

- (4) Estimating the net book income adjustment for purposes of estimated tax liability.

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§ 1.56-1 Adjustment for the book income of corporations.

(a) *Computation of the book income adjustment—(1) In general.* For taxable years beginning in 1987, 1988, and 1989, the alternative minimum taxable income of any taxpayer is increased by the book income adjustment described in this paragraph (a)(1). The book income adjustment is 50 percent of the excess, if any, of—

(i) The adjusted net book income (as defined in paragraph (b) of this section) of the taxpayer, over

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

For purposes of this section, pre-adjustment alternative minimum taxable income is alternative minimum taxable income, determined without regard to the book income adjustment or the alternative tax net operating loss determined under section 56(a)(4). See paragraph (a)(4) of this section for examples relating to the computation of the income adjustment.

(2) *Taxpayers subject to the book income adjustment.* The book income adjustment is applicable to any corporate taxpayer that is not an S corporation, regulated investment company (RIC), real estate investment trust (REIT), or real estate mortgage investment company (REMIC).

(3) *Consolidated returns.* In the case of a taxpayer that is a consolidated group, the book income adjustment equals 50 percent of the amount, if any, by which its consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) exceeds its consolidated pre-adjustment alternative minimum taxable income (as defined in paragraph (b)(3)(iii) of this section). See paragraph (a)(4), Example 4 of this section. For purposes of this section, with respect to any taxable year the term “consolidated group” has the same meaning as in § 1.1502-1T. See paragraph (d)(6) of this section for rules relating to adjustments attributable to related corporations.

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

Example 1. Corporation A has adjusted net book income of \$200 and pre-adjustment alternative minimum taxable income of \$100. A must increase its pre-adjustment alternative minimum taxable income by \$50 $((\$200 - \$100) \times .50)$.

Example 2. Corporation B has adjusted net book income of \$200 and pre-adjustment alternative minimum taxable income of \$300. B does not have a book income adjustment for the taxable year because its adjusted net book income does not exceed its pre-adjustment alternative minimum taxable income.

Example 3. Corporation C has adjusted net book income of negative \$200 and pre-adjustment alternative minimum taxable income of negative \$300. C must increase its pre-adjustment alternative minimum taxable income by \$50 $((-\$200 - (-\$300)) \times .50)$. Thus, C’s alternative minimum taxable income determined after the book income adjustment, but without regard to the alternative tax net operating loss, is negative \$250 $(-\$300 + \$50)$.

Example 4. Corporations D and E are a consolidated group for tax purposes. D and E do not have a consolidated financial statement. On their separate financial statements D and E have adjusted net book income of \$100 and \$50 respectively, and pre-adjustment alternative minimum taxable income of \$50 and \$80 respectively. Assuming there are no intercompany transactions, DE’s consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) is \$150 and its consolidated pre-adjustment alternative minimum taxable income (as defined in paragraph (b)(3)(iii) of this section) is \$130. DE must increase its consolidated pre-adjustment alternative minimum taxable income by \$10 $((\$150 - \$130) \times .50)$.

(b) *Adjusted net book income—(1) In general.* “Adjusted net book income” means the net book income (as defined in paragraph (b)(2) of this section) adjusted as provided in paragraph (d) of this section. Except as provided in paragraph (d) of this section, a taxpayer may not make any adjustments to net book income.

(2) *Net book income—(i) In general.* “Net book income” means the income or loss for a taxpayer reported in the taxpayer’s applicable financial statement (as defined in paragraph (c) of this section). Net book income must take into account all items of income, expense, gain and loss of the taxable year, including extraordinary items,

income or loss from discontinued operations, and cumulative adjustments resulting from accounting method changes. Net book income is not reduced by any distributions to shareholders. See paragraph (b)(5)(i) of this section for a similar rule for corporations using current earnings and profits to compute net book income.

(ii) *Measures of net book income.* Except as described in paragraph (b)(5) of this section, net book income is disclosed on the income statement included in a taxpayer's applicable financial statement. Such income statement must reconcile with the balance sheet, if any, that is included in the applicable financial statement and must be used in computing changes in owner's equity reflected in the applicable financial statement. See paragraph (c) of this section for the definition of an applicable financial statement.

(iii) *Tax-free transactions and tax-free income.* Net book income includes income or loss that is reported on a taxpayer's applicable financial statement regardless of whether such income or loss is recognized, realized or otherwise taken into account for other Federal income tax purposes. See paragraph (b)(7), Examples 1, 2 and 3 of this section.

(iv) *Treatment of dividends and other amounts.* The adjusted net book income of a taxpayer shall include the earnings of other corporations not filing a consolidated Federal income tax return with the taxpayer only to the extent that amounts are required to be included in the taxpayer's gross income under chapter 1 of the Code with respect to the earnings of such other corporation (e.g., dividends received from such corporation and amounts included under subpart A). See paragraph (b)(7), Examples 4 and 5 of this section.

(3) *Additional rules for consolidated groups—(i) Consolidated adjusted net book income.* "Consolidated adjusted net book income" means the consolidated net book income (as defined in paragraph (b)(3)(ii) of this section), after taking into account the adjustments under the rules of paragraph (d) of this section.

(ii) *Consolidated net book income.* Consolidated net book income is the income or loss of a consolidated group as

reported on its applicable financial statement as defined in paragraph (c)(5) of this section.

(iii) *Consolidated pre-adjustment alternative minimum taxable income.* Consolidated pre-adjustment alternative minimum taxable income is the taxable income of the consolidated group for the taxable year, determined with the adjustments provided in sections 56 and 58 (except for the book income adjustment and the alternative tax net operating loss determined under section 56(a)(4)) and increased by the preference items described in section 57.

(iv) *Cross references.* See paragraph (c)(5) of this section for rules relating to the applicable financial statement of related corporations and paragraph (d)(6) of this section for rules relating to adjustments attributable to related corporations.

(4) *Computation of adjusted net book income when taxable year and financial accounting year differ—(i) In general.* If a taxpayer's applicable financial statement is prepared on the basis of a financial accounting year that differs from the year that the taxpayer uses for filing its Federal income tax return, adjusted net book income must be computed either—

(A) By including a pro rata portion of the adjusted net book income for each financial accounting year that includes any part of the taxpayer's taxable year (see paragraph (b)(7), Example 6 of this section), or

(B) In accordance with the election described in paragraph (b)(4)(iii) of this section.

(ii) *Estimating adjusted net book income.* If a taxpayer is using the pro rata approach described in paragraph (b)(4)(i)(A) of this section and an applicable financial statement for part of the taxpayer's taxable year is not available when the taxpayer files its Federal income tax return, the taxpayer must make a reasonable estimate of adjusted net book income for the pro rata portion of the taxable year. If the actual pro rata portion of adjusted net book income that results from the taxpayer's applicable financial statement for the financial accounting year exceeds the estimate of adjusted net book income used on the

original tax return and results in additional tax liability, the taxpayer must file an amended Federal income tax return reflecting such additional liability. The amended return must be filed within 90 days of the date the previously unavailable applicable financial statement is available.

(iii) *Election to compute adjusted net book income based on the financial statement for the year ending within the taxable year—(A) In general.* If a taxpayer's accounting year ends five or more months after the end of its taxable year, the taxpayer may elect to compute adjusted net book income based on the net book income reported on the applicable financial statement prepared for the financial accounting year ending within the taxpayer's taxable year. See paragraph (b)(7), Examples 7 and 8 of this section. For purposes of this paragraph (b)(4)(iii)(A), if a taxpayer uses a 52-53 week year for financial accounting or Federal income tax purposes, the last day of such year shall be deemed to occur on the last day of the calendar month ending closest to the end of such year.

(B) *Time of making election.* An election under this paragraph (b)(4)(iii) is made by attaching the statement described in paragraph (b)(4)(iii)(C) of this section to the taxpayer's Federal income tax return for the first taxable year in which the taxpayer is eligible to make the election. An election under this paragraph (b)(4)(iii) that is made prior to the first taxable year in which the taxpayer is eligible to make the election (as determined under paragraph (b)(4)(iii)(C) of this section) is valid unless revoked pursuant to paragraph (b)(4)(iii)(D) of this section.

(C) *Eligibility to make and manner of making election.* A taxpayer is eligible to make the election specified in paragraph (b)(4)(iii)(A) of this section in the first taxable year beginning after 1986 in which—

(1) The taxpayer has an accounting year ending five or more months after the end of its taxable year,

(2) The use of the pro rata approach described in paragraph (b)(4)(i)(A) of this section produces an excess of adjusted net book income over pre-adjustment alternative minimum taxable

income, as defined in paragraph (a)(1) of this section, and

(3) The taxpayer has an excess of tentative minimum tax over regular tax for the taxable year, as defined in section 55(a), or is liable for the environmental tax imposed by section 59A.

Thus, a taxpayer is not required to evaluate the merits of an election to compute its adjusted net book income based on the applicable financial statement prepared for the financial accounting year ending within the taxpayer's taxable year unless the taxpayer, when using the pro rata approach described in paragraph (b)(4)(i)(A) of this section, either has an excess of tentative minimum tax over its regular tax or is liable for the environmental tax imposed by section 59A. The election statement must set forth the electing taxpayer's name, address, taxpayer identification number, taxable year and financial accounting year. An election under this paragraph (b)(4)(iii) will apply for the taxable year when initially made and for all subsequent years until revoked with the consent of the District Director.

(D) *Election or revocation of election made on an amended return.* An election under paragraph (b)(4)(iii) of this section may be made by attaching the statement described in paragraph (b)(4)(iii)(C) to an amended return for the first taxable year in which the taxpayer is eligible to make the election. An election under paragraph (b)(4)(iii) of this section that was made prior to the first taxable year in which the taxpayer was eligible to make the election, as determined under paragraph (b)(4)(iii)(C) of this section, may be revoked by filing an amended return for the taxable year in which the election was initially made. However, an election made or revoked on an amended return under paragraph (b)(4)(iii) of this section will be allowed only if the amended return is filed no later than December 14, 1990.

(iv) *Quarterly statement filed with the Securities and Exchange Commission (SEC).* A taxpayer with different financial accounting and taxable years that is required to file both annual and quarterly financial statements with the SEC may not aggregate quarterly statements filed with the SEC in order

to obtain a statement covering the taxpayer's taxable year. See paragraph (b)(7), Example 9 of this section. See paragraph (c)(3)(iv)(B)(1) of this section for priority rules relating to statements required to be filed with the SEC.

(5) *Computation of net book income using current earnings and profits*—(i) *In general.* If a taxpayer does not have an applicable financial statement, or only has a statement described in paragraph (c)(1)(iv) of this section and makes the election described in paragraph (c)(2) of this section, net book income for purposes of this section is equal to the taxpayer's current earnings and profits for its taxable year. Generally, a taxpayer's current earnings and profits is computed under the rules of section 312 and the regulations thereunder. Current earnings and profits therefore is reduced by Federal income tax expense and any foreign tax expense for foreign taxes eligible for the foreign tax credit under section 27 of the Code. Current earnings and profits is then adjusted as described in paragraph (d) of this section to arrive at adjusted net book income. No adjustment is made under paragraph (d) of this section, however, for any adjustment that is already reflected in current earnings and profits. See paragraph (d)(3) of this section for adjustments to net book income with respect to certain taxes. For purposes of this section, current earnings and profits is not reduced by any distribution to shareholders. See paragraph (d)(3)(iv), Example 5 of this section.

