract at the end of the

preceding taxable year (\$8,010) plus the premiums paid during the taxable year (\$2,200). See paragraph (c)(5)(iii) of this section. For purposes of determining adjusted current earnings, X's adjusted basis in the contract would be increased at the end of 1990 from \$8,800 to \$9,821 to reflect the \$1,021 inclusion. See paragraph (c)(5)(ii) of this section. The income under the contract attributable to taxable years prior to 1990 does not increase X's adjusted basis in the contract.

(iii) For 1991, the income on the contract included in adjusted current earnings is determined in the same manner as the preceding year, and there is a corresponding increase in X's adjusted basis in the contract. Thus, for 1991, the income on the contract is \$1,343, which is determined by subtracting from the net surrender value of the contract at the end of the taxable year (\$14,774) the sum of the net surrender value at the end of the preceding taxable year (\$11,231) plus the premiums paid during the taxable year (\$2,200). At the end of 1991, X's adjusted basis in the contract for adjusted current earnings is \$13,364, which reflects the basis of the contract at the beginning of 1991, increased by the premium paid during the year (\$2,200) and the income on the contract that has been included in adjusted current earnings for the taxable year (\$1,343).

*Example 2.* The facts are the same as in example 1, except that, after the payment of the premium for 1991, the insured dies and X receives the \$100,000 death benefit under the contract. Under paragraph (c)(5)(ii) of this section, no amount is included in adjusted current earnings for income on the contract for the taxable year in which the insured dies. Instead, under paragraph (c)(5)(v) of this section, X must include the adjusted current earnings for 1991 the excess of the death benefit (\$100,000) over the adjusted basis in the contract for purposes of computing adjusted current earnings at the time of the insured's death (\$12,021), which equals X's adjusted basis in the contract at the end of 1990 (\$9,821), increased by X's premium payment for 1991 (\$2,200).

*Example 3.* (i) The facts are the same as in example 1, except that in addition to making the \$2,200 planned premium payment for 1992, X receives a \$16,200 distribution under the contract on February 1, 1992, leaving a net surrender value of \$915 immediately following the distribution. On March 1, 1992, X pays an additional premium of \$5,000 under the contract. The net surrender value of the contract at the end of 1992 is \$6,417.

(ii) *Treatment of the distribution.* Under paragraph (c)(5)(iv) of this section, the \$16,200 distribution in 1992 is included in adjusted current earnings as an amount taxable in accordance with the principles of section 72(e) to the extent that the distribution (\$16,200) exceeds X's adjusted basis for adjusted current earnings, as determined at the

end of the immediately preceding period, and including premiums paid through the period ending on the date of the distribution (\$15,564). Thus, X must include \$636 in adjusted current earnings for 1992 as an amount taxable in accordance with the principles of section 72(e).

(iii) Determination of the income on the contract. Under paragraph (c)(5)(iii) of this section, for 1992, the income on the contract must be separately determined for the period beginning with the first day of the taxable year to the date of the distribution and for the period beginning immediately after the distribution to the end of the taxable year, using the contract's net surrender values at the beginning and end of each of these periods. The income on the contract for the period beginning on January 1, 1992 and ending on February 1, 1992 (the date of the distribution) is equal to the excess, if any, of (A) the sum of the net surrender value at the end of the period (\$915) and the amount of the distribution that is allocable to X's basis in the contract for adjusted current earnings (\$15,564), over (B) the sum of the net surrender value at the end of the preceding taxable year (\$14,774) plus any premiums paid on the contract during the period (\$2,200). Because the net result of this computation is a negative amount  $((\$915 + \$15,564) - (\$14,774 + \$2,200) = -495)$ , no income on the contract for the period ending with the date of the distribution is included in adjusted current earnings for 1992.

(iv) Under paragraph (c)(5)(ii), X must also determine the income on the contract for the period beginning immediately after the distribution through the end of the taxable year. The income on the contract for this period is \$502, which is equal to the excess of the net surrender value at the end of the taxable year (\$6,417) over the sum of the net surrender value at the end of the preceding period (\$915), plus any premiums paid during the period (\$5,000). At the end of 1992, X's adjusted basis in the contract for adjusted current earnings is \$5,502, determined by adding the income on the contract (\$502) and the premiums paid during the period (\$5,000) to the basis at the end of the preceding period (\$0).

(v) Thus, X must include a total of \$1,138 (\$636 + \$502) in adjusted current earnings for 1992. This inclusion reflects both the undistributed income on the contract for the taxable year plus the amount of income from distributions under the contract that is taxed in accordance with the principles of section 72(e) using X's adjusted basis in the contract for adjusted current earnings.

(6) *Partial list of income items excluded from gross income but included in earnings and profits.* The following is a partial list of items that are permanently excluded from pre-adjustment alter-

native minimum taxable income but that are included in earnings and profits, and are therefore included in adjusted current earnings under this paragraph (c).

(i) Proceeds of life insurance contracts that are excluded under section 101, to the extent provided in paragraph (c)(5)(v) or (c)(5)(vi) of this section.

(ii) Interest that is excluded under section 103.

(iii) Amounts received as compensation for injuries or sickness that are excluded under section 104.

(iv) Income taxes of a lessor of property that are paid by a lessee and are excluded under section 110.

(v) Income attributable to the recovery of an item deducted in computing earnings and profits in a prior year that is excluded under section 111.

(vi) Amounts received as proceeds from sports programs that are excluded under section 114.

(vii) Cost-sharing payments that are excluded under section 126, to the extent section 126(e) does not apply.

(viii) Interest on loans used to acquire employer securities that is excluded under section 133.

(ix) Financial assistance that is excluded under section 597.

(x) Amounts that are excluded from pre-adjustment alternative minimum taxable income as a result of an election under section 831(b) (allowing certain insurance companies to compute their pre-adjustment alternative minimum taxable income using only their investment income).

Items described in paragraph (c)(1) of this section must be included in earnings and profits (and therefore in adjusted current earnings) even if they are not identified in this paragraph (c)(6). The Commissioner may identify additional items described in paragraph (c)(1) in other published guidance.

(7) *Partial list of items excluded from both pre-adjustment alternative minimum taxable income and adjusted current earnings.* The following is a partial list of items that are excluded from both pre-adjustment alternative minimum taxable income and adjusted current earnings, and for which no adjustment is allowed under this section.



(i) The value of improvements made by a lessee to a lessor's property that is excluded from the lessor's income under section 109.

(ii) contributions to the capital of a corporation by a non-shareholder that are excluded from the corporation's income under section 118.

The Commissioner may identify additional items described in this paragraph (c)(7) in other published guidance.

