

## **HIGHLIGHTS OF THIS ISSUE**

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

### **INCOME TAX**

#### **Rev. Rul. 2003-108, page 963.**

**Tax lien.** This ruling under section 6323(a) of the Code concludes that actual notice or knowledge of the existence of a section 6321 federal tax lien is irrelevant for purposes of section 6323(a) lien priority.

#### **Rev. Rul. 2003-113, page 962.**

**LIFO; price indexes; department stores.** The August 2003 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, August 31, 2003.

#### **T.D. 9091, page 939.**

#### **REG-157164-02, page 1004.**

Final, temporary, and proposed regulations under sections 168 and 1400L of the Code provide rules for the additional first-year depreciation allowance. The regulations provide the requirements that must be met for depreciable property to qualify for the additional first-year depreciation allowance and instruct taxpayers how to determine the additional first-year depreciation allowance and the amount of depreciation otherwise allowable for the property. The regulations apply to property acquired by a taxpayer after September 10, 2001 (for the additional 30-percent first-year depreciation allowance), and for property acquired by a taxpayer after May 5, 2003 (for the additional 50-percent first-year depreciation allowance). A public hearing on the proposed regulations is scheduled for December 18, 2003.

#### **REG-146893-02 and REG-115037-00, page 967.**

Proposed regulations under section 482 of the Code explain that when controlled taxpayers transfer goods, services, intangibles or other items of value, the amount charged must be consistent with the amount charged at arm's length in the same or comparable transactions. These regulations provide updated guidance on determining the arm's length charge where one controlled taxpayer performs services that benefit one or more other controlled taxpayers. These regulations also provide updated guidance on the allocation among controlled taxpayers of income from intangibles, in particular when one controlled taxpayer performs activities that increase (or are expected to increase) the value of an intangible owned by another controlled taxpayer. A public hearing is scheduled for January 14, 2004.

#### **Rev. Proc. 2003-77, page 964.**

**Penalties; substantial understatement.** Guidance is provided concerning when information shown on a return in accordance with the applicable forms and instructions will be adequate disclosure for purposes of reducing an understatement of income tax under sections 6662(d) and 6694(a) of the Code.

### **EXEMPT ORGANIZATIONS**

#### **Announcement 2003-67, page 1005.**

Julie Renee Phelan Foundation, formerly Assured Nonprofit Services, Inc., of Sumner, WA, and Philanthropic Charities, Inc., of Castro Valley, CA, no longer qualify as organizations to which contributions are deductible under section 170 of the Code.

(Continued on the next page)

Finding Lists begin on page ii.



Department of the Treasury  
Internal Revenue Service

## GIFT TAX

### **Notice 2003-72, page 964.**

This notice announces that the Internal Revenue Service will follow the Tax Court's decision in *Walton v. Commissioner*, 115 T.C. 589 (2000), holding that section 25.2702-3(e), *Example 5*, of the Gift Tax Regulations is invalid.

## EMPLOYMENT TAX

### **Rev. Rul. 2003-106, page 936.**

**Travel and entertainment expenses.** This ruling specifies when an employer's use of electronic substantiation and expense reporting, as part of its travel and entertainment expense reimbursement procedures, satisfies the "accountable plan" requirements.

# The IRS Mission

Provide America's taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations,

court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### **Part II.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

### **Part III.—Administrative, Procedural, and Miscellaneous.**

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.\*

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\* **Beginning with Internal Revenue Bulletin 2003-43**, we are publishing the index at the end of the month, rather than at the beginning.

# Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

## Section 62.—Adjusted Gross Income Defined

26 CFR 1.62-2: Reimbursements and other expense allowance arrangements.

(Also: §§ 1.274-5, 1.274-5T, 31.3121(a), 31.3306(b), 31.3401(a).)

(Also: §§ 274(d), 3121(a), 3306(b), 3401(a).)

### Travel and entertainment expenses.

This ruling specifies when an employer's use of electronic substantiation and expense reporting, as part of its travel and entertainment expense reimbursement procedures, satisfies the "accountable plan" requirements.

## Rev. Rul. 2003-106

### ISSUE

Whether an employer's expense reimbursement arrangement for deductible travel and entertainment expenses, which includes new procedures for the use of electronic receipts and expense reports, is an accountable plan under § 62(a)(2)(A) and (c) of the Internal Revenue Code and the regulations thereunder.