(ii) *Current earnings and profits of a consolidated group.* For purposes of this paragraph (b)(5), the current earnings and profits of a consolidated group is the aggregate of the current earnings and profits of each member of the group, as determined pursuant to paragraph (d)(4)(iii) of this section.

(6) *Additional rules for computation of net book income of a foreign corporate taxpayer*—(i) *Adjusted net book income of a foreign taxpayer.* Adjusted net book income of a foreign corporate taxpayer ("foreign taxpayer") means the effectively connected net book income (as defined in paragraph (b)(6)(ii) of this section) of the foreign taxpayer, after taking into account the adjustments

under the rules of paragraph (d) of this section.

(ii) *Effectively connected net book income of a foreign taxpayer*—(A) *In general.* Effectively connected net book income of a foreign taxpayer is the income or loss reported in its applicable financial statement (as defined in paragraph (c)(5)(ii) of this section), but only to the extent that such amount is attributable to items of income or loss that would be treated as effectively connected with the conduct of a trade or business in the United States by the foreign taxpayer as determined under either the principles of section 864(c) and the regulations thereunder, or any other applicable provision of the Internal Revenue Code of 1986. Thus, if for tax purposes an item of income or loss is treated as effectively connected with the conduct of a trade or business in the United States, then the income or loss reported on the foreign taxpayer's applicable financial statement attributable to such item is effectively connected net book income. See paragraph (b)(7), Examples 11, 12 and 13 of this section.

(B) *Certain exempt amounts.* Effectively connected net book income does not include any amount attributable to an item that is exempt from United States taxation under sections 883, 892, 894 or 895 of the Internal Revenue Code of 1986. See paragraph (b)(7), Examples 14 and 15 of this section.

(iii) *Computation of net book income of a foreign taxpayer using current earnings and profits.* If a foreign taxpayer does not have an applicable financial statement or only has a statement described in paragraph (c)(1)(iv) of this section and makes the election described in paragraph (c)(2) of this section, net book income for purposes of this section is equal to the foreign taxpayer's current earnings and profits that are attributable to income or loss that is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States. Effectively connected current earnings and profits are computed under the rules of section 884(d) and the regulations thereunder, relating to effectively connected earnings and profits for purposes of computing the branch profits tax, but without regard

to the exceptions set forth under section 884(d)(2)(B) through (E). For purposes of this section, effectively connected current earnings and profits are not reduced by any remittances or distributions. Effectively connected current earnings and profits takes into account Federal income tax expense and any foreign tax expense; however, see paragraph (d)(3) of this section for adjustments to net book income with respect to certain taxes.

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

Example 1. Corporation A owns 100 percent of corporation B and the AB affiliated group files a consolidated Federal income tax return. AB uses a calendar year for both financial accounting and tax purposes. During 1987, A transfers all of its stock in B for stock on an acquiring corporation in a transaction described in section 368(a)(1)(B). Although AB recognizes no taxable gain on the transfer pursuant to section 354, gain from the transfer is reported on AB's 1987 applicable financial statement. Pursuant to paragraph (b)(2)(iii) of this section, AB's net book income includes the book gain attributable to the transfer.

Example 2. Corporation C uses a calendar year for both financial accounting and tax purposes. C adopted a plan of liquidation prior to August 1, 1986. On June 1, 1987, C makes a bulk sale of all of its assets subject to liabilities and completely liquidates. Pursuant to section 633(c) of the Tax Reform Act of 1986 (the Act), section 337, as in effect prior to its amendment by the Act, applies. Thus, C will generally not recognize taxable gain upon the bulk sale. However, C's applicable financial statement for the period January 1, 1987 through June 1, 1987, reports net book income of \$500, \$400 of which is attributable to the bulk sale of assets on June 1, 1987. Pursuant to paragraph (b)(2)(iii) of this section, C's net book income includes the amount attributable to the bulk sale. Thus, assuming C has no other adjustments to net book income, its adjusted net book income for the period January 1, 1987 through June 1, 1987, is \$500.

Example 3. Corporation Z has a large inventory of marketable securities. On its applicable financial statement, Z marks these securities to market, i.e., as they appreciate in value, Z restates their value on its balance sheet to their fair market value, and increases the income on its income statement by that amount. Pursuant to paragraph (b)(2)(iii) of this section, the adjusted net book income of Z includes the income from the valuation adjustment.

Example 4. Corporation D owns 100 percent of E, a controlled foreign corporation as defined in section 957. Both D and E use a calendar year for financial accounting and tax purposes. D's applicable financial statement includes E. Pursuant to section 951, D includes \$100 of E's subpart F income in its gross income for 1987. Although D's applicable financial statement is adjusted to eliminate E's income, pursuant to paragraph (b)(2)(iv) of this section, D's adjusted net book income for 1987 includes the \$100 of gross income included under section 951.

Example 5. Corporation F owns 20 percent of G, a foreign corporation. Both F and G use a calendar year for financial accounting and tax purposes. During 1987, G pays F a \$100 dividend. F's applicable financial statement accounts for F's investment in G by the equity method. F is eligible for a deemed paid foreign tax credit of \$30 with respect to the dividend from G and must include the \$130 in gross income pursuant to section 78 of the Code. Although F's applicable financial statement is adjusted to eliminate F's income from G under the equity method, pursuant to paragraph (b)(2)(iv) of this section, F's adjusted net book income for 1987 includes the \$130 of gross income recognized with respect to the dividend from G.

Example 6. Corporation H files its Federal income tax return on a calendar year basis. However, its applicable financial statement is based on a fiscal year ending June 30. H does not make the election described in paragraph (b)(4)(iii) of this section. Pursuant to paragraph (b)(4)(i) of this section, H's adjusted net book income for calendar year 1987 is computed by adding 50 percent of adjusted net book income from the applicable financial statement for the year ending June 30, 1987 and 50 percent of adjusted net book income from the applicable financial statement for the year ending June 30, 1988.

Example 7. Corporation J files its Federal income tax returns for 1987, 1988, and 1989 on a calendar year basis. However, its applicable financial statement is based on a year ending May 31. Pursuant to paragraph (b)(4)(iii) of this section, J elects in 1987 to compute its adjusted net book income by using the applicable financial statement for the fiscal year ending May 31, 1987. Unless the District Director consents to revocation of the election, for calendar year 1988 or 1989, J's adjusted net book income for 1988 and 1989 is determined from its applicable financial statements for the years ending May 31, 1988 and May 31, 1989, respectively.

Example 8. The facts are the same as in Example 7, except that J's applicable financial statement is based on a year ending April 30. Since April 30, is less than 5 months after December 31, the end of J's taxable year, J is not permitted to make the election described in paragraph (b)(4)(iii) of this section.

Example 9. The facts are the same as in Example 8, except H files quarterly and annual financial statements with the Securities and Exchange Commission (SEC). The fourth quarter statement is included as a footnote to the annual statement that it files with the SEC. Pursuant to paragraph (b)(4)(iv) of this section, H may not determine its net book income by aggregating its four quarterly statements for 1987. Thus, H's net book income is computed as described in Example 8.

Example 10. Corporation I is a United States corporation with a 100 percent owned subsidiary, J, a foreign sales corporation (FSC). I uses a calendar year for both financial accounting and tax purposes. Income from J is consolidated in I's applicable financial statement. I and J do not file a consolidated tax return. In 1987, J pays a dividend to I of \$100 out of J's earnings and profits. For purposes of this example, it is assumed that the distribution is made out of the profits attributable solely to foreign trade income determined through use of the administrative pricing rules of section 925(a) (1) and (2). Accordingly, the distribution is eligible for the 100 percent dividends received deduction under section 245(c). Although I's applicable financial statement is adjusted to eliminate income or loss attributable to J, the entire amount of the dividend distribution must be included in I's adjusted net book income pursuant to paragraph (b)(2)(iv) of this section.

Example 11. Corporation K is a foreign corporation incorporated under the laws of country X. K uses a calendar year for both financial accounting and tax purposes. In 1987, K actively conducts a real estate business, L, in the United States. The financial statement that is used as K's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses total net income of \$150. Of this amount, \$100 is attributable to L's real estate business and \$50 is attributable to dividends paid to L from its investment in certain securities. The securities investment is not connected with L's real estate business. Under the rules of section 864, only \$100 is effectively connected to the conduct of a trade or business in the United States. Thus, K's effectively connected net book income for 1987 equals \$100.

Example 12. Assume the same facts as in Example 11 except that K's applicable financial statement also discloses \$75 attributable to investment real property located in the United States, so that the net income amount reported on the financial statement equals \$225. The \$75 of income is not effectively connected with the conduct of a trade or business in the United States. K, for regular tax purposes, makes an election under section 882(d) to treat this income as effectively connected with the conduct of a trade or business in the United States. As a result,

K's effectively connected net book income for 1987 equals \$175 (\$100+\$75).

Example 13. Corporation M is a foreign corporation that actively conducts a manufacturing business, N, in the United States. M is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, the financial statement that is used as M's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) reflects an anticipated loss from the sale of a division of N. For Federal income tax purposes the loss is not recognized in 1987, but rather is recognized in 1988 when M sells the division. In determining M's effectively connected net book income for 1987, the anticipated loss reported on M's 1987 applicable financial statement is taken into account because the reported loss is effectively connected to the conduct of a trade or business in the United States under the principles of section 864.

Example 14. Corporation O is a foreign corporation that is engaged in the international shipping business. O is incorporated under the laws of X. O is a calendar year taxpayer for both financial accounting and tax purposes. In 1987, O actively conducts a shipping business, P, within the United States. The statement that is used in 1987 as O's applicable financial statement (as determined under paragraph (c)(5)(ii) of this section) discloses income of \$100 that is attributable to P's operation of ships in international traffic. Under section 864, \$50 is effectively connected with the conduct of a trade or business in the United States. However, the United States income tax treaty with X exempts from United States income tax any income derived by a resident of X from the operation of ships in international traffic. Thus, pursuant to paragraph (b)(6)(ii)(B) of this section, no amount of P's income is includible in O's effectively connected net book income.

Example 15. Assume the same facts as in Example 14 except that there is no United States income tax treaty with X. However, X by statute exempts United States citizens and United States corporations from tax imposed by X on gross income derived from the operation of a ship or ships in international traffic. Under section 883(a), P's income of \$50 that is effectively connected with the conduct of a trade or business in the United States is exempt from United States taxation. Thus, pursuant to paragraph (b)(6)(ii)(B) of this section, no amount of P's income is includible in O's effectively connected net book income.