(d) *Disallowance of items not deductible in computing earnings and profits*—(1) *In general.* Except as otherwise provided in this paragraph (d), no deduction is allowed in computing adjusted current earnings for any items that are not taken into account in determining earnings and profits for any taxable year, even if the items are taken into account in determining pre-adjustment alternative minimum taxable income. These items therefore increase adjusted current earnings to the extent they are deducted in computing pre-adjustment alternative minimum taxable income. An item of deduction is considered taken into account without regard to the timing of its deductibility in computing earnings and profits. Thus, to the extent an item is, has been, or will be deducted for purposes of determining earnings and profits, it does not increase adjusted current earnings in the taxable year in which it is deducted for purposes of determining pre-adjustment alternative minimum taxable income. For example, a deduction allowed (in determining pre-adjustment alternative minimum taxable income) under section 196 for unused research credits allowable under section 41 is taken into account in computing earnings and profits because the costs that gave rise to the credit were deductible in computing earnings and profits when incurred. Therefore, the deduction does not increase adjusted current earnings. As a further example, payments by a United States parent corporation with respect to employees of certain foreign subsidiaries, which are deductible under section 176, are considered contributions to the capital of the foreign subsidiary for purposes of computing earnings and profits. Although the payments are not deductible in computing the earnings and

profits of the United States parent corporation in the year incurred, the payments do increase the parent's basis in its stock in the foreign subsidiary. This basis increase will reduce any gain the parent may later realize for purposes of computing earnings and profits on the disposition of the stock of the foreign subsidiary. Therefore, the amount of the payment by the parent is considered taken into account in computing the earnings and profits of the parent and does not increase adjusted current earnings. Thus, only deduction items that are never taken into account in computing earnings and profits are disallowed in computing adjusted current earnings under this paragraph (d).

(2) *Deductions for certain dividends received*—(i) *Certain amounts deducted under sections 243 and 245.* Paragraph (d)(1) of this section does not apply to, and adjusted current earnings therefore are not increased by, amounts deducted under sections 243 and 245 that qualify as 100-percent deductible dividends under sections 243(a), 245(b) or 245(c), or to any dividend received from a 20-percent owned corporation (as defined in section 243(c)(2)), to the extent that the dividend giving rise to the deductions is attributable to earnings of the paying corporation that are subject to federal income tax. Earnings are considered subject to federal income tax return (that is filed or, if not, that should be filed) of an entity subject to United States taxation, even if there is no resulting United States tax liability (e.g., because of net operating losses or tax credits, other than the credit provided for in section 936).

(ii) *Special rules*—(A) *Dividends received from a foreign sales corporation.* The portion of a dividend received from a foreign sales corporation (FSC) that is classified as a 100-percent deductible dividend attributable to earnings of the FSC subject to federal income tax is that portion of the dividend distributed out of earnings and profits of the FSC attributable to non-exempt foreign trade income determined under either of the administrative pricing methods of section 925(a) (1) or (2), and to non-exempt foreign trade income determined under section 925(a)(3) that is effectively connected with the conduct of a trade or business in the United

States (determined without regard to section 921). If the FSC is a 20-percent owned corporation (as defined in section 243(c)(2)), an additional portion of that dividend is classified as being attributable to earnings of the FSC subject to federal income tax to the extent that the dividend is distributed out of earnings and profits of the FSC attributable to effectively connected income (as defined in section 245(c)(4)(B)). A FSC is defined in section 922 and, for purposes of this paragraph, includes a small FSC and a former FSC. The ordering rules for distributions from a FSC set forth in § 1.926(a)-1T(b)(1) apply to determine the classification of earnings and profits out of which a distribution has been made.

(B) *Dividends received from a section 936 corporation.* For example, assume that a section 936 corporation earns \$100 of income in its current taxable year, \$10 of which is not eligible for the credit under section 936. If the section 936 corporation makes a distribution of \$50 during that year, \$5 of that distribution (\$10 of income not eligible for the section 936 credit divided by \$100 of income, times \$50 distributed) is deemed to be attributable to earnings of the paying corporation that are subject to federal income tax.

(iii) *Special rule for certain dividends received by certain cooperatives.* Paragraph (d)(1) of this section does not apply to, and adjusted current earnings do not include, any dividend received by any organization to which part I of subchapter T of the Code applies and that is engaged in the marketing of agricultural or horticultural products, if the dividend is paid by a FSC and is allowable as a deduction under section 245(c).

(3) *Partial list of items not deductible in computing earnings and profits.* The following is a partial list of items that are not taken into account in computing earnings and profits and thus are not deductible in computing adjusted current earnings.

(i) Unrecovered losses attributable to certain damages that are deductible under section 186, to the extent those damages were previously deducted in computing earnings and profits.

(ii) The deduction for small life insurance companies allowed under section 806.

(iii) Dividends deductible under the following sections of the Code:

(A) Dividends received by corporations that are deductible under section 243, to the extent paragraph (d)(2)(i) of this section does not apply.

(B) Dividends received on certain preferred stock that are deductible under section 244.

(C) Dividends received from certain foreign corporations that are deductible under section 245, to the extent neither paragraph (d)(2)(i) nor (d)(2)(iii) of this section applies.

(D) Dividends paid on certain preferred stock of public utilities that are deductible under section 247.

(E) Dividends paid to an employee stock ownership plan that are deductible under section 404(k).

(F) Non-patronage dividends that are paid and deductible under section 1382(c)(1).

Items described in paragraph (d)(1) of this section are not taken into account in computing earnings and profits (and thus are not deductible in computing adjusted current earnings) even if they are not identified in this paragraph (d)(3). The Commissioner may identify additional items described in paragraph (d)(1) of this section in other published guidance.

(4) *Partial list of items deductible for purposes of computing both pre-adjustment alternative minimum taxable income and adjusted current earnings.* The following is a partial list of items that are deductible for purposes of computing both pre-adjustment alternative minimum taxable income and adjusted current earnings, and for which no adjustment is allowed under this section.

(i) Payments by a United States corporation with respect to employees of certain foreign corporations that are deductible under section 176.

(ii) Dividends paid on deposits by thrift institutions that are deductible under section 591.

(iii) Life insurance policyholder dividends that are deductible under section 808.

(iv) Dividends paid by cooperatives that are deductible under sections

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1382(b) or 1382(c)(2) and that are not paid with respect to stock.

The Commissioner may identify additional items described in this paragraph (d)(4) in other published guidance.

(e) *Treatment of income items included, and deduction items not allowed, in computing pre-adjustment alternative minimum taxable income.* Adjusted current earnings includes any income item that is included in pre-adjustment alternative minimum taxable income, even if that income item is not included in earnings and profits for the taxable year. Except as specifically provided in paragraph (c)(3) or (c)(5) of this section, no deduction is allowed for an item in computing adjusted current earnings if the item is not deductible in computing pre-adjustment alternative minimum taxable income for the taxable year, even if the item is deductible in computing earnings and profits for the year. Thus, for example, capital losses in excess of capital gains for the taxable year are not deductible in computing adjusted current earnings for the taxable year.

(f) *Certain other earnings and profits adjustments—(1) Intangible drilling costs.* For purposes of computing adjusted current earnings, the amount allowable as a deduction for intangible drilling costs (as defined in section 263(c)) for amounts paid or incurred in taxable years beginning after December 31, 1989, is determined as provided in section 312(n)(2)(A). See section 56(h) for an additional adjustment to alternative minimum taxable income based on energy preferences for taxable years beginning after 1990.

(2) *Certain amortization provisions do not apply.* For purposes of computing adjusted current earnings, sections 173 (relating to circulation expenditures) and 248 (relating to organizational expenditures) do not apply to amounts paid or incurred in taxable years beginning after December 31, 1989. If an election is made under section 59(e) to amortize circulation expenditures described in section 173 over a three-year period, the expenditures to which the election applies are deducted ratably over the three-year period for purposes of computing taxable income, pre-ad-

justment alternative minimum taxable income, and adjusted current earnings.

(3) *LIFO recapture adjustment—(i) In general.* Adjusted current earnings are generally increased or decreased by the increase or decrease in the taxpayer's LIFO recapture amount (as defined in paragraph (f)(3)(iii)(A) of this section) as of the close of each taxable year.