### FACTS

An employer currently maintains a reimbursement arrangement, meeting the accountable plan requirements, under which it reimburses business-related travel and entertainment expenses incurred by its employees; paper receipts and expense reports are required. The employer reimburses employees for all properly substantiated business-related travel and entertainment charges submitted timely on an expense report along with any necessary receipts. The employer excludes from employees' wages reimbursements of all deductible business expenses provided under the arrangement. The employer also reimburses nondeductible business expenses (such as travel not away from home) and treats those reimbursements as wages. The employer does not reimburse employees for personal expenses.

To facilitate reimbursement of travel and entertainment expenses, the employer arranges to have a credit card company issue a business credit card to each employee the employer determines is likely to incur travel and entertainment expenses for

necessary business reasons. Employees who use the business credit card receive monthly billing statements from the credit card company and are personally liable to the credit card company for all charges billed to the card, including late payment fees.

To reduce the burden associated with submitting receipts and expense reports, the employer implements an electronic reimbursement arrangement for travel and entertainment expenses that eliminates the need for paper receipts and paper expense reports in most instances. Under this new arrangement, the credit card company provides the employer with an electronic receipt for all expenses billed to an employee's business credit card on a daily basis. An electronic receipt contains the date of the charge, the amount of the charge, the merchant's name, the merchant's location, and, if available, an itemization from the merchant of each expense included in the charge. The credit card company generally issues three types of electronic receipts to the employer: 1) a receipt with sufficient information on its face to indicate the nature of the charge (such as a charge from an airline carrier for a passenger ticket); 2) a receipt with an aggregate charge itemizing each expense (such as a final bill from a hotel listing separately the costs for meals, lodging and telephone calls); and 3) a receipt with an aggregate charge without itemizing each expense (such as a final bill from a hotel that does not list each charge separately).

Under the employer's new electronic expense reimbursement arrangement, the employer transfers the electronic receipts received from the credit card company to a database. This information cannot be altered once entered. Employees access the database to create an electronic expense report to accompany the electronic receipts associated with their travel and entertainment expenses. For all expenses, the employees must indicate whether the expenses are personal or business-related travel and entertainment. For all business-related travel and entertainment expenses, the employee must provide the following information in the electronic expense reports for each travel and entertainment expense: 1) a description of the expense and the business purpose it served;

and 2) for each entertainment expense, the names and business relationship of the persons entertained in addition to the date of, place of, duration of, and participants in any business discussion that occurred directly before or after the entertainment.

The employer requires employees to submit paper expense reports and receipts for: 1) any expense over \$75 where the nature of the expense is not clear on the face of the electronic receipt; 2) all lodging invoices for which the credit card company does not provide the merchant's electronic itemization of each expense; and 3) any expenses paid for by the employee without using the business credit card. The employer requires that the paper receipts and expense reports contain information sufficient to substantiate the amount, date, time, place, and business purpose of each expense. For example, if the credit card company provides an electronic receipt for an amount billed from a hotel that does not itemize each expense on the bill, the employee must provide paper documentation detailing each expense. Also, if the employee incurs a travel or entertainment expense for necessary business reasons but pays for it without using the business credit card, the employee must submit paper receipts and a paper expense report.

To receive reimbursements under the reimbursement arrangement, employees must submit expense reports with any necessary receipts to the employer within 30 days after returning from a business trip or incurring a travel or entertainment expense, but no later than 60 days after incurring the expense. Once the employer approves an employee's travel and entertainment expense report, the employer sends payment directly to the credit card company for the business expenses listed in the report. The employer does not reimburse any charges made to the employee's business credit card that are not listed in the expense report approved by the employer. The employer treats the reimbursement of any nondeductible business expenses as wages paid to the employee and does not reimburse personal expenses.

The employer's use and retention of electronic records meets the requirements of Rev. Proc. 98-25, 1998-1 C.B. 689.

Section 62 generally defines “adjusted gross income” as gross income minus certain (“above-the-line”) deductions. Section 62(a)(2)(A) allows an employee an above-the-line deduction for expenses paid or incurred by the employee, in conjunction with services performed as an employee, under a reimbursement or other expense allowance agreement with the employer. Section 62(c) provides that an arrangement will not be treated as a reimbursement or other expense allowance arrangement for purposes of § 62(a)(2)(A) if: 1) the arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement; or 2) the arrangement provides the employee with the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

Under § 1.62–2(c)(1) of the Income Tax Regulations, a reimbursement or other expense allowance arrangement satisfies the requirements of § 62(c) if it meets the requirements set forth in paragraphs (d), (e), and (f) of § 1.62–2 (business connection, substantiation, and return of excess). If an arrangement meets these requirements, all amounts paid under the arrangement are treated as paid under an accountable plan. § 1.62–2(c)(2)(i). Amounts paid under an accountable plan are excluded from the employee’s gross income, are not required to be reported on the employee’s Form W–2, and are exempt from the withholding and payment of employment taxes. §§ 31.3121(a)–3, 31.3306(b)–2, 31.3401(a)–4 of the Employment Tax Regulations, and 1.6041–3(h)(1) of the Procedure and Administration Regulations.