(c) *Applicable Financial Statement—(1) In general.* A taxpayer's applicable financial statement is the statement described in this paragraph (c)(1) that has the highest priority, as determined

under paragraph (c)(3) of this section. Generally, an applicable financial statement includes an income statement, a balance sheet (listing assets, liabilities, and owner's equity including changes thereto), and other appropriate information. An income statement alone may constitute an applicable financial statement for purposes of this section if the other materials described in this paragraph are not prepared or used by the taxpayer. However, an income statement that does not reconcile with financial materials otherwise issued will not qualify as an applicable financial statement. For purposes of determining the book income adjustment, the following may be considered applicable financial statements (subject to the rules relating to priority among statements under paragraph (c)(3) of this section)—

(i) *Statement required to be filed with the Securities and Exchange Commission (SEC).* A financial statement that is required to be filed with the Securities and Exchange Commission.

(ii) *Certified audited financial statement.* A certified audited financial statement that is used for credit purposes, for reporting to shareholders or for any other substantial non-tax purpose. Such a statement must be accompanied by the report of an independent (as defined in the American Institute of Certified Public Accountants Professional Standards, Code of Professional Conduct, Rule 101 and its interpretations and rulings) Certified Public Accountant or, in the case of a foreign corporation, a similarly qualified and independent professional who is licensed in any foreign country. A financial statement is "certified audited" for purposes of this section if it is—

(A) Certified to be fairly presented (an unqualified or "clean" opinion),

(B) Subject to a qualified opinion that such financial statement is fairly presented subject to a concern about a contingency (a qualified "subject to" opinion),

(C) Subject to a qualified opinion that such financial statement is fairly presented, except for a method of accounting with which the accountant disagrees (a qualified "except for" opinion), or

(D) Subject to an adverse opinion, but only if the accountant discloses the amount of the disagreement with the statement.

Any other statement or report, such as a review statement or a compilation report that is not subject to a full audit is not a certified audited statement. See paragraph (c)(3)(iv)(B)(2) of this section for a special rule for a statement accompanied by a review report when there are statements of equal priority. See also paragraph (d)(5)(iii) of this section for rules relating to adjustments for information disclosed in an accountant's opinion to a certified audited statement.

(iii) *Financial statement provided to a government regulator.* A financial statement that is required to be provided to the Federal government or any agency thereof (other than the Securities and Exchange Commission), a state government or any agency thereof, or a political subdivision of a state or any agency thereof. An income tax return, franchise tax return or other tax return prepared for the purpose of determining any tax liability that is filed with a Federal, state or local government or agency cannot be an applicable financial statement.

(iv) *Other financial statements.* A financial statement that is used for credit purposes, for reporting to shareholders, or for any other substantial non-tax purpose, even though such financial statement is not described in paragraphs (c)(1)(i) through (c)(1)(iii) of this section.

(v) *Required use of current earnings and profits.* If a taxpayer does not have a financial statement described in paragraphs (c)(1)(i) through (c)(1)(iv) of this section, the taxpayer does not have an applicable financial statement. In that case, net book income for the taxable year will be treated as being equal to the taxpayer's current earnings and profits for the taxable year. See paragraph (b)(5) of this section for rules relating to the computation of current earnings and profits for the taxable year. See paragraph (c)(4) of this section for rules relating to use of a financial statement for a substantial non-tax purpose.

(2) *Election to treat net book income as equal to current earnings and profits for*

the taxable year—(i) *In general.* If a taxpayer's only financial statement is a statement described in paragraph (c)(1)(iv) of this section, the taxpayer may elect to treat net book income as equal to the taxpayer's current earnings and profits for all taxable years in which the taxpayer is eligible to make the election.

(ii) *Time of making election.* An election under this paragraph (c)(2) is made by attaching the statement described in paragraph (c)(2)(iii) of this section to the taxpayer's Federal income tax return for the first taxable year the taxpayer is eligible to make the election. An election under this paragraph (c)(2), which is made prior to the first taxable year in which the taxpayer is eligible to make the election, as determined under paragraph (c)(2)(iii) of this section, is valid unless revoked pursuant to paragraph (c)(2)(iv) of this section.

(iii) *Eligibility to make and manner of making election.* A taxpayer is eligible to make the election in the first taxable year in which—

(A) The taxpayer has an applicable financial statement described in paragraph (c)(1)(iv) of this section;

(B) The use of this applicable financial statement produces an excess of adjusted net book income over preadjustment alternative minimum taxable income, as defined in paragraph (a)(1) of this section, and

(C) The taxpayer has, as determined under section 55(a), an excess of tentative minimum tax over regular tax for the taxable year, or is liable for the environmental tax imposed by section 59A.

Thus, a taxpayer is not required to evaluate the merits of an election to use its current earnings and profits as its net book income unless the taxpayer, when using an applicable financial statement described in paragraph (c)(1)(iv) of this section, has an excess of tentative minimum tax over its regular tax or is liable for the environmental tax imposed by section 59A. The election statement must set forth the electing taxpayer's name, address and taxpayer identification number, state that the election is being made under the provisions of section 56(f)(3)(B), and state that the only fi-

ancial statement of the taxpayer is a financial statement described in paragraph (c)(1)(iv) of this section. An election under this paragraph (c)(2) is effective for every taxable year in which the taxpayer does not have a financial statement described in paragraphs (c)(1)(i) through (c)(1)(iii) of this section and may be revoked only with the consent of the District Director. See paragraph (c)(6), Example 1 of this section.

(iv) *Election or revocation of election made on an amended return.* An election under paragraph (c)(2) of this section may be made by attaching the statement described in paragraph (c)(2)(iii) to an amended return for the first taxable year in which the taxpayer is eligible to make the election. An election under paragraph (c)(2) of this section that was made prior to the first taxable year in which the taxpayer was eligible to make the election, as determined under paragraph (c)(2)(iii) of this section, may be revoked by filing an amended return for the taxable year in which the election was initially made. However, an election made or revoked on an amended return will be allowed only if the amended return is filed no later than December 14, 1990.

(v) *Election by common parent of consolidated group.* The election by the common parent of a consolidated group to treat net book income as equal to current earnings and profits shall bind all members of the group. This rule shall not apply in the case of any taxpayer that first, has made the election on a return filed before August 16, 1990, second, applied the election only to those members of the group that are themselves eligible to make the election, and third, properly consolidated the adjusted net book income of the group. In order to change its election to apply to all members of the group, a taxpayer must attach a statement to an amended return for the first taxable year the taxpayer is eligible to make the election. However, an election made on an amended return under this paragraph (c)(2)(iv) will be allowed only if the amended return is filed no later than December 14, 1990. See paragraph (b)(5)(ii) of this section regarding the current earnings and profits of a consolidated group. See paragraph

(d)(4)(iii) of this section for adjustments that apply when a consolidated group uses current earnings and profits to compute its net book income.

(3) *Priority among statements*—(i) *In general.* If a taxpayer has more than one financial statement described in paragraphs (c)(1)(i) through (c)(1)(iv) of this section, the taxpayer's applicable financial statement is the statement with the highest priority. Priority is determined in the following order—

(A) A financial statement described in paragraph (c)(1)(i) of this section.

(B) A certified audited statement described in paragraph (c)(1)(ii) of this section.

(C) A financial statement required to be provided to a Federal or other government regulator described in paragraph (c)(1)(iii) of this section.

(D) Any other financial statement described in paragraph (c)(1)(iv) of this section.

For example, corporation A, which uses a calendar year for both financial accounting and tax purposes, prepares a financial statement for calendar year 1987 that is provided to a state regulator and an unaudited financial statement that is provided to A's creditors. The statement provided to the state regulator is A's financial statement with the highest priority and thus is A's applicable financial statement.

(ii) *Special priority rules for use of certified audited financial statements and other financial statements.* In the case of financial statements described in paragraphs (c)(1)(ii) and (c)(1)(iv) of this section, within each of these categories the taxpayer's applicable financial statement is determined according to the following priority—

(A) A statement used for credit purposes,

(B) A statement used for disclosure to shareholders, and

(C) Any other statement used for other substantial non-tax purposes.

For example, corporation B uses a calendar year for both financial accounting and tax purposes. B prepares a financial statement for calendar year 1987 that it uses for credit purposes and prepares another financial statement for calendar year 1987 that it uses for disclosure to shareholders. Both finan-

cial statements are unaudited. The statement used for credit purposes is B's financial statement with the highest priority and thus is B's applicable financial statement.

(iii) *Priority among financial statements provided to a government regulator.* In the case of two or more financial statements described in paragraph (c)(1)(iii) of this section (relating to financial statements required to be provided to a Federal or other governmental regulator) that are of equal priority, the taxpayer's applicable financial statement is determined according to the following priority—

(A) A statement required to be provided to the Federal government or any of its agencies,

(B) A statement required to be provided to a State government or any of its agencies, and

(C) A statement required to be provided to any subdivision of a state or any agency of a subdivision.

(iv) *Statements of equal priority*—(A) *In general.* Except as provided in paragraph (c)(3)(iv)(B) and paragraph (c)(5)(i)(B) of this section, if a taxpayer has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i), (c)(3)(ii) and (c)(3)(iii) of this section), the taxpayer's applicable financial statement is the statement that results in the greatest amount of adjusted net book income.

(B) *Exceptions to the general rule in paragraph (c)(3)(iv)(A)*—(1) In the case of two or more financial statements described in paragraph (c)(1)(i) of this section (relating to financial statements required to be filed with the SEC) that are of equal priority, a certified audited financial statement has a higher priority than an unaudited financial statement.

(2) In the case of two or more financial statements described in paragraph (c)(1)(iv) of this section (relating to other financial statements) that are of equal priority, a financial statement accompanied by an auditor's "review report" has a higher priority than another financial statement of otherwise equal priority. For purposes of this section, an auditor's review report is defined in the American Institute of Certified Public Accountant Professional

Standards, AR section 100.32. See paragraph (c)(6), Examples and 3 of this section.

(4) *Use of financial statement for a substantial non-tax purpose.* In order to be an applicable financial statement for purposes of computing the book income adjustment, a financial statement described in paragraph (c)(1)(ii) or (c)(1)(iv) must be used by the taxpayer for credit purposes, for disclosure to shareholders, or for any other substantial non-tax purpose. A financial statement is used by a taxpayer if the taxpayer reasonably anticipates that users of the statement will rely on it for non-tax purposes. Thus, a financial statement used for the purpose of computing the book income adjustment is not an applicable financial statement even if it is provided to shareholders or creditors, unless the taxpayer reasonably anticipates that users of the statement will rely on it for non-tax purposes. See paragraph (c)(6), Examples 4, 5, 19 and 20 of this section.

(5) *Special rules—(i) Applicable financial statement of related corporations—(A) Applicable financial statement of a consolidated group.* The applicable financial statement of a consolidated group (as defined in paragraph (a)(3) of this section) is the financial statement of the common parent (within the meaning of section 1504(a)(1)) of the consolidated group that has the highest priority under the rules of paragraphs (c)(3)(i), (c)(3)(ii) and (c)(5)(i)(B) of this section. See paragraph (d)(6)(i) of this section for rules relating to adjustments to net book income of a consolidated group. See paragraph (c)(6), Example 7 of this section. See paragraph (c)(2)(iv) of this section for rules relating to the election by the common parent of a consolidated group to use current earnings and profits to compute net book income.