(ii) *Beginning LIFO and FIFO inventory.* For purposes of computing the increase or decrease in the LIFO recapture amount, the beginning LIFO and FIFO inventory amounts for the first taxable year beginning after December 31, 1989, are—

(A) The ending LIFO inventory amount used in computing pre-adjustment alternative minimum taxable income for the last year beginning before January 1, 1990; and

(B) The ending FIFO inventory amount for the last year beginning before January 1, 1990, computed with the adjustments described in section 56 (other than the adjustment described in section 56(g)) and section 58, the items of tax preference described in section 57 and using the methods used in computing pre-adjustment alternative minimum taxable income.

(iii) *Definitions—(A) LIFO recapture amount—(1) Definition.* The taxpayer's LIFO recapture amount is the excess, if any, of—

(i) the inventory amount of its assets under the FIFO method, computed using the rules of this section; over

(ii) the inventory amount of its assets under the LIFO method, computed using the rules of this section.

(2) *Assets included.* Only the assets for which the taxpayer uses the LIFO method to compute pre-adjustment alternative minimum taxable income are taken into account in determining the LIFO recapture amount.

(B) *FIFO Method.* For purposes of this paragraph, the LIFO method is the first in, first out method described in section 471, determined by using—

(1) The retail method if that is the method the taxpayer uses in computing pre-adjustment alternative minimum taxable income; or

(2) The lower of cost or market method for all other taxpayers.

(C) *LIFO method.* The LIFO method is the last in, first out method authorized by section 472.

(D) *Inventory amounts.* Except as otherwise provided, inventory amounts are computed using the methods used in computing pre-adjustment alternative minimum taxable income. To the extent inventory is treated as produced or acquired during taxable years beginning after December 31, 1989, the inventory amount is determined with the adjustments described in sections 56 and 58 and the items of tax preference described in section 57. Thus, for example, the amount of depreciation to be capitalized under section 263A with respect to inventory produced in taxable years beginning after December 31, 1989, is based on the depreciation allowed under the rules of paragraph (b) of this section. See paragraph (a)(5) of this section.

(iv) *Exchanges under sections 351 and 721.* For purposes of this section, any decrease in a transferor's LIFO recapture amount that occurs as a result of a transfer of inventories in an exchange to which section 351 or section 721 applies cannot be used to decrease the adjusted current earnings of the transferor. A decrease that is disallowed under the preceding sentence is

instead carried over to reduce any LIFO recapture adjustment that the transferee (or its corporate partners, if section 721 applies) would otherwise make (in the absence of this paragraph (f)(3)(iv)) solely by reason of its carryover basis in inventories received in the section 351 or section 721 exchange. Nothing in this paragraph (f)(3)(iv), however, alters the computation of the LIFO recapture amount of the transferor or transferee as of the close of any taxable year.

(v) *Examples.* The following examples illustrate the provisions of this paragraph (f)(3).

*Example 1.* M Corporation, a calendar-year taxpayer, uses the LIFO method of accounting for its inventory for purposes of computing pre-adjustment alternative minimum taxable income. M's ending LIFO inventory for all of its pools for purposes of computing pre-adjustment alternative minimum taxable income on December 31, 1989, is \$300. M computes a \$500 FIFO inventory amount on that date, after applying the provisions of section 263A along with the adjustments and preferences required in computing pre-adjustment alternative minimum taxable income. M's FIFO and LIFO ending inventory amounts at the close of its taxable years, its LIFO reserves, and its adjustment under this paragraph (f)(3), are as follows:

	1989	1990	1991	1992
Ending inventory:				
A. FIFO .....	<sup>1</sup> \$500	\$360	\$560	\$600
B. LIFO .....	<sup>2</sup> 300	180	320	440
LIFO recapture amount:				
A - B .....	200	180	240	160
Change in LIFO recapture amount and adjustment under paragraph (f)(3) .....		(20)	60	(80)

<sup>1</sup> Beginning FIFO inventory amount under paragraph (f)(3)(ii).

<sup>2</sup> Beginning LIFO inventory amount under paragraph (f)(3)(ii).

*Example 2.* (A) X Corporation, a calendar-year taxpayer, uses the LIFO method for purposes of computing pre-adjustment alternative minimum taxable income. X's LIFO recapture amount is \$300 as of December 31, 1992, and is \$200 as of December 31, 1993. Immediately prior to calculating its LIFO recapture amount as of December 31, 1993, X transfers inventory with an adjusted current earnings (ACE) basis of \$500 to Y Corporation in an exchange to which section 351 applies. X determines that the \$100 decrease in its LIFO recapture amount occurred as a result of its transfer of inventories to Y in the section 351 exchange. Thus, under paragraph

(f)(3)(iv) of this section, X cannot decrease its adjusted current earnings by that amount. In computing its 1994 LIFO recapture adjustment, X will use \$200 as its LIFO recapture amount as of December 31, 1993, even though it was not entitled to reduce adjusted current earnings by the \$100 decrease in its LIFO recapture amount in 1993.

(B) For purposes of computing its ACE, Y takes a \$500 carryover basis in the inventories received from X. If Y, a newly formed calendar-year taxpayer, engages in no other inventory transactions in 1993 and adopts the LIFO inventory method on its 1993 tax return, it will have a LIFO recapture amount

of \$0 as of December 31, 1993 (because its FIFO inventory amount and its LIFO inventory amount are both \$500). Assume that at December 31, 1994, Y has a LIFO recapture amount of \$200 (\$1,000 FIFO inventory amount—\$800 LIFO inventory amount). Under paragraph (f)(3)(i) of this section, Y computes a LIFO recapture adjustment for 1994 of \$200 (\$200—\$0). If any portion of Y's \$200 LIFO recapture adjustment occurs solely by reason of its carryover basis in the inventories it received from X, Y reduces its \$200 LIFO recapture adjustment by that portion under paragraph (f)(3)(iv). In any event, however, Y will use its \$200 LIFO recapture amount as of December 31, 1994, in computing its 1995 LIFO recapture adjustment.

(vi) *Effective date.* Paragraph (f)(3) is effective for taxable years beginning after December 18, 1992. A taxpayer may choose to apply this paragraph, however, to all taxable years beginning after December 31, 1989.

(4) *Installment sales—(i) In general.* Adjusted current earnings are computed without regard to the installment method, except as provided in this paragraph (f)(4).

(ii) *Exception for prior dispositions.* Paragraph (f)(4)(i) of this section does not apply to any disposition in a taxable year beginning before January 1, 1990, that is taken into account under the installment method for purposes of computing pre-adjustment alternative minimum taxable income. Thus, for any disposition in a taxable year beginning before January 1, 1990, the installment method applies in computing adjusted current earnings for taxable years beginning after December 31, 1989, to the same extent it applies in determining pre-adjustment alternative minimum taxable income for the taxable year.

(iii) *Special rules for obligations to which section 453A applies—(A) In general.* The following special rules apply to any installment sale occurring in a taxable year beginning after December 31, 1989, that results in an installment obligation to which section 453A(a)(1) applies and with respect to which preadjustment alternative minimum taxable income is determined under the installment method. As explained in paragraph (f)(4)(iii)(B) of this section, for purposes of computing adjusted current earnings, a portion of the contract price is eligible for the installment method, and the remainder

of the contract price is not eligible for the installment method. Payments under the obligation are allocated pro-rata between the two accounting methods.