If an arrangement does not satisfy one or more of these requirements, all amounts paid under the arrangement are paid under a “nonaccountable plan.” § 1.62–2(c)(3). Amounts paid under a nonaccountable plan are included in the employee’s gross income for the taxable year, must be reported to the employee on Form W–2, and are subject to withholding and payment of employment taxes. §§ 1.62–2(c)(5), 31.3121(a)–3(b)(2), 31.3306(b)–2(b)(2), 31.3401(a)–4(b)(2), and § 1.6041–3(h)(1). Additionally, § 1.62–2(k) provides that if a payor’s reimbursement or other expense

allowance arrangement evidences a pattern of abuse of the rules of § 62(c) and the regulations thereunder, all payments made under the arrangement will be treated as made under a nonaccountable plan.

An arrangement meets the business connection requirement of § 1.62–2(d)(1) if it provides advances, allowances, or reimbursements only for business expenses that are allowable as deductions under part VI (§ 161 and following), subchapter B, chapter 1 of the Code, and that are paid or incurred by the employee in connection with the performance of services as an employee. Under § 1.62–2(d)(2), if an arrangement, in addition to reimbursing deductible business expenses, also reimburses nondeductible but otherwise *bona fide* expenses related to the employer’s business (such as travel not away from home), the payor will be treated as maintaining two arrangements—the deductible business expenses will be treated as satisfying the business connection requirement, and the nondeductible business expenses will be treated as paid under a nonaccountable plan. The payment may be actually received from the employer, its agent, or a third party for whom the employee performs services as an employee of the employer. § 1.62–2(d)(1). Section 1.62–2(d)(3)(i) provides that the business connection requirement will not be satisfied if the payor arranges to pay an amount to an employee regardless of whether the employee incurs or is reasonably expected to incur *bona fide* business expenses related to the employer’s business.

An arrangement for travel and entertainment expenses meets the substantiation requirement of § 1.62–2(e)(1) if the arrangement requires each business expense to be substantiated to the payor in accordance with paragraph (e)(2), within a reasonable period of time. An arrangement for those expenses meets the substantiation requirements if the employee makes an adequate accounting to the payor that satisfies the substantiation requirements of § 274(d) and the regulations thereunder. § 1.62–2(e)(2).

Section 274(d) disallows a deduction under § 162 for any expense for travel away from home, including meals and lodging, or entertainment unless the taxpayer substantiates by adequate records or by sufficient evidence the requisite elements of each expenditure. For travel

expenses, the taxpayer must establish the amount, time, place, and business purpose of the expenditure. § 1.274–5T(b)(2). For business entertainment expenses, the taxpayer must establish the amount, date (and possibly duration of business discussion), place, business purpose, names and business relationship of the persons entertained, all as set forth in more detail in § 1.274–5T(b)(3) and (b)(4). Section 1.274–5T(c)(2)(i) provides that, to substantiate each element by adequate records, the taxpayer must maintain: 1) an account book, diary, log, statement of expense, trip sheets, or similar record; and 2) documentary evidence that, in combination, are sufficient to establish each element of an expenditure. The account book, diary, log, statement of expense, trip sheet, or similar record must be prepared or maintained in such manner that each recording of an element of an expenditure is “made at or near the time of the expenditure.” § 1.274–5T(c)(2)(ii). The phrase “made at or near the time of the expenditure” means the elements of an expenditure are recorded at a time when, in relation to making the expenditure, the taxpayer has full present knowledge of each element of the expenditure, such as the amount, time, place, and business purpose. An expense account statement which is a transcription of an account book, diary, log, or similar record prepared or maintained at or near the time of the expenditure, is considered a record prepared or maintained at or near the time of the expenditure if the expense account statement is submitted by an employee to his employer in the regular course of good business practice. § 1.274–5T(c)(2)(ii)(A). An employee must use adequate records to make an adequate accounting to substantiate expenses to the payor. § 1.274–5(f)(4)(i).

Section 1.274–5(c)(2)(iii) requires documentary evidence for any expenditure for lodging while traveling away from home and for any other expenditure of \$75 or more, except for transportation charges if the documentary evidence is not readily available. Acceptable documentary evidence includes receipts, paid bills, or similar evidence sufficient to support an expenditure. Ordinarily, documentary evidence will be considered adequate to support an expenditure if it includes sufficient information to establish the amount, date, place, and the essential character of

the expenditure. For example, a hotel receipt is sufficient to support expenditures for business travel if it contains the name, location, and date of the expenditures and separate amounts for each charge, such as lodging, meals, and telephone. § 1.274-5(c)(2)(iii)(B).