(B) *Special rule for statements of equal priority.* If a consolidated group has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i) and (c)(3)(ii) of this section and this paragraph (c)(5)), the consolidated group's applicable financial statement is determined under either paragraph (c)(5)(i)(B) (1) or (2), whichever is applicable.

(1) *Two or more financial statements reporting on the same corporations.* If two or more financial statements of equal priority report on the same corporations, the consolidated group's applicable financial statement is determined under the rules of paragraph (c)(3)(iv) of this section. Thus, the financial statement that results in the greatest consolidated adjusted net book income is the consolidated group's applicable financial statement.

(2) *Two or more financial statements reporting on different corporations.* If two or more financial statements of equal priority report on different corporations, the consolidated group's applicable financial statement is—

(i) The statement that reflects the greatest amount of gross receipts attributable to members of the consolidated group, or

(ii) The statement that reflects the greatest amount of gross receipts (including gross receipts attributable to corporations that are not members of the consolidated group), but only if the consolidated group has financial statements of equal priority after applying the rules of paragraph (c)(5)(i)(B)(2)(i).

If after applying the rules of paragraphs (c)(5)(i)(B)(2)(i) and (ii) of this section, the consolidated group still has financial statements of equal priority, the rules of paragraph (c)(3)(iv) of this section apply. See paragraph (c)(6), Examples 7 and 8 of this section.

(C) *Special rule for related corporations.* If any portion of the net book income of a corporation (the "first corporation") is included on the applicable financial statement of a second corporation, but the first and second corporations are not members of the same consolidated group, the applicable financial statement of the second corporation is disregarded when determining the applicable financial statement of the first corporation. Thus, the applicable financial statement of the first corporation is the financial statement of highest priority determined under the rules of paragraph (c)(3) of this section without regard to the financial statement of the second corporation. Pursuant to paragraph (c)(1)(iv) of this section, if a separate financial statement is not prepared by the first corporation, the rules of paragraph (b)(5)

(relating to current earnings and profits) apply. See paragraph (c)(6), Examples 9 and 10 of this section.

(D) *Anti-abuse rule.* The special rules of this paragraph (c)(5)(i) will not apply if the taxpayer rearranges its corporate structure or modifies its financial reporting and the principal purpose of such action is to use the special rules of this paragraph (c)(5)(i) to reduce the amount of the book income adjustment. In such cases, the District Director may, based upon all the facts and circumstances, determine the taxpayer's applicable financial statement. See paragraph (c)(6), Examples 13 and 14 of this section.

(ii) *Applicable financial statement of a foreign corporation with a United States trade or business—(A) In general.* The applicable financial statement of a foreign taxpayer conducting one or more trades or businesses in the United States is the financial statement prepared by any such trade or business (or attributable to more than one such trades or businesses) that has the highest priority as determined under paragraph (c)(3) of this section. See paragraph (c)(6), Example 15 of this section.

(B) *Special rules for applicable financial statement of a trade or business of a foreign taxpayer—(1) Financial statement prepared under generally accepted accounting principles.* Subject to the rules of this section, a financial statement prepared by a United States trade or business using generally accepted accounting principles of a foreign country may be an applicable financial statement under this paragraph (c). See paragraph (c)(6), Example 16 of this section.

(2) *Financial statement denominated in United States dollars.* Except as provided in paragraph (c)(5)(ii)(D) of this section, the financial statement of a United States trade or business must be denominated in United States dollars in order to be considered the applicable financial statement of the foreign taxpayer under this paragraph (c). See paragraph (c)(6), Example 17 of this section.

(C) *Special rule for statements of equal priority.* If a foreign taxpayer has two or more financial statements of equal priority (determined under paragraphs (c)(3)(i) and (c)(3)(ii) of this section and

this paragraph (c)(5)(ii)), the foreign taxpayer's applicable financial statement is determined under either paragraph (c)(5)(ii)(C) (1) or (2) of this section, whichever is applicable.

(1) *Two or more financial statements reporting on the same trades or businesses.* If two or more financial statements of equal priority report on the same United States trades or businesses, the applicable financial statement of the foreign taxpayer is determined under the rule of paragraph (c)(3)(iv) of this section. In applying this rule, adjusted net book income (as defined under paragraph (b)(6) of this section) shall be used. Thus, the financial statement that results in the greatest amount of adjusted net book income is the foreign taxpayer's applicable financial statement.

(2) *Two or more financial statements reporting on different trades or businesses.* If two or more financial statements of equal priority report on different United States trades or businesses, the foreign taxpayer's applicable financial statement is—

(i) The financial statement that reflects the greatest amount of gross receipts attributable to United States trades or businesses, or

(ii) If after applying the rules of paragraph (c)(5)(ii)(C)(2)(i) of this section, the foreign taxpayer still has financial statements of equal priority, the financial statement determined under the rules of paragraph (c)(3)(iv) of this section (using effectively connected adjusted net book income).

See paragraph (c)(6), Example 18 of this section.

(D) *Anti-abuse rules.* The special rules of this paragraph (c)(5)(ii) will not apply if a trade or business conducted in the United States by a foreign taxpayer modifies its financial reporting and the principal purpose of such action is to reduce the amount of the book income adjustment. In such cases, the District Director may, based upon all the facts and circumstances, determine the taxpayer's applicable financial statement. See paragraph (c)(6), Example 21, of this section.

(iii) *Supplement or amendment to an applicable financial statement—(A) Excluding a restatement of net book income.*

An applicable financial statement includes any supplement or amendment thereto (excluding a restatement of net book income) for the taxable year that is prepared and used for a substantial non-tax purpose (within the meaning of paragraph (c)(4) of this section) prior to the date the taxpayer's Federal income tax return for the taxable year would be due if the time for filing were extended under section 6081. For example, a calendar year taxpayer's applicable financial statement includes any supplement or amendment prepared and used prior to September 15 of the year immediately following its taxable year. If a taxpayer files its Federal income tax return before the issuance of a supplement or amendment to the applicable financial statement and before the extended due date for filing under section 6081, the taxpayer must file an amended Federal income tax return reporting any additional tax that results from treating the supplement or amendment as part of the applicable financial statement. A supplement or amendment (excluding restatements of net book income) to an applicable financial statement after the date specified in section 6081 is disregarded for purposes of the book income adjustment.

(B) *Restatement of net book income.* If a taxpayer restates net book income in what otherwise would have been its applicable financial statement (its "original financial statement"), referred to in this section as a "restatement of net book income," prior to the date that the taxpayer's Federal income tax return for such taxable year would be due if the time for filing were extended under section 6081, then—

(1) If the financial statement that includes the restated net book income is of a higher priority than the original financial statement, the restated financial statement is the taxpayer's applicable financial statement.

(2) If the financial statement that includes the restated net book income is of equal priority to the original financial statement and—

(i) The restatement is attributable to an error (as described in Accounting Principles Board Opinion No. 20, paragraph 13), the restated financial state-

ment is the taxpayer's applicable financial statement, or

(ii) The restatement is not attributable to an error, the original and restated financial statements will be considered of equal priority, and paragraph (c)(3)(iv) will apply. Thus, the taxpayer's applicable financial statement is the financial statement that results in the greatest amount of adjusted net book income.

See paragraph (d)(4)(iv) of this section for rules that apply to restatements occurring after the due date (including the extension under section 6081) of the return for the taxable year to which the applicable financial statement relates. See paragraph (c)(6), Examples 11 and 12 of this section.

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

Example 1. In 1987, Corporation A only has a financial statement described in paragraph (c)(1)(iv) of this section and elects to treat net book income as equal to its current earnings and profits. In 1988, A has a certified audited financial statement (as described in paragraph (c)(1)(ii) of this section). In 1989, A only has a statement described in paragraph (c)(1)(iv) of this section. In 1988, A's certified audited financial statement is its applicable financial statement. However, in 1989, A is bound by the election it made in 1987 (unless revoked with the consent of the District Director) and must treat net book income as equal to its current earnings and profits.

Example 2. Corporation B prepares two unaudited financial statements. Both statements are distributed to creditors and are used for substantial non-tax purposes. The first financial statement is accompanied by an auditor's review report while the second statement has no auditor's review report. B has no other financial statement. Pursuant to paragraph (c)(3)(iv)(B)(2) of this section, the financial statement accompanied by the auditor's review report is B's applicable financial statement.

Example 3. Assume the same facts as in Example (2), except the financial statement accompanied by an auditor's review report is distributed to shareholders while the other statement is distributed to creditors, and both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(3)(ii) of this section, B's applicable financial statement is the statement distributed to its creditors. Paragraph (c)(3)(iv)(B)(2) of this section does not apply because the two statements are not of equal priority after applying paragraphs (c)(3)(i) and (ii) of this section.

Example 4. Corporation C is a closely held corporation with two shareholders. Both shareholders participate in the business on a day-to-day basis and are aware of the financial status of the business. C prepares a financial statement that is used by C's two shareholders to calculate bonuses. The financial statement prepared by C is used for a substantial non-tax purpose.

Example 5. Corporation D prepares a financial statement that it only sends to banks with which D is neither currently doing business nor negotiating. D does not reasonably anticipate that the financial statement will be relied on by the banks for any non-tax purpose, and therefore, for purposes of computing net book income, the financial statement is not used for a substantial non-tax purpose. The result would be the same if D sent the statement to a bank whose only relationship to D is that it holds a mortgage on D's property and D's rights and obligations under the mortgage are not affected by changes in its financial condition. The result would also be the same if D sent the statement to a bank with which D is doing business, and the statement is not reasonably expected to come to the attention of the bank's employees who are responsible for D's account.

Example 6. Corporation E and its subsidiaries, F and G are a consolidated group. Certified audited financial statements are prepared by EF and by FG. Both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(5)(i)(A) of this section, the financial statement that is prepared by EF is the applicable financial statement of the consolidated group. However, pursuant to paragraph (d)(6)(i)(B) of this section, an adjustment will be required to include the adjusted net book income attributable to G. The result would be the same even if the financial statement prepared by FG is of higher priority (under the rules of paragraph (c)(3) of this section) than the statement prepared by E and F.

Example 7. Corporation H and its subsidiaries I, J, and K are a consolidated group. Certified audited financial statements are prepared by H and I and by H, J, and K. Both statements are used for substantial non-tax purposes. The financial statement prepared by H, J, and K includes the greater amount of gross receipts attributable to members of the consolidated group and thus, pursuant to paragraph (c)(5)(i)(B)(2)(i) of this section, it is the consolidated group's applicable financial statement.

Example 8. Corporation L and its subsidiary M are a consolidated group. Corporation L also owns 100 percent of N, a foreign corporation that is not part of the consolidated group. A certified audited financial statement prepared by L, M and N discloses gross receipts of \$200, of which \$150 is attributable to L and M, and a separate certified audited

financial statement prepared by L and M discloses gross receipts of \$150. Both statements are used for substantial non-tax purposes. Pursuant to paragraph (c)(5)(i)(B) of this section, the consolidated group's applicable financial statement is the statement prepared by L, M and N.