(B) *Limitation on application of installment method.* Only a portion of the contract price of an installment sale described in paragraph (f)(4)(iii)(A) of this section is eligible to be accounted for under the installment method for purposes of computing adjusted current earnings. The portion eligible for the installment method is equal to the total contract price of the sale multiplied by the applicable percentage (as determined under section 453A(c)(4)) for the taxable year of the sale. The remainder of the contract price is not eligible to be accounted for under the installment method for purposes of computing adjusted current earnings. The gross profit ratio is determined without regard to this bifurcated treatment of the sale.

(C) *Treatment of the ineligible portion.* The gain on the sale that is taken into account in the taxable year of the sale for purposes of computing adjusted current earnings is equal to the gross profit ratio multiplied by the entire portion of the contract price that is ineligible for the installment method.

(D) *Treatment of the eligible portion.* For purposes of calculating adjusted current earnings, the amount of gain recognized in a taxable year on the portion of the contract price that is eligible for the installment method is equal to—

- (1) The amount of payments received during the taxable year, multiplied by
- (2) The applicable percentage for the taxable year of the sale, multiplied by
- (3) The gross profit ratio.

(E) *Coordination with the pledge rule.* For purposes of determining the amount of payments received during the taxable year under paragraph (f)(4)(iii)(D), the rules of section 453A(d) (relating to the treatment of certain pledge proceeds as payments) apply. This includes the rules under section 453A(d)(3) that relate to treating later payments as receipts of amounts on which tax has already been paid.

(F) *Example.* The following example illustrates the provisions of this paragraph (f)(4)(iii):

(J) On January 1, 1990, corporation A, a calendar-year taxpayer, sells a building with an adjusted basis for purposes of computing adjusted current earnings of \$10 million, for \$5 million and an installment obligation bearing adequate stated interest with a principal amount of \$20 million. The installment obligation calls for 4 annual payments of \$5 million on January 1 of 1991, 1992, 1993, and 1994. A does not elect out of the installment method, and disposes of no other property under the installment method during 1990. No gain with respect to the sale is recaptured pursuant to section 1250.

(2) The gross profit percentage for purposes of computing adjusted current earnings on the sale is 60 percent, computed as follows: gross profit of \$15 million (\$25 million contract price less \$10 million adjusted basis) divided by \$25 million contract price. The applicable percentage on the sale is 75 percent, computed as follows: \$15 million (\$20 million of installment obligations arising during and outstanding at the end of 1990 less \$5 million) divided by \$20 million of installment obligations arising during and outstanding at the end of 1990. See section 453A(c)(4). The portion of the contract price eligible for accounting under the installment method for purposes of computing adjusted current earnings is \$18.75 million, or \$25 million total contract price times applicable percentage of 75 percent. The portion of the contract price ineligible for the installment method is \$6.25 million, or \$25 million less \$18.75 million.

(3) In computing adjusted current earnings for 1990, A must include \$3.75 million of the gain on the sale. This amount is equal to the portion of the contract price that is ineligible for the installment method times the gross profit ratio, or \$6.25 million times 60 percent. A must also include \$2.25 million of gain from the \$5 million payment received in 1990. This amount is computed as follows: the eligible portion of the payment, \$3.75 million (\$5 million payment times the applicable percentage of 75 percent), times the gross profit ratio of 60 percent. Thus, the total amount of gain from the sale that A must include in adjusted current earnings for 1990 is \$6 million (\$3.75 million of gain from the portion of the contract price that is not eligible for the installment method, plus \$2.25 million of gain from the 1990 payment).

(4) A does not pledge or otherwise accelerate payments on the note in any other taxable year. In computing adjusted current earnings for 1991, 1992, 1993, and 1994, A therefore includes \$2.25 million of gain on the installment sale, computed as follows: \$5 million payment times the applicable percentage of 75 percent, times the gross profit ratio of 60 percent.

(g) *Disallowance of loss on exchange of debt pools.* [Reserved]

(h) *Policy acquisition expenses of life insurance companies—(1) In general.* This paragraph (h) addresses the treatment of policy acquisition expenses of life insurance companies in determining adjusted current earnings. Policy acquisition expenses are those expenses that, under generally accepted accounting principles in effect at the time the expenses are incurred, are considered to vary with and to be primarily related to the acquisition of new and renewal insurance policies. Generally, these acquisition expenses must be capitalized and amortized for purposes of adjusted current earnings over the reasonably estimated life of the acquired policy, using a method that provides a reasonable allowance for amortization. This method of amortization is treated as if it applied to all taxable years in determining the amount of policy acquisition expenses deducted for adjusted current earnings. The rules in this paragraph (h) apply to any life insurance company, as defined in section 816(a).

(2) *Reasonably estimated life.* The reasonably estimated life of an acquired policy is determined based on the facts with respect to each policy (such as the age, sex, and health of the insured), and the company's experience (such as mortality, lapse rate and renewals) with similar policies. A company may treat as the reasonably estimated life of an acquired policy the period for amortizing expenses of the acquired policy that would be required by the Financial Accounting Standards Board (FASB) at the time the acquisition expenses are incurred. If the FASB has not established such a period, the period for amortizing acquisition expense of an acquired policy under guidelines issued by the American Institute of Certified Public Accountants in effect at the time the acquisition expenses are incurred may be treated as the reasonably estimated life of the acquired policy.

(3) *Reasonable allowance for amortization.* For purposes of determining a reasonable allowance for amortization, a company may use a method that amortizes acquisition expenses in the same proportion that gross premiums and

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gross investment income for the taxable year bear to total anticipated receipts of gross premiums (including anticipated renewal premiums) and gross investment income to be realized over the reasonably estimated life of the policy.

(4) *Safe harbor for public financial statements.* Any company that is required to file with the Securities and Exchange Commission (SEC) a financial statement with respect to the taxable year will be treated as having complied with paragraph (h)(1) of this section if it accounts for acquisition expenses for adjusted current earnings purposes in the same manner as it accounts for those expenses on its financial statements filed with the SEC.

(i) [Reserved]

(j) *Depletion.* For purposes of computing adjusted current earnings, the allowance for depletion with respect to any property placed in service in a taxable year beginning after December 31, 1989 is determined under the cost depletion method of section 611.

(k) *Treatment of certain ownership changes—(1) In general.* In the case of any corporation that has an ownership change as defined in paragraph (k)(2) of this section in a taxable year beginning after December 31, 1989, and that also has a net unrealized built-in loss (as defined in paragraph (k)(3) of this section) immediately before the ownership change, the adjusted basis of each asset of the corporation for purposes of computing adjusted current earnings following the ownership change shall be its proportionate share (determined on the basis of the respective fair market values of each asset) of the fair market value of the assets of the corporation immediately before the ownership change. The rules of §1.338-6(b), if otherwise applicable to the transaction, are applied in making this allocation of basis. If such rules apply, the limitations of §§1.338-6(c) (1) and (2) also apply in allocating basis under this paragraph (k)(1).