Reimbursement of any expenses not substantiated within a reasonable period of time must be treated as made under a nonaccountable plan, and treated as wages. Section 1.62-2(g)(2)(i) provides a fixed date method safe harbor for purposes of satisfying the “reasonable period of time” requirement. Under this safe harbor, an expense substantiated to the payor within 60 days after it is paid or incurred will be treated as substantiated within a reasonable period of time.

An arrangement meets the return of excess requirement of § 1.62-2(f)(1) if the arrangement requires the employee to return to the payor within a reasonable period of time any amount paid under the arrangement in excess of the substantiated expenses.

Revenue Procedure 98-25 specifies the basic requirements that the Internal Revenue Service considers to be essential for satisfying the recordkeeping requirements of § 6001 in cases where a taxpayer’s records are maintained by electronic or other non-manual methods. Failure to comply with the revenue procedure may result in imposition of applicable penalties under Subtitle F of the Code.

#### ANALYSIS

The employer’s reimbursement arrangement for the employee’s deductible business expenses, which includes the use of electronic receipts and electronic expense reports, satisfies all three of the essential elements for an accountable plan under § 62(a)(2)(A) and (c).

First, the expenses that are reimbursed through the plan are exclusively business expenses. All expenses must be submitted on either electronic or paper reports and must include specific information. If the electronic information is insufficient to

determine whether the expenses are business expenses, paper documentation is required. The employer’s expense reporting procedures give the employer the information it needs to verify that it is reimbursing exclusively for business expenses, and furthermore to distinguish reimbursements for business expenses deductible under part VI (§ 161 and following), subchapter B, chapter 1 of the Code, from reimbursements of nondeductible but otherwise *bona fide* business expenses that must be treated as wages paid under a nonaccountable plan. Moreover, the electronic receipts are generated only for employees with business credit cards, and the business credit cards are provided only to employees who are likely to incur travel and entertainment expenses for business reasons. Consequently, the employer’s travel and entertainment reimbursement arrangement satisfies the business connection requirements of § 1.62-2(d).

Second, the arrangement meets the substantiation requirement of § 1.62-2(e)(1). The employees are required to submit expense reports, electronic or otherwise, within 30 days of traveling or incurring an entertainment expense (but no later than 60 days after an expense is paid or incurred), describing each element of the expenditure. This time period is within the fixed date method safe harbor of substantiating to the payor within 60 days after an expense is paid or incurred provided in § 1.62-2(g)(2)(i). Requiring employees to complete an expense report within 30 days after returning from a trip or incurring an entertainment expense, supported by the electronic or paper receipts, also satisfies the requirement under § 1.274-5T(c)(2)(ii) that an individual have full present knowledge of each element of the expenditure, such as the amount, time, place and business purpose of the expenditure.

The electronic receipts provided to the employer by the credit card company for certain expenses include information sufficient to establish the amount, date, place and essential character of the expenditure and, therefore, qualify as “receipts, paid bills, or similar evidence” for purposes of the documentary evidence requirements of § 1.274-5(c)(2)(iii). Additionally, the employer requires paper receipts and expense reports for any expense over \$75

where the nature of the expense is not clear on the face of the electronic receipt, all lodging expenses for which the credit card company does not provide an electronic listing of expenses itemized by the merchant, and any expenses paid for by the employee without using the business credit card. The electronic data and or paper documents submitted to the employer constitute adequate records under § 1.274-5(c)(2) and satisfy the requirement that the employee make an adequate accounting to the employer to substantiate the respective expenses for purposes of § 274(d) and the regulations thereunder. Thus, the employer’s travel and entertainment expense reimbursement procedures satisfy the substantiation requirement of § 1.62-2(e)(2).

Third, the plan meets the requirement for return of any payments in excess of the employee’s substantiated expenses under § 1.62-2(f) because the employer’s travel and entertainment expense reimbursement procedures reimburse only substantiated expenses. Although the credit card company provides the employer with electronic receipts for all expenses charged to the employee’s business credit card, the employer reimburses only those expenses identified to the employer as business expenses and included in the expense report with appropriate documentation. Therefore, there is no amount in excess of substantiated expenses provided that must be returned within a reasonable period of time.