Example 9. Corporation O is 60 percent owned by corporation P and 40 percent owned by corporation Q. Both P and Q prepare financial statements that are required to be filed with the SEC reflecting their respective interests in O. O also separately prepares a certified audited financial statement, or uses a summary of its books and records for credit purposes. Under paragraph (c)(5)(i)(C), O's separate statement is its applicable financial statement.

Example 10. Assume the same facts as in Example 9 except that O does not prepare a separate financial statement or a summary of its books and records for credit purposes. Pursuant to paragraph (c)(5)(i)(C) of this section, O must treat its net book income as equal to its current earnings and profits.

Example 11. Corporation R uses a calendar year for both financial accounting and tax purposes. Initially, R issues its calendar year 1987 financial statement on March 1, 1988. R's adjusted net book income resulting from this statement is \$80. This would be R's applicable financial statement for 1987, but for the restatement described in the next sentence. On September 1, 1988, R restates its 1987 financial statement to correct an error (as described in Accounting Principles Board Opinion No. 20, paragraph 13). The restated financial statement is of the same priority as the initial financial statement. The restatement results in adjusted net book income for calendar year 1987 of \$50. Pursuant to paragraph (c)(5)(iii)(B)(2)(i) of this section, the restated financial statement is treated as R's 1987 applicable financial statement.

Example 12. Assume the same facts as in Example (11), except that R restates its financial statement in order to reflect a change in accounting method. Since the restatement does not result from an error, paragraph (c)(5)(iii)(B)(2)(i) of this section does not apply. Pursuant to paragraph (c)(5)(iii)(B)(2)(ii) of this section, R's 1987 applicable financial statement is the financial statement for 1987 that results in the greater amount of adjusted net book income. Thus, R's March 1, 1988 financial statement is treated as its 1987 applicable financial statement.

Example 13. Corporation S, which is not a member of an affiliated group, uses a calendar year for both financial accounting and tax purposes. S's 1987 applicable financial statement is a certified audited financial statement. On January 1, 1988, S transfers all of its assets subject to liabilities to T, a newly created subsidiary that is 100 percent owned by S. The principal purpose of the

transfer is to use the special rules of paragraph (c)(5)(i) of this section to reduce the adjusted net book income of S. For calendar year 1988, T prepares and uses a certified audited financial statement. Since S's only asset is its investment in T, S does not prepare a financial statement for calendar year 1988. In addition, since S is only a holding company, T's 1988 certified audited financial statement reports the same net book income that would have been reported on a consolidated ST financial statement. If paragraph (c)(5)(i)(D) of this section does not apply, ST's 1988 applicable financial statement is the financial statement of S (the parent of the consolidated group) with the highest priority. Under paragraph (c)(1) of this section, since S does not have a financial statement in 1988, the net book income of the ST consolidated group is ordinarily deemed to equal the aggregate earnings and profits of the members of the consolidated group. However, given these facts, the District Director may determine that the 1988 certified audited financial statement of T is the 1988 applicable financial statement of the ST consolidated group.

Example 14. The facts are the same as in Example 13, except that S has owned 100 percent of T for several years prior to calendar year 1987. In addition, prior to 1987, ST prepared a consolidated certified audited financial statement. For calendar year 1987, ST does not prepare a consolidated certified audited financial statement. Instead, T prepares and uses a certified audited financial statement while S does not prepare a financial statement. The principal purpose of the change in financial reporting is to use the special rules of paragraph (c)(5)(i) of this section to reduce the adjusted net book income of the ST consolidated group. Given these facts, the District Director may determine that the 1987 certified audited financial statement of T is the 1987 applicable financial statement of the ST consolidated group.

Example 15. Corporation U is a foreign corporation incorporated in A. U is a calendar year taxpayer for both financial accounting and tax purposes. U actively conducts three real estate businesses, X, Y and Z, in the United States. In 1987, X prepares a certified audited financial statement that it provides to its United States creditor. In addition, in 1987, X, Y and Z each prepare unaudited financial statements that they provide to U for incorporation in U's worldwide financial statement. Under paragraph (c)(5)(ii)(A) of this section, U's applicable financial statement is the certified audited financial statement prepared by X. However, pursuant to paragraph (d)(7) of this section, an adjustment is required to include any of U's effectively connected net book income that is not included in X's certified audited financial statement (*i.e.*, the effectively connected net book income attributable to Y and Z).

Example 16. Corporation A is a foreign corporation incorporated in Z. A is a calendar year taxpayer for both financial accounting and tax purposes. A actively conducts a real estate business, B, in the United States. B prepares a certified audited financial statement for 1987 using the accounting principles of Z that it provides to A for incorporation into A's worldwide financial statement. In addition, B prepares a review statement for 1987 using United States generally accepted accounting principles that it provides to its United States creditors. Both the certified statement and the review statement are denominated in United States dollars. Under paragraphs (c)(5)(ii)(A) and (c)(5)(ii)(B)(1) of this section, the financial statement prepared under the accounting principles of Z is the applicable financial statement.

Example 17. Assume the same facts as in Example (16) except that amounts are reported on B's certified audited financial statement in the currency of Z and amounts are reported on B's review statement in United States dollars. Since the review statement is denominated in United States dollars, under paragraph (c)(5)(ii)(B)(2) of this section, it is the applicable financial statement.

Example 18. Corporation C is a foreign corporation incorporated in Z. C is a calendar year taxpayer for both financial accounting and tax purposes. C actively conducts two real estate businesses, D and E, in the United States. D and E each separately prepare a certified audited financial statement for 1987 that they provide to their United States creditors. D's financial statement reports gross receipts of \$100. E's financial statement reports gross receipts of \$200. Under paragraph (c)(5)(ii)(C)(2) of this section, E's certified audited financial statement is the applicable financial statement and must be adjusted under the rules of paragraph (d)(7) of this section to include effectively connected book income attributable to D.

Example 19. F is a foreign corporation incorporated in X. F is a calendar year taxpayer for both financial accounting and tax purposes. F actively conducts a banking business, G, in the United States. G has been engaged in business in the United States since 1977. For the years 1977 through 1986, G did not prepare a separate financial statement. However, each year G provided F with its books, records and other raw financial data. F used this data in preparing its worldwide financial statement. G provides F with its 1987 books and records on January 5, 1988, in accordance with its historic practice. On February 15, 1988, G prepares an unaudited financial statement for calendar year 1987 that it provides to F. The principal purpose of creating this financial statement is to reduce net book income. Under these facts, the financial statement provided by G is not intended to be reasonably relied upon by F in

preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has not been used for a substantial non-tax purpose.

Example 20. Assume the same facts as in Example 19 except that for purposes of preparing F's 1987 worldwide financial statement, G does not provide F with any raw financial data, and G only provides F with an audited financial statement that is prepared for a substantial non-tax purpose. Under these facts, the financial statement provided by G is intended to be relied upon by F in preparing its worldwide financial statement. Therefore, for purposes of computing net book income, G's financial statement has been used for a substantial non-tax purpose.

Example 21. Corporation H is a foreign corporation incorporated in I. H is a calendar year taxpayer for both financial accounting and tax purposes. H actively conducts a real estate business, J, in the United States. For the years 1976 through 1986, J prepared a certified audited financial statement using United States dollars that it provided to H. In 1987, J prepares a certified audited financial statement using the currency of I. The principal purpose of the modification of J's financial reporting is to reduce the amount of the book income adjustment. Given these facts, the District Director may determine that J's 1987 certified audited financial statement prepared in the currency of I is J's applicable financial statement for 1987, and such statement must be converted into United States dollars based upon the translation used to prepare the certified audited financial statement in the currency of I. Accordingly, the effectively connected net book income of J for 1987 is the effectively connected net book income reported on the financial statement that has been converted into United States dollars.

(d) *Adjustments to net book income*—(1) *In general.* Adjusted net book income is computed by making the adjustments described in this paragraph (d) to net book income (as defined in paragraph (b)(2) of this section). No adjustment may be made to net book income except as provided in this paragraph (d).

(2) *Definitions*—(i) *Historic practice.* For purposes of this paragraph (d), historic practice is defined as an accounting practice that—

(A) Was used consistently by the taxpayer for each of the 2 years immediately preceding its first taxable year beginning after 1986, and

(B) Was used on the financial statement that would have been the taxpayer's applicable financial statement (as determined under paragraph (c) of

this section) for each of the 2 years immediately preceding its first taxable year beginning after 1986 if section 56(f), as amended by the Tax Reform Act of 1986, had been in effect.

Thus, in order for a calendar year corporation to have an historic practice in 1987, the corporation must have used the accounting practice in its 1985 and 1986 financial statements. However, to be treated as used for purposes of this paragraph, an accounting practice must have been used prior to April 23, 1987. For example, an accounting practice that is first used after April 23, 1987, in a restatement of a taxpayer's 1985 and 1986 financial statements is not the taxpayer's historic practice.

(ii) *Accounting literature.* For purposes of this paragraph (d), the term "accounting literature" means—

(A) Generally accepted accounting principles (GAAP) as defined in the American Institute of Certified Public Accountants Professional Standards, AU §411.05, paragraphs (a) through (c), and

(B) Pronouncements by the SEC including, but not limited to, Regulations S-X, SEC Financial Reporting Releases, and SEC Staff Accounting Bulletins,

that are effective for the accounting period covered by the applicable financial statement.

(3) *Adjustments for certain taxes*—(i) *In general.* Net book income for purposes of this paragraph (d) must be adjusted to disregard (for example, by adding back) any Federal income taxes or income, war profits, or excess profits taxes imposed by any foreign country or possession of the United States that are directly or indirectly taken into account on the taxpayer's applicable financial statement. No adjustment is made for taxes not described in the preceding sentence. Taxes directly or indirectly taken into account consist of the taxpayer's total income tax expense that includes both current and deferred income tax expense. In addition, items of income and expense, including extraordinary items that are stated net of tax, must be adjusted to disregard the taxes described in this paragraph (d)(3)(i). See paragraph (d)(4)(vii) of this section for an adjustment for certain deferred foreign taxes.

(ii) *Exception for certain foreign taxes.* Net book income is not adjusted to disregard taxes imposed by a foreign country or possession of the United States if the taxpayer does not choose to take the benefits of section 901 (relating to the foreign tax credit) with respect to these taxes for the taxable year. The rule in the preceding sentence only applies to the amount of taxes the taxpayer deducts in the current taxable year under section 164(a). See paragraph (d)(3)(iv), Example 4 of this section. Net book income also is not adjusted to disregard foreign taxes that cannot be claimed as a credit (other than by virtue of a foreign tax credit limitation). Thus, a taxpayer does not add back to net book income any taxes it is not allowed to claim as a credit against its United States income tax liability because of section 245(a)(8), 901(j), 907(b) or 908 of the Code.

(iii) *Certain valuation adjustments.* Income tax expense under paragraph (d)(3)(i) of this section does not include valuation adjustments such as the valuation adjustments related to purchase accounting described in Accounting Principles Board (APB) Opinion No. 16, paragraph 89. However, income tax expense does include the tax associated with any gain or loss on the sale or other disposition of any asset the basis of which was adjusted under paragraph 89 of Opinion 16. See paragraph (d)(3)(iv), Example 6 of this section.