(2) *Definition of ownership change.* A corporation has an ownership change for purposes of section 56(g)(4)(G)(i) and this paragraph (k) if there is an ownership change under section 382(g) for purposes of computing the corporation's amount of taxable income that

may be offset by pre-change losses or the regular tax liability that may be offset by pre-change credits. See §1.382-2T for rules to determine whether a corporation has an ownership change. Accordingly, in order for an ownership change to occur for purposes of this paragraph (k), a corporation must be a loss corporation as defined in §1.382-2(a)(1). In determining whether the corporation is a loss corporation, the determination of whether there is a net unrealized built-in loss is made by using the aggregate adjusted basis of the assets of the corporation used in computing taxable income. The aggregate adjusted basis of the corporation's assets for purposes of computing adjusted current earnings is not relevant in determining whether the corporation is a loss corporation. See part (iv) of the example in paragraph (k)(4) of this section.

(3) *Determination of net unrealized built-in loss immediately before an ownership change.* In order to determine whether it has a net unrealized built-in loss for purposes of section 56(g)(4)(G)(ii) and paragraph (k)(1) of this section, a corporation that has an ownership change as defined in paragraph (k)(2) of this section must use the aggregate adjusted basis of its assets that it uses in computing its adjusted current earnings. The rules of section 382 (including sections 382(h)(3)(B)(i) and 382(h)(8)) otherwise apply in determining whether the corporation has a net unrealized built-in loss.

(4) *Example.* The following example illustrates the provisions of this paragraph (k):

(i) Individual A has owned all the issued and outstanding stock of corporation L for the past 5 years. A sells all of his stock in L to unrelated individual B. On the date of the sale, L owns the following assets (all numbers are in millions):

Asset	Adjusted basis for computing taxable income	Adjusted basis for computing adjusted current earnings	Fair market value
x .....	\$45	\$50	\$50
y .....	55	60	30
z .....	10	10	20
	\$110	\$120	\$100

For purposes of computing taxable income, L has a \$500 million net operating loss carryforward to the taxable year in which the sale occurs. Therefore, L is a loss corporation. As a result of the transfer of shares of L from A to B, L has had an ownership change.

(ii) L has no net unrealized built-in loss for purposes of computing taxable income because the amount by which the aggregate adjusted basis of its assets for that purpose exceeds their fair market value is \$10 million, which is less than 15 percent of their fair market value and is not greater than \$10 million. See section 381(h)(3)(B)(i). L, however, does have a net unrealized built-in loss for purposes of computing adjusted current earnings because the aggregate adjusted basis of its assets for the purpose exceeds their fair market value by \$20 million, and that amount is greater than \$10 million.

(iii) Under paragraph (k)(1) of this section, L must restate the adjusted basis of its assets for purposes of computing adjusted current earnings to their fair market values, as follows (all numbers are in millions):

Asset	New adjusted basis
x .....	\$50
y .....	30
z .....	20

L must use these new adjusted bases for all purposes in determining adjusted current earnings, including computing depreciation and any gain or loss on disposition.

(iv) If L did not have the net operating loss carryforward, and had no other loss or credit carryovers or other attributes described in §1.382-2(a)(1) for purposes of computing the amount of its taxable income that may be offset by pre-change losses or its regular tax liability that may be offset by pre-change credits, it would not have been a loss corporation on the date of the sale and therefore would not be treated as having had an ownership change for purposes of computing adjusted current earnings. This would be true even though L had a net unrealized built-in loss for purposes of computing adjusted current earnings. Therefore, this paragraph (k) would not have applied.

(l) [Reserved]

(m) *Adjusted current earnings of a foreign corporation*—(1) *In general.* The alternative minimum taxable income of a foreign corporation is increased by 75 percent of the excess of—

(i) Its effectively connected adjusted current earnings for the taxable year; over

(ii) Its effectively connected pre-adjustment alternative minimum taxable income for the taxable year.

(2) *Definitions*—(i) *Effectively connected pre-adjustment alternative minimum taxable income.* Effectively connected pre-adjustment alternative minimum taxable income is the effectively connected taxable income of the foreign corporation for the taxable year, determined with the adjustments under sections 56 and 58 (except for the adjustment for adjusted current earnings, the alternative tax net operating loss and the alternative tax energy preference deduction) and increased by the tax preference items of section 57, but taking into account only items of income of the foreign corporation that are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and any expense, loss or deduction that is properly allocated and apportioned to that income.

(ii) *Effectively connected adjusted current earnings.* Effectively connected adjusted current earnings is the effectively connected pre-adjustment alternative minimum taxable income of the foreign corporation for the taxable year, adjusted under section 56(g) and this section, but taking into account only items of income of the foreign corporation that are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and any expense, loss or deduction that is properly allocated and apportioned to that income.

(3) *Rules to determine effectively connected pre-adjustment alternative minimum taxable income and effectively connected adjusted current earnings.* The principles of section 864 (c) (and the regulations thereunder) and any other applicable provision of the Internal Revenue Code apply to determine whether items of income of the foreign corporation are effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and whether any expense, loss or deduction is properly allocated and apportioned to that income.

(4) *Certain exempt amounts.* Effectively connected adjusted current earnings and effectively connected pre-adjustment alternative minimum taxable



income do not include any item of income, or any expense, loss or deduction that is properly allocated and apportioned to income that is exempt from United States taxation under section 883 or an applicable income tax treaty. See section 894.

(n) *Adjustment for adjusted current earnings of consolidated groups*—(1) *Positive adjustments*. For taxable years beginning after December 31, 1989, the alternative minimum taxable income of a consolidated group (as defined in § 1.1502-1T) is increased by 75 percent of the excess, if any, of—

(i) The consolidated adjusted current earnings for the taxable year, over

(ii) The consolidated pre-adjustment alternative minimum taxable income for the taxable year.

(2) *Negative adjustments*—(i) *In general*. The alternative minimum taxable income of a consolidated group is decreased, subject to the limitation of paragraph (n)(2)(ii) of this section, by 75 percent of the excess, if any, of the consolidated pre-adjustment alternative minimum taxable income over consolidated adjusted current earnings.

(ii) *Limitation on negative adjustments*. The amount of the negative adjustment for any taxable year shall be limited to the excess, if any, of—

(A) The aggregate increases in the alternative minimum taxable income of the group in prior years under this section, over

(B) The aggregate decreases in the alternative minimum taxable income of the group in prior years under this section.

(3) *Definitions*—(i) *Consolidated pre-adjustment alternative minimum taxable income*. Consolidated pre-adjustment alternative minimum taxable income is the consolidated taxable income (as defined in § 1.1502-11) of a consolidated group for the taxable year, determined with the adjustments provided in sections 56 and 58 (except for the adjustment for adjusted current earnings and the alternative tax net operating loss determined under section 56(a)(4)) and increased by the preference items described in section 57.

(ii) *Consolidated adjusted current earnings*. The consolidated adjusted current earnings of a consolidated group is the consolidated pre-adjustment alter-

native minimum taxable income of the consolidated group for the taxable year, adjusted as provided in section 56(g) and this section.

(4) *Example*. The following example illustrates the provisions of this paragraph (n):

(i) P is the common parent of a consolidated group. In 1990, the group has consolidated pre-adjustment alternative minimum taxable income of \$1,400,000 and consolidated adjusted current earnings of \$1,600,000. Thus, the group has a consolidated adjustment for adjusted current earnings for 1990 of \$150,000 (75 percent of the \$200,000 excess of consolidated adjusted current earnings over consolidated pre-adjustment alternative minimum taxable income), and alternative minimum taxable income of \$1,550,000 (\$1,400,000 plus \$150,000).