#### HOLDING

An employer’s expense reimbursement arrangement for deductible travel and entertainment expenses, which includes new procedures for the use of electronic receipts and expense reports, is an accountable plan under § 62(a)(2)(A) and (c) and the regulations thereunder.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Joe Spires of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). For further information regarding this revenue ruling, contact Mr. Spires at (202) 622-6040 (not a toll-free call).

## Section 168.—Accelerated Cost Recovery System

26 CFR 1.168(d)-1: Applicable conventions—half-year and mid-quarter conventions.

### T.D. 9091

## DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 1

### Special Depreciation Allowance

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains regulations relating to the depreciation of property subject to section 168 of the Internal Revenue Code (MACRS property) and the depreciation of computer software subject to section 167. Specifically, these regulations provide guidance regarding the additional first year depreciation allowance provided by sections 168(k) and 1400L(b) for certain MACRS property and computer software. The regulations reflect changes to the law made by the Job Creation and Worker Assistance Act of 2002 and the Jobs and Growth Tax Relief Reconciliation Act of 2003. The text of these temporary regulations also serves as the text of the proposed regulations (REG-157164-02) set forth in the notice of proposed rulemaking on this subject in this issue of the Bulletin.

DATES: *Effective Dates:* These regulations are effective September 8, 2003.

*Applicability Dates:* For dates of applicability, see §§1.167(a)-14T(e), 1.168(d)-1T(d), 1.168(k)-1T(g), 1.169-3T(g), and 1.1400L(b)-1T(g).

FOR FURTHER INFORMATION CONTACT: Douglas Kim, (202) 622-3110 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

#### Background

This document contains amendments to 26 CFR part 1 to provide regulations under

sections 168(k) and 1400L(b) of the Internal Revenue Code (Code). Sections 168(k) and 1400L(b) were added to the Code by, respectively, sections 101 and 301(a) of the Job Creation and Worker Assistance Act of 2002, Public Law 107-147 (116 Stat. 21), and were modified by section 201 of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Public Law 108-27 (117 Stat. 752).

#### Explanation of Provisions

##### *Background*

Section 167 allows as a depreciation deduction a reasonable allowance for the exhaustion, wear, and tear of property used in a trade or business or held for the production of income. The depreciation allowable for tangible, depreciable property placed in service after 1986 generally is determined under section 168 (MACRS property). The depreciation allowable for computer software that is placed in service after August 10, 1993, and is not an amortizable section 197 intangible is determined under section 167(f)(1).

Section 168(k)(1) allows a 30-percent additional first year depreciation deduction for qualified property acquired after September 10, 2001, and, in most cases, placed in service before January 1, 2005. Section 168(k)(4) allows a 50-percent additional first year depreciation deduction for 50-percent bonus depreciation property acquired after May 5, 2003, and, in most cases, placed in service before January 1, 2005. Section 1400L(b) allows a 30-percent additional first year depreciation deduction for qualified New York Liberty Zone property (Liberty Zone property) acquired after September 10, 2001, and placed in service before January 1, 2007 (January 1, 2010, in the case of qualifying nonresidential real property and residential rental property).

##### *Scope*

The regulations provide the requirements that must be met for depreciable property to qualify for the additional first year depreciation deduction provided by sections 168(k) and 1400L(b). Further, the regulations instruct taxpayers how to determine the additional first year depreciation deduction and the amount of

depreciation otherwise allowable for this property.

#### *Property Eligible for the Additional First Year Depreciation Deduction*

The regulations provide that depreciable property must meet four requirements to be qualified property under section 168(k)(2) (property for which the 30-percent additional first year depreciation deduction is allowable) or 50-percent bonus depreciation property under section 168(k)(4) (property for which the 50-percent additional first year depreciation deduction is allowable). These requirements are: (1) the depreciable property must be of a specified type; (2) the original use of the depreciable property must commence with the taxpayer after September 10, 2001, for qualified property or after May 5, 2003, for 50-percent bonus depreciation property; (3) the depreciable property must be acquired by the taxpayer within a specified time period; and (4) the depreciable property must be placed in service by a specified date. These requirements are more fully discussed below.

#### *Property of a Specified Type*

The regulations provide that qualified property or 50-percent bonus depreciation property must be one of the following: (1) MACRS property that has a recovery period of 20 years or less; (2) computer software as defined in, and depreciated under, section 167(f)(1); (3) water utility property as defined in section 168(e)(5) and depreciated under section 168; or (4) qualified leasehold improvement property depreciated under section 168. Because the additional first year depreciation deduction applies to MACRS property that is depreciated under the general depreciation system (GDS) or would be depreciated under the GDS but for an alternative depreciation system (ADS) election made by the taxpayer, the regulations provide that for purposes of determining the eligibility of MACRS property as qualified property or 50-percent bonus depreciation property, the recovery period applicable for the MACRS property under section 168(c) of the GDS is used regardless of any election made by the taxpayer to depreciate the class of property under the ADS of section 168(g). Further, with respect to

qualified leasehold improvement property, the regulations define those improvements specified in section 168(k)(3)(B) that are not considered as qualified leasehold improvement property.