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

Example 1. Corporation A has \$120 of net book income. In calculating net book income, A has deducted \$20 of state income tax expense and \$60 of Federal income tax expense. Assuming there are no other adjustments to net book income, A's adjusted net book income is \$180 (\$120 of net book income + \$60 of Federal income tax expense). Pursuant to paragraph (d)(3)(i) of this section, no adjustment is made for the state income tax expense.

Example 2. Assume the same facts as in Example 1, except that A also has a net extraordinary item of \$40. Thus, A has net book income of \$160 (\$120 + \$40). The \$40 net extraordinary item is composed of a \$70 gross extraordinary item less \$30 of Federal income tax expense. Assuming there are no other adjustments to net book income, A's adjusted net book income is \$250 (\$160 of net book income + \$60 of Federal income tax ex-

pense on book income other than the extraordinary item + \$30 of Federal income tax expense on the extraordinary item).

Example 3. Assume the same facts as in Example 1, except that in calculating A's \$120 of net book income, A has \$50 of Federal income tax expense and \$10 of foreign income tax expense. The \$10 of foreign income tax expense results from a foreign branch and is composed of \$7 of current foreign income tax expense and \$3 of deferred foreign income tax expense. A chooses to take the benefits of the foreign tax credit under section 901 for the current taxable year. Assuming there are no other adjustments to net book income, A's adjusted net book income is \$180 (\$120 of net book income + \$50 of Federal income tax expense + \$10 of foreign income tax expense).

Example 4. Assume the same facts as in Example 3, except that A does not choose to take the benefits of the foreign tax credit in the current taxable year and instead deducts the \$7 of current foreign income tax paid. Pursuant to paragraph (d)(3)(ii) of this section, net book income is not adjusted for the \$7 of current foreign income tax expense. However, net book income is adjusted for the \$3 of deferred foreign income tax expense. Thus, assuming there are no other adjustments to net book income, D's adjusted net book income is \$173 (\$120 of net book income + \$50 of Federal income tax expense + \$3 of deferred foreign income tax expenses).

Example 5. In 1987, corporation B only has a financial statement described in paragraph (c)(1)(iv) of this section. B elects pursuant to paragraph (c)(2) of this section to treat net book income as equal to its current earnings and profits. B's current earnings and profits in 1987 is \$60, after reduction for \$40 of Federal income tax (see paragraph (b)(5)(i) of this section). Pursuant to paragraph (d)(3) of this section, B must make a \$40 adjustment to net book income. Thus, assuming no other adjustments to net book income, B's 1987 adjusted net book income is \$100 (\$60 of net book income + \$40 adjustment for Federal income taxes).

Example 6. Corporation A acquires assets from corporation B in a transaction where the tax basis of B's assets will carry over to A. For financial accounting purposes, A will account for the acquisition in accordance with Accounting Principles Board (APB) Opinion No. 16. One of the assets acquired from B has an appraised value of \$10,000. However, because the tax basis of B's assets will carry over to A, A's tax basis in the asset is only \$7,000. Given these facts, APB Opinion No. 16, paragraph 89 requires that the asset be recorded at \$10,000 less the tax effect of the difference between the appraised value and the tax basis. Assuming a 30 percent tax rate for A, the asset would be recorded at \$9,100 (\$10,000 appraised value—(\$3,000 difference between the appraised value and the tax basis × 30 percent)). If A

sells the asset for \$10,000, A will recognize a book gain of \$900 with respect to the sale (assuming the asset is not amortized for book purposes). However, A will also have income tax expense of \$900 ($(\$10,000 \text{ sales proceeds} - \$7,000 \text{ tax basis}) \times 30 \text{ percent}$) with respect to the sale. Thus, A will have no net book income from the sale. Pursuant to paragraph (d)(3)(iii) of this section, A's income tax expense includes the \$900 of income tax expense attributable to the effects of the valuation adjustment made in accordance with APB Opinion No. 16, paragraph 89. As a result, A's adjusted net book income with respect to its asset sale is \$900 ($\$0 \text{ of net book income} + \$900 \text{ adjustment for income tax expense}$).

(4) *Adjustments to prevent omission or duplication*—(i) *In general.* In order to prevent omissions or duplications, net book income must be adjusted for the items described in paragraph (d)(4)(ii) through (d)(4)(vii) of this section and for such other items as approved or required by the Commissioner in published guidance. Except as provided in this paragraph (d), a taxpayer may not adjust net book income to prevent omission or duplication of items. See paragraph (d)(4)(viii), Example 1 of this section.

(ii) *Special rule for depreciating an asset below its cost.* Net book income must be adjusted to exclude depreciation or amortization expense to the extent such expense exceeds the asset's financial accounting historical cost ("excess depreciation"). However, no adjustment is required if excess depreciation has been the taxpayer's historic practice (as defined in paragraph (d)(2)(i) of this section) or if the excess depreciation is properly attributable to negative salvage value (*i.e.*, where the cost of removal or clean-up exceeds the salvage value).

(iii) *Consolidated group using current earnings and profits.* In the case of a consolidated group that uses its aggregate current earnings and profits as net book income (as determined under the rules of paragraph (b)(5)(ii) of this section), the current earnings and profits of the group is the aggregate of the current earnings and profits of each member of the group. In determining aggregate current earnings and profits, the adjustments described in § 1.1502-33 apply except for the adjustment for intercompany distributions with respect to stock and obligations or members of the group described in § 1.1502-

33(c)(1) and the investment adjustment described in § 1.1502-33(c)(4)(ii)(a).

(iv) *Restatement of a prior year's applicable financial statement*—(A) *In general.* If a taxpayer restates an applicable financial statement and as a result, the net book income for a taxable year is restated after the last date that the taxpayer could have filed its Federal income tax return for such taxable year (if it had obtained an extension of time under section 6081 of the Code), net book income for the first successor year (as defined in paragraph (d)(4)(iv)(D) of this section) must be adjusted by that part of the cumulative effect of the restatement on net book income attributable to taxable years beginning after 1986. To the extent that the cumulative effect of the restatement on net book income includes a tax component, paragraph (d)(3) of this section may apply. See paragraph (c)(5)(iii) of this section for rules relating to the restatement of an applicable financial statement prior to the date the taxpayer's return for the taxable year would be due if the time for filing the return is extended.

(B) *Reconciliation of owner's equity in applicable financial statements.* If—

(1) The beginning balance of owner's equity on the taxpayer's applicable financial statement for the current taxable year is different than the ending balance of owner's equity on the taxpayer's applicable financial statement for the preceding taxable year, and

(2) The taxpayer is not otherwise subject to the restatement rules in paragraph (d)(4)(iv)(A) of this section,

the taxpayer will be deemed to have restated its applicable financial statement for the preceding year and paragraph (d)(4)(iv)(A) of this section will apply.

(C) *Use of different priority applicable financial statements in consecutive taxable years.* If the priority of a taxpayer's applicable financial statement (as determined under the rules of paragraph (c)(3) of this section) for the current taxable year is different than the priority of the taxpayer's applicable financial statement for the preceding taxable year, the taxpayer shall be required to adjust net book income to the extent required under the rules of

either paragraph (d)(4)(iv) (A) or (B) of this section.

(D) *First successor year defined.* The “first successor year” is the first taxable year for which the taxpayer could have timely filed a return if it had obtained an extension of time under section 6081 of the Code after the restatement occurs. For example, if a calendar year corporation restates and uses its 1987 applicable financial statement between September 16, 1988 and September 15, 1989, any adjustment resulting from the restatement will be made in the taxpayer’s 1988 Federal income tax return. If the restatement occurs prior to September 15, 1988, the rules of paragraph (c)(5)(iii) of this section will apply.

(E) *Exceptions.* (1) No adjustment is made under paragraph (d)(4)(iv)(A) of this section for a restatement prepared in accordance with APB Opinion No. 16, paragraph 53, requiring restatements of financial statements to reflect the combined operation of corporations combined in a pooling transaction.

(2) In order to prevent duplication of an adjustment, an adjustment otherwise required under paragraph (d)(4)(iv)(A) of this section may be decreased to take into account an adjustment previously made under the disclosure rules described in paragraph (d)(5) of the section. See paragraph (d)(4)(viii), Example 3 of this section.

(v) *Adjustment for items previously taxed as subpart F income.* Net book income does not include any item excluded from regular taxable income under section 959 if the item was included in adjusted net book income in a prior taxable year under the provisions of paragraph (b)(2)(iv) of this section and due to section 951. A taxpayer may not adjust net book income under this paragraph (d)(4)(v) to the extent any portion of the subpart F income was recognized during taxable years beginning before 1987. See Example 5 of paragraph (d)(4)(viii) of this section.

(vi) *Adjustment for poolings of interests.* In a business combination accounted for as a pooling of interests under paragraph 50 of APB Opinion 16, net book income does not include the income of a separate corporation for that part of the taxable year preceding the combination of that corporation

with the taxpayer, to the extent the separate corporation included this income in its net book income for the taxable year preceding the business combination. A taxpayer may not adjust net book income under this paragraph (d)(4)(vi) to the extent the separate corporation’s income is attributable to taxable years beginning before 1987.

(vii) *Adjustment for certain deferred foreign taxes.* In the case of deferred foreign taxes that were previously added back to net book income in accordance with paragraph (d)(3) of this section, a deduction is allowed in computing adjusted net book income for the taxable year in which the deferred foreign taxes are deducted under section 164(a). A taxpayer may not adjust net book income under this paragraph (d)(4)(vii) to the extent the foreign taxes were deferred during taxable years beginning before 1987.

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

Example 1. Corporation A uses a calendar year for both financial accounting and tax purposes. In 1986, A’s financial statement included a \$100 financial accounting loss for a plant shutdown. A could not deduct the loss on its 1986 Federal income tax return. In 1987, A deducts the loss from the 1986 plant shutdown in its 1987 Federal income tax return. As a result, A’s 1987 adjusted net book income exceeds its 1987 pre-adjustment alternative minimum taxable income by \$100 (an amount equal to the deduction for the 1986 plant shutdown). Pursuant to paragraph (d)(4)(i) of this section, A cannot make an adjustment to net book income.

Example 2. Corporation B uses a calendar year for both financial accounting and tax purposes. B issues its calendar year 1987 applicable financial statement on March 1, 1988. The applicable financial statement reports net book income for the calendar years 1985 through 1987 of \$50, \$70, and \$80, respectively. On March 1, 1989 when it issues its calendar year 1988 applicable financial statement, B restates its 1985, 1986, and 1987 applicable financial statements. The restatement results from a change in accounting method that is made during calendar year 1988. After restatement, B’s net book income for 1985, 1986, and 1987 is \$60, \$80, and \$90, respectively. Based upon these facts, the cumulative effect of the restatement on B’s net book income for years prior to 1988 is \$30. However, since \$20 of the cumulative effective is attributable to years beginning before 1987, B’s 1988 net book income is increased by only \$10

(§30–§20). If the cumulative effect includes a tax adjustment, see paragraph (d)(3) of this section

Example 3. Assume the same facts for Corporation B as in Example 2, except that B's 1987 net book income of \$80 is increased by \$10 for purposes of B's 1987 Federal income tax return. The \$10 adjustment is made pursuant to paragraph (d)(5)(iii) of this section relating to disclosure in the accountant's opinion. Specifically, the accountant's opinion on B's 1987 applicable financial statement disclosed that if D had used a certain accounting method, B's 1987 net book income would have been \$90 rather than \$80. The restatement of B's 1987 applicable financial statement on March 1, 1988 results entirely from B changing to the accounting method referred to in the 1987 accountant's opinion. Pursuant to paragraph (d)(4)(iv)(E)(2) of this section, no adjustment is made to B's 1988 net book income as a result of the restatement of B's 1987 applicable financial statement.