(ii) In 1991, the group has consolidated pre-adjustment alternative minimum taxable income of \$1,500,000 and consolidated adjusted current earnings of \$1,100,000. Thus, the group can reduce its alternative minimum taxable income by \$150,000. The potential negative adjustment of \$300,000 (75 percent of the \$400,000 excess of consolidated pre-adjustment alternative minimum taxable income over consolidated adjusted current earnings) is limited to the \$150,000 consolidated adjustment for adjusted current earnings taken into account in 1990.

(o) [Reserved]

(p) *Effective dates for corporate partners in partnerships*—(1) *In general*. The provisions of this section apply to a corporate partner's distributive share of items of income and expense from a partnership for any taxable year of the partnership ending within or with any taxable year of the corporate partner beginning after December 31, 1989.

(2) *Application of effective dates*. Solely for purposes of the effective date provisions of this section, a partnership event (such as placing property in service, paying or incurring a cost, or closing an installment sale) is deemed to occur on the last day of the partnership's taxable year.

(3) *Example*. The following example illustrates the provisions of this paragraph (p):

(i) X is a calendar-year corporation that is a partner in P, an accrual-basis partnership with a taxable year ending March 31. During P's taxable year ending March 31, 1990, P earned ratably throughout the year interest

income on tax-exempt obligations. In addition, P incurred intangible drilling costs in November 1989 and in February 1990.

(ii) X's adjusted current earnings for 1990 includes X's distributive share of the interest on the tax-exempt obligations earned by P for its taxable year ending March 31, 1990. This is true even though P earned a portion of the interest prior to January 1, 1990.

(iii) For purposes of computing X's adjusted current earnings for 1990, the adjustment provided in paragraph (f)(1) of this section applies to X's distributive share of P's November 1989 and February 1990 intangible drilling costs.

(q) *Treatment of distributions of property to shareholders—(1) In general.* If a distribution of an item of property by a corporation with respect to its stock gives rise to more than one adjustment to earnings and profits under section 312, all of the adjustments with respect to that item of property (including the adjustment described in section 312(c) with respect to liabilities to which the item is subject or which are assumed in connection with the distribution) are combined for purposes of determining the corporation's adjusted current earnings for the taxable year. If the amount included in pre-adjustment alternative minimum taxable income with respect to a distribution of an item of property exceeds the net increase in earnings and profits caused by the distribution, pre-adjustment alternative minimum taxable income is not reduced in computing adjusted current earnings. If the net increase in earnings and profits caused by a distribution of an item of property exceeds the amount included in pre-adjustment alternative minimum taxable income with respect to the distribution, that excess is added to pre-adjustment alternative minimum taxable income in computing adjusted current earnings.

(2) *Examples.* The following examples illustrate the provisions of this paragraph (q).

(i) *Example 1.* K corporation distributes property with a fair market value of \$150 and an adjusted basis of \$100. The adjusted basis is the same for purposes of computing taxable income, pre-adjustment alternative minimum taxable income, adjusted current earnings, and earnings and profits. Under section 312(a)(3), as modified by section 312(b)(2), K decreases its earnings and profits by the fair market value of the property, or \$150. Under section 312(b)(1), K increases its

earnings and profits by the excess of the fair market value of the property over its adjusted basis, or \$50. As a result of the distribution, there is a net decrease in K's earnings and profits of \$100. K recognizes \$50 of gain under section 311(b) as a result of the distribution as if K sold the property for \$150. K thus has no amount permanently excluded from pre-adjustment alternative minimum taxable income that is taken into account in determining current earnings and profits, and thus has no adjustment under paragraph (c)(1) of this section.

(ii) *Example 2.* The facts are the same as in example 1, except that the distribution shareholder assumes a \$190 liability in connection with the distribution. Under section 312(c)(1), K must adjust the adjustments to its earnings and profits under section 312 (a) and (b) to account for the liability the shareholder assumes. K adjusts the \$100 net decrease in its earnings and profits to reflect the \$190 liability, resulting in an increase in its earnings and profits of \$90. Because section 311(b)(2) makes the rules of section 336(b) apply, the fair market value of the property is not less than the amount of the liability, or \$190. K therefore is treated as if it sold the property for \$190, recognizing \$90 of gain. K thus has no amount permanently excluded from pre-adjustment alternative minimum taxable income that is taken into account in determining current earnings and profits, and thus has no adjustment under paragraph (c)(1) of this section.

(r) *Elections to use simplified inventory methods to compute alternative minimum tax—(1) In general.* If a taxpayer makes an election under this paragraph (r) (and does not make the election in paragraph (r)(5) of this section), the rules of paragraph (r)(2) of this section apply in computing the taxpayer's pre-adjustment alternative minimum taxable income and adjusted current earnings.

(2) *Effect of election—(i) Inventories.* The taxpayer's inventory amounts as determined for purposes of computing taxable income are used for purposes of computing pre-adjustment alternative minimum taxable income and adjusted current earnings. Subject to the further modification described in paragraph (r)(2)(ii) of this section, the taxpayer's cost of sales as determined for purposes of computing taxable income is also used for purposes of computing pre-adjustment alternative minimum taxable income and adjusted current earnings.

(ii) *Modifications required—(A) In general.* If a taxpayer makes an election

under this paragraph (r), pre-adjustment alternative minimum taxable income and adjusted current earnings are computed with the modifications described in this paragraph. The items of adjustment under sections 56 and 58 and the items of tax preference under section 57 are computed without regard to the portion of those adjustments and preferences which, but for the election described in this paragraph, would have been capitalized in ending inventory. For example, pre-adjustment alternative minimum taxable income is increased by the excess of the depreciation allowable for the taxable year under section 168 for purposes of computing taxable income (determined without regard to section 263A) over the depreciation allowable for the taxable year under section 56(a)(1) and section 57 for purposes of computing pre-adjustment alternative minimum taxable income (determined without regard to section 263A). Similarly, adjusted current earnings is further increased by the excess of the depreciation allowable for the taxable year under section 56(a)(1) and section 57 for purposes of computing pre-adjustment alternative minimum taxable income (determined without regard to section 263A) over the depreciation allowable for the taxable year under section 56(g)(4)(A) for purposes of computing adjusted current earnings (determined without regard to section 263A). Thus, the modifications described in the preceding sentence do not duplicate amounts that are taken into account in computing pre-adjustment alternative minimum taxable income. See paragraph (a)(6)(ii) of this section.

(B) *Negative modifications allowed.* An election under this paragraph (r) does not affect the taxpayer's ability to make negative adjustments. Thus, if an election is made under this paragraph (r) and the amount of any adjustment under section 56 or 58, determined after modification under paragraph (r)(2)(ii)(A) of this section, is a negative amount, then this amount reduces pre-adjustment alternative minimum taxable income or adjusted current earnings. However, no negative adjustment under this paragraph (r)(2)(ii)(B) is allowed for the items of tax preference under section 57.

(iii) *LIFO recapture adjustment.* If a taxpayer makes an election under this paragraph (r) and uses the LIFO method for some assets, for purposes of computing the LIFO recapture adjustment under paragraph (f)(3) of this section for taxable years beginning after December 31, 1989—

(A) The LIFO inventory amount as determined for purposes of computing taxable income is used in lieu of the LIFO inventory amount as determined under paragraph (f)(3)(iii) of this section;

(B) The FIFO inventory amount is computed without regard to the adjustments under sections 56 (including the adjustments of section 56(g)(4)) and 58 and the items of tax preference of section 57; and

(C) The beginning LIFO and FIFO inventory amounts under paragraph (f)(3)(ii) of this section are the ending LIFO inventory amount as determined for purposes of computing taxable income and the ending FIFO inventory amount computed without regard to the adjustments under sections 56 (including the adjustments of sections 56(g)(4)) and 58 and the items of tax preference of section 57 for the last taxable year beginning before January 1, 1990.