The regulations also provide that qualified property or 50-percent bonus depreciation property does not include: (1) property excluded from the application of section 168 as a result of section 168(f); (2) property that is required to be depreciated under the ADS; (3) any class of property for which the taxpayer elects not to deduct the 30-percent or 50-percent additional first year depreciation; or (4) qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c).

Property is required to be depreciated under the ADS if the property is described under section 168(g)(1)(A) through (D) or if other provisions of the Code require depreciation for the property to be determined under the ADS (for example, section 263A(e)(2)(A) or section 280F(b)(1)). Thus, MACRS property for which the taxpayer makes an election under section 168(g)(7) to depreciate the property under the ADS is eligible for the additional first year depreciation deduction (assuming all other requirements are met).

With respect to the election out of the additional first year depreciation deduction, a taxpayer may elect out of the 30-percent additional first year depreciation deduction for any class of qualified property. For any class of 50-percent bonus depreciation property, a taxpayer may elect either to deduct the 30-percent, instead of the 50-percent, additional first year depreciation deduction or to deduct no additional first year depreciation deduction. The regulations provide the rules for making these elections and also define what is a class of property for purposes of the elections.

#### *Original Use*

Pursuant to section 168(k)(2)(A)(ii), the regulations provide that qualified property is property the original use of which commences with the taxpayer after September 10, 2001. Further, pursuant to section 168(k)(4)(B)(i), the regulations provide that 50-percent bonus depreciation property is property the original use

of which commences with the taxpayer after May 5, 2003. The regulations provide that the original use generally means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer. Thus, new property initially used by a taxpayer for personal use and then subsequently converted by the taxpayer for use in its trade or business satisfies the original use requirement. However, new property acquired by a taxpayer for personal use and then subsequently acquired by a different taxpayer for use in its trade or business does not satisfy the original use requirement.

Likewise, additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfies the original use requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer does not satisfy the original use requirement. The question of whether property is reconditioned or rebuilt property is a question of fact. The regulations provide a safe harbor that property containing used parts will not be treated as reconditioned or rebuilt if the cost of the used parts is not more than 20 percent of the total cost of the property. See Rev. Rul. 68-111, 1968-1 C.B. 29.

The regulations also provide special rules for certain sale-leaseback transactions and syndication transactions. If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a person and the property is involved in a sale-leaseback transaction described in section 168(k)(2)(D)(ii), the taxpayer-lessor is considered the original user of the property. Likewise, if qualified property is originally placed in service by a lessor after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service by a lessor after May 5, 2003, and is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor, and the user of the property does not change during this three-month period, the purchaser of the property in the last sale is considered the original user of the property.

The regulations also provide that if in the ordinary course of its business a taxpayer sells fractional interests in qualified property or 50-percent bonus depreciation property to unrelated third parties, each first fractional owner of the property is considered as the original user of its proportionate share of the property. Furthermore, if a taxpayer uses the qualified property or the 50-percent bonus depreciation property before all of the fractional interests are sold and the property continues to be held primarily for sale by the taxpayer, the original use of any fractional interest sold to an unrelated third party subsequent to the taxpayer's use begins with the first purchaser of that interest.

#### *Acquisition of Property*

Pursuant to section 168(k)(2)(A)(iii), the regulations provide that qualified property is property: (1) acquired by the taxpayer after September 10, 2001, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001; or (2) acquired by the taxpayer pursuant to a written binding contract that was entered into after September 10, 2001, and before January 1, 2005. Further, pursuant to section 168(k)(4)(B)(ii), the regulations provide that 50-percent bonus depreciation property is property acquired by the taxpayer after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before May 6, 2003.

The regulations define a binding contract as any contract that is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount. However, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. Further, the fact that there will be little or no damages because the contract price does not significantly differ from the fair market value will not be taken into account in determining whether a contract limits damages.

The regulations also provide that a contract is binding even if the contract is subject to a condition, as long as the condition is not within the control of either one of the parties or a predecessor. Further, an



option to either acquire or sell property is not treated as a binding contract.

The regulations also provide that a binding contract does not include a supply agreement or similar agreement, if the amount and design specifications of the property to be purchased have not been specified. In this case, the contract is not treated as a binding contract until both the amount and design specifications are specified.