Example 4. Assume the same facts as in Example 1, except that when A issues its 1987 applicable financial statement it also restates the net book income reported on its 1986 financial statement to exclude the \$100 loss attributable to the plant shutdown. Furthermore, the \$100 loss from the plant shutdown is included in A's 1987 net book income as reported on its 1987 applicable financial statement. Pursuant to paragraph (d)(4) of this section, no adjustment is made to A's 1987 net book income as a result of the restatement of A's 1986 net book income.

Example 5. Corporation D is a domestic corporation. D owns ten percent of the issued and outstanding stock of corporation F, a foreign corporation. D and F file separate financial statements and federal income tax returns, both on a calendar-year basis. F is a controlled foreign corporation as defined in section 957. In 1987, D includes ten percent of F's subpart F income in its income under section 951. F makes no actual distributions to D in that year, and D's applicable financial statement includes the earnings of F only when actual distributions are made. See paragraph (d)(6)(i)(A) of this section. In 1987, D must adjust its net book income under paragraph (b)(2)(iv) of this section to include ten percent of F's subpart F income. In 1988, F makes an actual distribution to D which qualifies for the exclusion of section 959. D includes this actual distribution as income on its applicable financial statement for 1987. Pursuant to paragraph (d)(4)(v) of this section, D must adjust its net book income for 1988 to exclude the actual distribution from F.

(5) *Adjustments resulting from disclosure—(i) Adjustment for footnote disclosure or other supplementary information—(A) In general.* Except as described

in this paragraph (d)(5)(i), net book income must be increased by any amount disclosed in a footnote or other supplementary information to the applicable financial statement if the disclosure supports a calculation of a net book income amount that would be greater than the net book income reported on the taxpayer's applicable financial statement. However, net book income will not be increased if the disclosure—

(1) Is specifically authorized by the accounting literature described in paragraph (d)(2)(ii) of this section, or

(2) Is in accordance with the taxpayer's historic practice as defined in paragraph (d)(2)(i) of this section.

See paragraph (d)(5)(v), Examples 1 and 2 of this section.

(B) *Disclosures not specifically authorized in the accounting literature.* The following footnote or other supplementary disclosure will not be considered specifically authorized in the accounting literature—

(1) Disclosure of what the taxpayer's net book income would have if GAAP had been used in preparing the applicable financial statement instead of tax accounting rules (or disclosure of the adjustment necessary to determine net book income on a GAAP basis), and

(2) Disclosure of what the taxpayer's net book income would have been if the accrual method had been used in preparing the applicable financial statement instead of the cash method (or disclosure of the adjustment necessary to determine net book income on the accrual method).

(ii) *Equity adjustments—(A) In general.* Except as described in this paragraph (d)(5)(ii), net book income must be increased by the amount of any equity adjustment (as defined in paragraph (d)(5)(ii)(B) of this section) included in the applicable financial statement if the equity adjustment increases owner's equity as reported on the taxpayer's applicable financial statement and the increase is attributable to the taxpayer or a member of the taxpayer's consolidated group. However, net book income will not be increased if the equity adjustment—

(1) Is specifically authorized by the accounting literature described in paragraph (d)(2)(ii) of this section, or

(2) Is in accordance with the taxpayer's historic practice as defined in paragraph (d)(2)(i) of this section.

See paragraph (d)(5)(v), Examples 3 and 4 of this section.

(B) *Definition of equity adjustment.* An equity adjustment is any reconciling item between beginning and ending owner's equity as reported on the taxpayer's applicable financial statement for the current taxable year. However, if properly accounted for, the following reconciling items are not considered equity adjustments and do not require adjustment under paragraph (d)(5)(ii)(A) of this section—

- (1) Net book income,
- (2) Non-liquidating dividend distributions, and
- (3) Contributions to capital.

(iii) *Amounts disclosed in an accountant's opinion.* Net book income must be increased by the amount of any item disclosed in the accountant's opinion (as described in paragraphs (c)(1)(ii)(C) and (c)(1)(ii)(D) of this section) if the disclosure supports a calculation of a net book income amount that would be greater than the net book income reported on the taxpayer's applicable financial statement. However, net book income will not be increased if the disclosure is in accordance with the taxpayer's historic practice, as defined in paragraph (d)(2)(i) of this section.

(iv) *Accounting method changes that result in cumulative adjustments to the current year's applicable financial statement—(A) In general.* If net book income for the current taxable year includes a cumulative adjustment attributable to an accounting method change and the amount of the cumulative adjustment may be determined upon review of the applicable financial statement (including footnotes) or other supplementary disclosure, net book income for the current taxable year shall be adjusted to exclude that portion of the cumulative adjustment attributable to taxable years beginning before 1987. To the extent the cumulative adjustment is reported net of a tax, paragraph (d)(3) of this section may apply. See paragraph (d)(5)(V), Example 5 of this section. If an accounting method change results in a restatement of an applicable financial state-

ment, paragraphs (c)(5)(iii) or (d)(4)(iv)(A) of this section may apply.

(B) *Exception.* In order to prevent duplication of an adjustment, the adjustment required under paragraph (d)(5)(iv)(A) of this section may be decreased to take into account any adjustment for the accounting method change previously made under the rules described in paragraph (d)(5) of this section (relating to adjustments resulting from disclosure).

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

Example 1. Corporation A uses a calendar year for both financial accounting and tax purposes. For calendar years 1984 through 1986, A used the cash method of accounting on its financial statement and disclosed in a footnote the net income or loss that would have resulted if the accrual method of accounting had been used. A's 1987 net book income, as reported on its 1987 applicable financial statement, is \$100 and is calculated on the cash method of accounting. In addition, a footnote in A's 1987 applicable financial statement states that A's 1987 net book income would have been \$30 greater had the accrual method of accounting been used. Pursuant to paragraph (d)(5)(i)(B)(2) of this section, A's 1987 footnote disclosure is not considered specifically authorized by the accounting literature. However, since A made such disclosure for calendar years 1985 and 1986, the 1987 disclosure is in accordance with A's historic practice, as defined in paragraph (d)(2)(i) of this section. Since A satisfies the exception described in paragraph (d)(5)(i)(A)(2) of this section, no adjustment is made to A's 1987 net book income for the footnote disclosure.

Example 2. Assume the same facts for corporation B as in Example (1), except that B's 1985 and 1986 financial statements did not disclose the amount of income or loss that would result if the accrual method of accounting (rather than the cash method of accounting) were used. Since B does not satisfy either of the exceptions described in paragraph (d)(5)(i)(A) of this section, B's 1987 adjusted net book income is \$130 (\$100 of net book income plus \$30 adjustment for footnote disclosure).

Example 3. Corporation C uses a calendar year for both financial accounting and tax purposes. C's 1987 net book income, as reported on its 1987 applicable financial statement, is \$200. However, as specifically authorized in FASB Statement of Standards No. 52, C's 1987 applicable financial statement also includes a \$50 equity adjustment (as defined in paragraph (d)(5)(ii)(B) of this section) for foreign currency translation

gains. Since the equity adjustment is specifically authorized in the accounting literature, C satisfies the exception described in paragraph (d)(5)(ii)(A)(1) of this section, and no adjustment is made to C's 1987 net book income for the \$50 equity adjustment.

Example 4. Assume the same facts for corporation D as in Example (3), except that D's equity adjustment is for foreign currency transaction gains instead of foreign currency translation gains. Pursuant to FASB Statement of Financial Accounting Standards No. 52, foreign currency transaction gains (as compared with foreign currency translation gains) are included in the income statement rather than in equity. In addition, in 1985 and 1986, D included foreign currency transaction gains in its income statement. Since D does not satisfy either of the exceptions described in paragraph (d)(5)(ii)(A) of this section, D's 1987 adjusted net book income is \$250 (\$200 of net book income plus \$50 equity adjustment).

Example 5. Corporation E uses a calendar year for both financial accounting and tax purposes. E's net book income for 1988 is \$100. The \$100 of net book income includes \$30 of financial accounting loss attributable to a cumulative adjustment as of January 1, 1988, resulting from a change in E's accounting method. The \$30 cumulative loss is disclosed in E's 1988 applicable financial statement. If E had made the accounting method change in calendar year 1987, the cumulative loss as of January 1, 1987 would have been \$20. Based upon the above facts, E must increase net book income by \$20 to disregard that portion of the cumulative adjustment attributable to years beginning before 1987. Thus, assuming no other adjustments to net book income, E's adjusted net book income for 1988 is \$120 (\$100 plus \$20).

(6) *Adjustments applicable to related corporations—(i) Consolidated returns—(A) In general.* Pursuant to paragraphs (a)(3) and (b)(3) of this section, the book income adjustment with respect to a consolidated group (as described under paragraph (a)(3) of this section) is computed based on the consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section). In the case of any corporation that is not included in the consolidated group, consolidated adjusted net book income of the consolidated group shall include only the sum of the dividends received from such other corporation and other amounts includible in gross income under this chapter with respect to the earnings of such other corporation. See paragraph (d)(6)(v), Example 4 of this section.

(B) *Corporations included in the consolidated Federal income tax return but excluded from the applicable financial statement—(1) In general.* Consolidated net book income reported on the applicable financial statement (as determined under paragraph (c)(5) of this section) shall be adjusted to include net book income attributable to a corporation that is included in the consolidated group but is not included in the applicable financial statement. Net book income for the corporation not included in the applicable financial statement of the consolidated group is the net book income reported on such corporation's applicable financial statement (determined under the rules of paragraph (c) of this section and adjusted under the rules of this paragraph (d)). The adjusted net book income of such corporation must be consolidated with the adjusted net book income of other members of the consolidated group and appropriate adjustments, including consolidating elimination entries, must be made.

(2) *Adjustments to net book income for minority interests.* Consolidated net book income must be adjusted to include income or loss allocated to minority interests in members of the consolidated group. Failure to include income or loss allocated to minority interests shall be treated as an omission of net book income. See paragraph (d)(6)(v), Example 1 of this section.

(3) *Corporations included in the consolidated group that are accounted for under the equity method of accounting.* No adjustment is required to consolidated net book income for income or loss of a member of the consolidated group that is reported in the applicable financial statement under the equity method of accounting (as described in APB Opinion No. 18, paragraph (6)). However, consolidated adjusted net book income (as defined in paragraph (b)(3)(i) of this section) must include 100 percent of the net book income attributable to such member. See paragraph (d)(6)(i)(B)(2) of this section. For example, if consolidated net book income (as defined in paragraph (b)(3)(ii) of this section) only includes 85 percent of the equity income attributable to a member of the consolidated group, an adjustment will be required to include

the 15 percent of equity income excluded from consolidated net book income. In addition, to the extent the equity income reflects an adjustment for tax expense or benefit, paragraph (d)(3) may apply. See paragraph (d)(6)(v), Examples 2 and 3 of this section.