(3) *Time and manner of making election—(i) Prospective election.* (A) A prospective election under this paragraph (r) may be made by any taxpayer—

(1) That has computed pre-adjustment alternative minimum taxable income and adjusted current earnings for all prior taxable years in accordance with the method described in this paragraph (r); or

(2) That has not computed pre-adjustment alternative minimum taxable income and adjusted current earnings for all prior tax years in accordance with the method described in this paragraph (r), but for which the use of the method described in this paragraph (r) for all prior taxable years would not have changed the taxpayer's tax liability (as shown on returns filed as of the date the election is made) for any prior taxable year for which the period of limitations under section 6501(a) has not expired (as of the date the election is made).

(B) A prospective election under this paragraph (r) may only be made by attaching a statement to the taxpayer's timely filed (including extensions) original Federal income tax return for any taxable year that is no later than its first taxable year to which this paragraph (r) applies and in which the taxpayer's tentative minimum tax (computed under the provisions of this paragraph (r)) exceeds its regular tax. However, in the case of a taxpayer described in paragraph (r)(3)(i)(A)(1) of this section that had tentative minimum tax in excess of its regular tax for any prior taxable year, the election may only be made by attaching a statement to its timely filed (including extensions) original Federal income tax return for the first taxable year ending after December 18, 1992. The statement must—

(1) Give the name, address and employer identification number of the taxpayer; and

(2) Identify the election as made under this paragraph (r).

(C) The determination of whether a taxpayer is described in paragraph (r)(3)(i)(A)(2) of this section is to be made as of the time the taxpayer makes a prospective election in accordance with the procedures in paragraph (r)(3)(i)(B) of this section.

(D) Any taxpayer described in paragraph (r)(3)(i)(A)(2) of this section that makes a prospective election will be deemed to have used the method described in this paragraph (r) in computing pre-adjustment alternative minimum taxable income and adjusted current earnings for all prior taxable years.

(ii) *Retroactive election*—(A) A retroactive election under this paragraph (r) may be made by any taxpayer not described in paragraph (r)(3)(i)(A)(1) or (2) of this section. Except as provided in paragraph (r)(3)(iii) of this section, a retroactive election may only be made by attaching a statement to the taxpayer's amended Federal income tax return for the earliest taxable year for which the period of limitations under section 6501(a) has not expired and which begins after December 31, 1986. The amended return to which the election under this paragraph (r)(3)(ii) is

attached must be filed no later than June 21, 1993.

(B) The amended return must contain the statement described in paragraph (r)(3)(i)(B) of this section. In addition, the statement must contain a representation that the taxpayer will modify its pre-adjustment alternative minimum taxable income and adjusted current earnings for all open taxable years in accordance with paragraph (r)(2) of this section. Upon this change in method of accounting, the taxpayer must include the entire adjustment required under section 481(a), if any, in preadjustment alternative minimum taxable income and adjusted current earnings on the amended return for the year of the election. The taxpayer must also reflect the method of accounting described in paragraph (r)(2) of this section on amended returns filed for all taxable years after the year of the election for which returns were originally filed before making the election (and for which the period of limitations under section 6501(a) has not expired).

(C) Provided a taxpayer meets the requirements of this paragraph (r), any change in method of accounting arising as a result of making a retroactive election will be treated as made with the advance consent of the Commissioner.

(D) Any retroactive election under this paragraph (r) that is made without filing amended returns required under this paragraph (r)(3)(ii) shall constitute a change in method of accounting made without the consent of the Commissioner.

(iii) *Taxpayers under examination*—(A) *In general.* A taxpayer that wishes to make a retroactive election under section (r)(3)(ii) of this section may use the procedures in paragraph (r)(3)(iii)(A)(1) or (2) in lieu of filing an amended return for any taxable year that is under examination by the Internal Revenue Service.

(1) *Year of change under examination.* If the year of the change is under examination at the time the taxpayer timely makes the election, the taxpayer may (in lieu of filing an amended return for the year of the change) furnish the written statement described in paragraph (r)(3)(iii)(B) of this section

to the revenue agent responsible for examining the taxpayer's return no later than June 21, 1993. It is the taxpayer's responsibility to make a timely election either by furnishing the statement to the revenue agent or by filing amended returns by June 21, 1993.

(2) *Other open years under examination.* If any other year for which the taxpayer must modify its pre-adjustment alternative minimum taxable income and adjusted current earnings (see paragraph (r)(3)(ii)(B) of this section) is examined, the taxpayer may (in lieu of filing an amended return) furnish the amount of the conforming adjustment to the revenue agent responsible for examining the taxpayer's return. It is the taxpayer's responsibility to timely modify its pre-adjustment alternative minimum taxable income and adjusted current earnings for each year other than the year of change, either by furnishing the amount of the adjustment to the revenue agent or by filing amended returns.

(B) *Statement required.* The statement required under paragraph (r)(3)(iii)(A)(I) of this section must include all of the items required under paragraph (r)(3)(ii)(B) of this section, as well as—

(1) The caption "Election to use regular tax inventories for AMT purposes;"

(2) A description of the nature and amount of all items that would result in adjustments and that the taxpayer would have reported if the taxpayer had used the method described in this paragraph (r) for all prior taxable years for which the period of limitations under section 6501(a) has not expired and which begin after December 31, 1986; and

(3) The following declaration signed by the person authorized to sign the return for the taxpayer: "Under penalties of perjury, I declare that I have examined this written statement, and to the best of my knowledge and belief this written statement is true, correct, and complete."

(C) *Year of change.* The year of change is the earliest taxable year for

which the period of limitations under section 6501(a) has not expired at the time the statement is submitted to the appropriate revenue agent and that begins after December 31, 1986. Thus, the adjustments required to be included on the statement must include any adjustment under section 481(a) determined as if the method described in this paragraph (r) had been used in all taxable years prior to the year of change that begin after December 31, 1986.

(D) *Treatment of additional tax liability.* Any additional tax liability that results from the adjustments identified in the written statement described in paragraph (r)(3)(iii)(B) of this section is treated as an additional amount of tax shown on an amended return.

(iv) *Election as method of accounting.* The elections provided in paragraphs (r)(3) (i) and (ii) of this section constitute either adoptions of, or changes in, methods of accounting. These elections, once made, may be revoked only with the consent of the Commissioner in accordance with the rules of section 446(e) and §1.446-1(e).

(v) *Untimely election to use simplified inventory method.* If a taxpayer makes an election described in this paragraph (r) after the times set forth in paragraph (r)(3) (i) or (ii) of this section, the taxpayer must comply with the requirements of §1.446-1(e)(3) in order to secure the consent of the Commissioner to change to the method of accounting prescribed in this paragraph (r). The taxpayer generally will be subject to terms and conditions designed to place the taxpayer in a position no more favorable than a taxpayer that timely complied with paragraph (r)(3) (i) and (ii) of this section, whichever is applicable.

(4) *Example.* The following example illustrates the provisions of this paragraph (r).