With respect to self-constructed property, the regulations provide that the property acquisition requirement is met if a taxpayer manufactures, constructs, or produces qualified property or 50-percent bonus depreciation property for its own use and such manufacturing, construction, or production began after, respectively, September 10, 2001, or May 5, 2003, and before January 1, 2005. Further, property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract that is entered into before the manufacture, construction, or production of the property begins is considered to be manufactured, constructed, or produced by the taxpayer.

The regulations also define when construction begins. Construction of qualified property or 50-percent bonus depreciation property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature has begun depends on the facts and circumstances. The regulations, however, provide a safe harbor that physical work of a significant nature has begun when the taxpayer incurs or pays more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities).

The regulations also provide rules for a contract to acquire, or for the manufacture, construction, or production of, a component of the larger self-constructed property. If a binding contract to acquire a component was in effect, or the manufacture, construction, or production of a component began, before September 11, 2001, for qualified property or before May 6, 2003, for 50-percent bonus depreciation property, the component does not qualify for the additional first year depreciation deduction. Similarly, if a

binding contract to acquire a component was in effect, or the manufacture, construction, or production of a component began, before September 11, 2001, for qualified property or before May 6, 2003, for 50-percent bonus depreciation property, but the manufacture, construction, or production of the larger self-constructed property began after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, the larger self-constructed property qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the component does not. Additionally, if the manufacture, construction, or production of the larger self-constructed property began before September 11, 2001, for qualified property or before May 6, 2003, for 50-percent bonus depreciation property, the larger self-constructed property and any acquired or self-constructed component related to the larger self-constructed property do not qualify for the 30-percent or 50-percent additional first year depreciation deduction. However, if the binding contract to acquire the component was entered into, or the manufacture, construction, or production of the component began, after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, but the manufacture, construction, or production of the larger self-constructed property begins after December 31, 2004, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not.

The regulations provide rules for when certain acquired or self-constructed property will not meet the acquisition date requirement (disqualified transactions). When the user of property as of the date on which the property was originally placed in service, or a related party to the user, acquired, or had a written binding contract in effect for the acquisition of, the property at any time before September 11, 2001, or before May 6, 2003, as applicable, the property does not qualify for the 30-percent or 50-percent additional first year depreciation deduction. Similarly, property manufactured, constructed, or produced for the taxpayer or a related

party does not qualify for the 30-percent or 50-percent additional first year depreciation deduction if the manufacture, construction, or production began at any time before September 11, 2001, or before May 6, 2003, as applicable. For this purpose, persons are related if they have a relationship specified in section 267(b) or 707(b).

#### *Placed-in-service Date*

Pursuant to section 168(k)(2)(A)(iv) and 168(k)(4)(B)(iii), the regulations provide that qualified property or 50-percent bonus depreciation property is property that is placed in service by the taxpayer before January 1, 2005. However, the placed in service date of January 1, 2005, is extended for one year to January 1, 2006, for property described in section 168(k)(2)(B).

The regulations also provide special rules for sale-leaseback transactions and syndication transactions. If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a person and is involved in a sale-leaseback transaction described in section 168(k)(2)(D)(ii), the property is treated as originally placed in service by the taxpayer-lessor not earlier than the date on which the property is used by the lessee under the sale-leaseback. Likewise, if qualified property is originally placed in service by a lessor after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service by a lessor after May 5, 2003, and is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor, and the user of the property does not change during this three-month period, the property is treated as originally placed in service not earlier than the date of the last sale by the purchaser of the property in the last sale.

Special rules also are provided for certain nonrecognition transactions. In the case of a technical termination of a partnership under section 708(b)(1)(B), qualified property or 50-percent bonus depreciation property placed in service by the terminated partnership during the taxable year of termination is treated as originally placed in service by the new partnership

on the date the qualified property or the 50-percent bonus depreciation property is contributed by the terminated partnership to the new partnership. Additionally, qualified property or 50-percent bonus depreciation property transferred in a “step-in-the-shoes” transaction described in section 168(i)(7) in the taxable year the qualified property or the 50-percent bonus depreciation property is placed in service by the transferor is treated as originally placed in service on the date the transferor placed the qualified property or the 50-percent bonus depreciation property in service.

### *Liberty Zone Property*

Generally, the requirements for determining the eligibility of property for the additional first year depreciation deduction for Liberty Zone property provided by section 1400L(b) are similar to the requirements for the 30-percent additional first year depreciation deduction for qualified property provided by section 168(k)(1). There are, however, some differences that are discussed below.