(C) *Corporations included in the applicable financial statement but excluded from the consolidated tax return.* Net book income or consolidated net book income must be adjusted to eliminate the income or loss of a corporation that is included in the applicable financial statement, but is not included in the consolidated group. When net book income attributable to a corporation that is not a member of the consolidated group is removed from the computation of net book income in the applicable financial statement, consolidating elimination entries attributable to the excluded member must also be removed.

(ii) *Adjustment under the principles of section 482.* In order to fairly allocate items relating to intercompany transactions between corporations that are owned or controlled directly or indirectly by the same interests but are not members of a consolidated group, adjustments must be made to the net book income reported on the applicable financial statement of each corporation under the principles of section 482 and the regulations thereunder (relating to allocation of income and deductions among related taxpayers). For example, assume corporation A owns 100 percent of F, a foreign subsidiary, but A and F are not members of a consolidated group. However, A and F prepare a consolidated financial statement. In adjusting A's applicable financial statement to eliminate the net book income attributable to F, A must apply the principles of section 482. If a corporation fails to make appropriate adjustments to its applicable financial statement under the rules of this paragraph (d)(6)(ii), the District Director may make such adjustments under the principles of section 482 and the regulations thereunder.

(iii) *Adjustment for dividends received from section 936 corporations—(A) In general.* Any dividend received from a corporation eligible for the credit provided by section 936 (relating to the

possession tax credit) shall be included in adjusted net book income. For example, assume corporation A owns 100 percent of B, a section 936 corporation, and B pays a \$100 dividend to A. Furthermore, assume that of the \$100 dividend, \$15 of withholding tax is paid to a possession of the United States, so that A only receives \$85 from the dividend. Given these facts, A's adjusted net book income includes \$100 with respect to the dividend from B.

(B) *Treatment as foreign taxes.* Fifty percent of any withholding tax paid to a possession of the United States with respect to dividends referred to in paragraph (d)(6)(iii)(A) of this section may be treated for purposes of the alternative minimum foreign tax credit as a tax paid to a foreign country by the corporation receiving the dividend. However, if the aggregate of these dividends exceeds the excess referred to in paragraph (a)(1) of this section, the amount treated as a tax paid to the foreign country shall not exceed 50 percent of the aggregate amount of the tax withheld multiplied by a fraction.

(1) The numerator of which is the excess referred to in paragraph (a)(1) of this section; and

(2) The denominator numerator of which is the aggregate amount of these dividends.

(C) *Treatment of taxes imposed on section 936 corporations.* Taxes paid by any corporation eligible for the credit provided under section 936 shall be treated as a withholding tax paid with respect to any dividend paid by such corporation, and thus subject to the rules of this paragraph (d)(6)(iii), but only to the extent such taxes would be treated as paid by the corporation receiving the dividend under rules similar to the rules of section 902.

(iv) *Adjustment to net book income on sale of certain investments.* If a taxpayer accounts for an investment under any method equivalent to the equity method of accounting (as described in APB Opinion No. 18, paragraph 6) and pursuant to paragraphs (b)(2)(iv) or (d)(6)(i) of this section the taxpayer excludes net book income attributable to that investment, the taxpayer must adjust its net book income in the year the investment is sold (or partially sold). The adjustment equals the amount of net

book income previously excluded under paragraphs (b)(2)(iv) or (d)(6)(i)(A) of this section). See paragraph (d)(6)(v), Example 4 of this section.

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

Example 1. Corporation A and its 100 percent owned subsidiary B and its 90 percent owned subsidiary C are a consolidated group. A also owns 100 percent of D, a foreign corporation. ABC's applicable financial statement is a certified audited financial statement that includes A, B, C and D. The net book income reported on the statement excludes \$10 of C's net book income that is attributable to the 10 percent minority interest in C held outside of the consolidated group. Pursuant to paragraph (d)(6)(i)(B)(2) of this section, net book income of the consolidated group must be adjusted to include the \$10 of net book income attributable to the minority interest in C. In addition, pursuant to paragraph (d)(6)(i)(C) of this section, net book income shown on the applicable financial statement must be adjusted to eliminate the net book income attributable to D.

Example 2. Corporation E owns 100 percent of F, a finance subsidiary, and EF are a consolidated group. Since F is a finance subsidiary E's applicable financial statement accounts for F under the equity method of accounting. F also prepares a separate financial statement that is of equal or higher priority than E's applicable financial statement. In 1987, E's applicable financial statement includes \$60 of equity income from F. The \$60 of equity income reflects a reduction for \$40 of Federal income tax expense. Thus, E's equity income from F prior to the reduction for Federal income tax expense, is \$100 (\$60 + \$40). Since E's applicable financial statement includes E's equity income in F, F's separate financial statement is not relevant for determining the adjusted net book income of the EF consolidated group. However, pursuant to paragraphs (d)(3) and (d)(6)(i)(B)(3) of this section, E is required to adjust its equity income in F by the \$40 of Federal income tax expense attributable to F. Thus, assuming there are no other adjustments, E's adjusted net book income with respect to F is \$100.

Example 3. The facts are the same as Example (2), except that E reports its equity income in F without reduction for F's Federal income tax expense. The \$40 of Federal income tax expense attributable to F is combined with E's Federal income tax expense. Assuming no other adjustments, E's adjusted net book income with respect to F is \$100. Thus, E's adjusted net book income with respect to F will be the same regardless of whether E's equity income in F is reported before or after taxes.

Example 4. A, a domestic corporation, uses a calendar year for both financial accounting and tax purposes. On January 1, 1987, A purchases 100 percent of F, a foreign corporation, for \$100. F does not file a Federal income tax return and A does not recognize any taxable income with respect to F under section 951 (relating to controlled foreign corporations). In its applicable financial statement, A accounts for its investment in F under the equity method of accounting. Thus, A's initial investment in F is \$100. During calendar year 1987, F has \$50 of net book income but makes no dividend payments to A. Under the equity method of accounting, A's net book income includes the \$50 of net book income attributable to A's net book investment in F. Thus, A's investment in F is increased to \$150. Pursuant to paragraph (d)(6)(i)(C) of this section, A's net book income is adjusted to eliminate the \$50 of net book income attributable to F. On January 1, 1988, A sells F for \$150. Since A's investment in F under the equity method of accounting is \$150, A's net book income for 1988 will not include any gain on the sale of F. However, pursuant to paragraph (d)(6)(iv), A's 1988 net book income must be increased by \$50, the amount of net book income previously eliminated with respect to A's investment in F. The result would be the same if instead of accounting for its investment in F under the equity method of accounting, A and F prepare a consolidated financial statement.

(7) *Adjustments for foreign taxpayers with a United States trade or business—(i) In general.* Pursuant to paragraph (b)(6) of this section, the book income adjustment with respect to a foreign taxpayer with a United States trade or business is computed based on the effectively connected net book income of the foreign taxpayer (as defined in paragraph (b)(6)(ii) of this section). The net book income amount reported on the applicable financial statement of the foreign taxpayer (as determined under paragraph (c)(5)(ii) of this section) must be adjusted to—

(A) Include effectively connected net book income attributable to a trade or business conducted in the United States by the foreign taxpayer that is not reported on the applicable financial statement. Such amounts shall be determined from a financial statement (determined under paragraph (c) of this section and adjusted under the rules of this paragraph (d)) that would have qualified as an applicable financial statement of such excluded trade or business or upon effectively connected

earnings and profits (if the rules of section (b)(6)(iii) of this section apply), and

(B) Exclude any amount reported on such applicable financial statement that does not qualify as effectively connected net book income.

See the example in paragraph (d)(7)(ii) of this section.

(ii) *Example.* The provisions of this paragraph may be illustrated by the following example.

Example. Foreign corporation A, a calendar year taxpayer for financial accounting and tax purposes, is incorporated in X. A actively conducts two real estate businesses, B and C, in the United States. B prepares a certified audited financial statement that it provides to its United States creditor. C does not prepare a financial statement. The certified audited financial statement prepared by B is treated as A's applicable financial statement under paragraph (c)(5)(ii) of this section. B's certified audited financial statement, in addition to amounts related to the conduct of its real estate business, also reports income received from its investment in United States securities, unrelated to its conduct of business in the United States that does not qualify as effectively connected net book income. In order to determine A's effectively connected net book income from the net book income reported on the applicable financial statement, such statement must be adjusted to exclude amounts attributable to the securities. In addition, book income or loss attributable to C, to the extent effectively connected to its business in the United States, must be included in the effectively connected net book income reported on B's financial statement. Since C does not have a financial statement, C's effectively connected net book income is determined by computing its effectively connected earnings and profits under paragraph (b)(6)(iii) of this section.

(8) *Adjustment for corporations subject to subchapter F.* A corporation subject to tax under subchapter F of chapter 1 of the Code shall adjust its book income to exclude all items of income, loss or expense other than those relating to the calculation of unrelated business taxable income for purposes of section 512(a).

(e) *Special rules—(1) Cooperatives.* For purposes of computing the book income adjustment, net book income of a cooperative to which section 1381 applies is reduced by patronage dividends and per-unit retain allocations under section 1382(b) that are paid by the cooper-

ative to the extent such amounts are deductible for regular income tax and general alternative minimum tax purposes under section 1382, and not otherwise taken into account in determining adjusted net book income.

(2) *Alaska Native Corporations.* In computing the net book income of an Alaska Native Corporation, cost recovery and depletion are computed using the asset basis determined under section 21(c) of the Alaska Native Claims Settlement Act (43 U.S.C. 1620(c)). In addition, net book income is reduced by expenses payable under either section 7(i) or section 7(j) of the Alaska Native Claims Settlement Act (43 U.S.C. 1606 (i) and (j)) only when deductions for such expenses are allowed for tax purposes.

(3) *Insurance companies.* In the case of an insurance company whose applicable financial statement is a statement describing in paragraph (c)(1)(iii) of this section (relating to statements provided to a government regulator), net book income for purposes of the book income adjustment is the net income or loss from operations, after reduction for dividends paid to policyholders, but without reduction for Federal income taxes.

(4) *Estimating the book income adjustment for purposes of the estimated tax liability.* See §1.6655-7 for special rules for estimating the corporate alternative minimum tax book income adjustment under the annualization exception.

[T.D. 8307, 55 FR 33676, Aug. 17, 1990]

REGULATIONS APPLICABLE TO TAXABLE YEARS BEGINNING IN 1969 AND ENDING IN 1970

§ 1.56A-1 Imposition of tax.

(a) *In general.* Section 56(a) imposes an income tax on the items of tax preference (as defined in §1.57-1) of all persons other than persons specifically exempt from the taxes imposed by chapter 1. The items of tax preference represent income of a person which either is not subject to current taxation by reason of temporary exclusion (such as stock options) or by reason of an acceleration of deductions (such as accelerated depreciation) or is sheltered from