*Example.* (i) Corporation L is a calendar year manufacturer of baseball bats and uses the LIFO method of accounting for inventories. During 1987, 1988, and 1989, L's cost of goods sold in computing taxable income was as follows:

	1987	1988	1989
Beginning LIFO inventory .....	\$3,000	\$4,000	\$5,000
Purchases and other costs .....	9,000	9,000	9,000

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	1987	1988	1989
Ending LIFO inventory .....	(4,000)	(5,000)	(6,000)
Cost of goods sold .....	8,000	8,000	8,000

(ii) L has no preferences under section 57 during 1987, 1988, and 1989. L's sole adjustment in computing alternative minimum tax during 1987, 1988, and 1989 was the depreciation adjustment under section 56(a)(1). De-

preciation determined for both production and non-production assets under section 168 and under section 56(a)(1) during 1987, 1988, and 1989 was as follows:

	1987	1988	1989
Section 168 depreciation .....	\$1,800	\$1,800	\$1,800
Section 56(a)(1) depreciation .....	(900)	(900)	(900)
Depreciation difference .....	900	900	900
Portion of difference capitalized in the increase in inventory .....	(100)	(100)	(100)
Adjustment required under section 56(a)(1) .....	800	800	800

(iii) In computing taxable income, a portion of each year's section 168 depreciation attributable to production assets is deducted currently and a portion is capitalized into the increase in ending inventory. For 1987, 1988, and 1989, L computed alternative minimum tax by deducting the cost of goods sold which was reflected in taxable income (\$8,000) in accordance with paragraph (r)(2)(i) of this section. For 1987, 1988, and 1989, L also modified its adjustments under sections 56 and 58 and its preferences under section 57 to disregard the portion of any adjustment or preference that was capitalized in inventory. Thus, under section 56(a)(1), L increased alternative minimum taxable income during each year by \$900.

(iv) L is eligible to make the election under paragraph (r)(1) of this section in accordance with paragraph (r)(3)(i) of this section (a prospective election).

(v) L must compute its LIFO recapture adjustment for each year by reference to—

(A) The FIFO inventory amount after applying the provisions of section 263A but before applying the adjustments of sections 56 and 58 and the items of preference in section 57; and

(B) The LIFO inventory amount used in computing taxable income.

(5) *Election to use alternative minimum tax inventories to compute adjusted current earnings.* A taxpayer may elect under this paragraph (r)(5) to use the inventory amounts used to compute pre-adjustment alternative minimum taxable income in computing its adjusted current earnings. Rules similar to those of paragraphs (r)(2) and (r)(3) of this section apply for purposes of this election.

(s) *Adjustment for alternative tax energy preference deduction—(1) In general.* For purposes of computing adjusted current earnings, any taxpayer claiming a deduction under section 56(h) must properly decrease basis by the portion of the deduction allowed under section 56(h) which is attributable to adjustments under section 56(g)(4). In taxable years following the taxable year in which the section 56(h) deduction is claimed, basis recovery (including amortization, depletion, and gain on sale) must properly take into account this basis reduction.

(2) *Example.* The following example illustrates the provisions of this paragraph (s):

*Example.* Corporation A, a calendar year taxpayer, incurs \$100 of intangible drilling costs on January 1, 1994 and as a result of these intangible drilling costs A claims a deduction under section 56(h) of \$40. Assume that \$20 of A's deduction under section 56(h) is attributable to the adjustment under paragraph (f)(1) of this section. A must reduce by \$20 the amount of intangible drilling costs to be amortized under paragraph (f)(1) of this section in 1995 through 1998 (the balance of the 60-month amortization period).

[T.D. 8340, 56 FR 11084, Mar. 15, 1991, as amended by T.D. 8352, 56 FR 29433, June 27, 1991; T.D. 8454, 57 FR 60477, Dec. 21, 1992; T.D. 8482, 58 FR 42207, Aug. 9, 1993; T.D. 8566, 59 FR 51371, Oct. 11, 1994; T.D. 8858, 65 FR 1237, Jan. 7, 2000; T.D. 8940, 66 FR 9929, Feb. 13, 2001]

## § 1.57-0

## 26 CFR Ch. I (4-1-04 Edition)

### TAX PREFERENCE REGULATIONS

#### § 1.57-0 Scope.

For purposes of the minimum tax for tax preferences (subtitle A, chapter I, part VI), the items of tax preference are:

- (a) Excess investment interest,
- (b) The excess of accelerated depreciation on section 1250 property over straight line depreciation,
- (c) The excess of accelerated depreciation on section 1245 property subject to a net lease over straight line depreciation,
- (d) The excess of the amortization deduction for certified pollution control facilities over the depreciation otherwise allowable,
- (e) The excess of the amortization deduction for railroad rolling stock over the depreciation otherwise allowable,
- (f) The excess of the fair market value of a share of stock received pursuant to a qualified or restricted stock option over the exercise price,
- (g) The excess of the addition to the reserve for losses on bad debts of financial institutions over the amount which have been allowable based on actual experience,
- (h) The excess of the percentage depletion deduction over the adjusted basis of the property, and
- (i) The capital gains deduction allowable under section 1202 or an equivalent amount in the case of corporations.

Accelerated depreciation on section 1245 property subject to a net lease and excess investment interest are not items of tax preference in the case of a corporation, other than a personal holding company (as defined in section 542) and an electing small business corporation (as defined in section 1371(b)). In addition, excess investment interest is an item of tax preference only for taxable years beginning before January 1, 1972. Rules for the determination of the items of tax preference are contained in §§ 1.57-1 through 1.57-5. Generally, in the case of a nonresident alien or foreign corporation, the application of §§ 1.57-1 through 1.57-5 will be limited to cases in which the taxpayer has income effectively connected with the conduct of a trade or business within the United States. Special rules for the treatment of items of tax pref-

erence in the case of certain entities and the treatment of items of tax preference relating to income from sources outside the United States are provided in section 58 and in §§ 1.58-1 through 1.58-8.

[T.D. 7564, 43 FR 40470, Sept. 12, 1978]

#### § 1.57-1 Items of tax preference defined.

- (a) [Reserved]
- (b) *Accelerated depreciation on section 1250 property*—(1) *In general.* Section 57(a)(2) provides that, with respect to each item of section 1250 property (as defined in section 1250(c)), there is to be included as an item of tax preference the amount by which the deduction allowable for the taxable year for depreciation or amortization exceeds the deduction which would have been allowable for the taxable year if the taxpayer had depreciated the property under the straight line method for each year of its useful life for which the taxpayer has held the property. The determination of the excess under section 57(a)(2) is made with respect to each separate item of section 1250 property. Accordingly, where the amount of depreciation which would have been allowable with respect to one item of section 1250 property if the taxpayer had originally used the straight line method exceeds the allowable depreciation or amortization with respect to such property, such excess may not be used to reduce the amount of the item of tax preference resulting from another item of section 1250 property.

(2) *Separate items of section 1250 property.* The determination of what constitutes a separate item of section 1250 property is to be made on the facts and circumstances of each individual case. In general, each building (or component thereof, if the taxpayer uses the component method of computing depreciation) is a separate item of section 1250 property. However, for purposes of this section, assets placed in a group, classified, or composite account are to be treated as a single item by a taxpayer, provided that such account contains only property placed in service during a single taxable year. In addition, two or more items may be treated as one item of section 1250