The regulations provide that Liberty Zone property includes the same property that is described as qualified property or 50-percent bonus depreciation property for purposes of section 168(k). In addition, Liberty Zone property includes nonresidential real property or residential rental property to the extent such property rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed or condemned property if, as part of an integrated plan, the property replaces real property that is included in a continuous area that includes real property destroyed or condemned. Real property is considered to have been destroyed or condemned only if an entire building or structure was destroyed or condemned as a result of the terrorist attacks of September 11, 2001.

While Liberty Zone property includes the same property that is described as qualified property or 50-percent bonus depreciation property for purposes of section 168(k), only one additional first year depreciation deduction is allowable for the property. Thus, pursuant to section 1400L(b)(2)(C)(i), the regulations provide

that if the 30-percent or 50-percent additional first year depreciation deduction under section 168(k) applies to the property, it is not Liberty Zone property.

Pursuant to section 1400L(b)(2)(A)(ii), property is Liberty Zone property if substantially all of the use of the property is in the Liberty Zone and the property is used in the active conduct of a taxpayer’s trade or business in the Liberty Zone. The regulations provide that the term *substantially all* means 80 percent or more.

In addition to the application of the original use rules for qualified property, the regulations provide that used property will satisfy the original use requirement for Liberty Zone property if the used property has not been previously used within the Liberty Zone.

Pursuant to section 1400L(b)(2)(A)(iv), the regulations provide that Liberty Zone property is property that is acquired by the taxpayer by purchase after September 10, 2001, but only if no written binding contract for the acquisition of the property was in effect before September 10, 2001. The term *by purchase* is defined in section 179(d) and §1.179-4(c). The regulations also provide that the binding contract rules and the disqualified transactions rules for qualified property apply to Liberty Zone property. The self-construction rules for qualified property also apply to self-constructed Liberty Zone property except that the requirement to begin the manufacture, construction, or production of the qualified property before January 1, 2005, does not apply to Liberty Zone property.

Finally, the regulations provide that Liberty Zone property generally must be acquired by a taxpayer after September 10, 2001, and placed in service by the taxpayer before January 1, 2007. However, qualifying nonresidential real property and residential rental property must be acquired by a taxpayer after September 10, 2001, and placed in service by the taxpayer before January 1, 2010.

### *Computation of Additional First Year Depreciation Deduction and Otherwise Allowable Depreciation*

The allowable additional first year depreciation deduction for qualified property or Liberty Zone property is equal to 30 percent of the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of

the property. The allowable additional first year depreciation deduction for 50-percent bonus depreciation property is equal to 50 percent of the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the property. For qualified property or 50-percent bonus depreciation property described in section 168(k)(2)(B) (property having a longer production period), the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the property is limited to the property’s basis attributable to manufacture, construction, or production of the property before January 1, 2005.

The additional first year depreciation deduction is allowed for both regular tax and alternative minimum tax purposes. However, for alternative minimum tax purposes, the amount of the additional first year depreciation deduction is based on the unadjusted depreciable basis of the property for alternative minimum tax purposes. The amount of the additional first year depreciation deduction is not affected by a taxable year of less than 12 months for either regular or alternative minimum tax purposes.

Before determining the amount of depreciation otherwise allowable for qualified property, 50-percent bonus depreciation property, or Liberty Zone property, the taxpayer must first reduce the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the property by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater (the remaining adjusted depreciable basis). Then, the remaining adjusted depreciable basis is depreciated using the applicable depreciation provisions of the Code for the property (that is, section 168 for MACRS property and section 167(f)(1) for computer software). This amount of depreciation is allowed for both regular tax and alternative minimum tax purposes, and is affected by a taxable year of less than 12 months. However, for alternative minimum tax purposes, the amount of depreciation allowed is determined by calculating the remaining adjusted depreciable basis of the property for alternative minimum tax purposes and using the same depreciation method, recovery period, and convention that applies to the property for regular tax purposes. If a taxpayer uses the optional depreciation tables in Rev.

Proc. 87-57, 1987-2 C.B. 687, to compute depreciation for qualified property, 50-percent bonus depreciation property, or Liberty Zone property that is MACRS property, the regulations also provide that the remaining adjusted depreciable basis of the property is the basis to which the annual depreciation rates in those tables apply.

### *Special Rules*

The regulations also provide rules for the following situations: (1) qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service and disposed of in the same taxable year; (2) redetermination of basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (3) recapture of additional first year depreciation for purposes of section 1245 and section 1250; (4) a certified pollution control facility that is qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (5) like-kind exchanges and involuntary conversions of qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (6) a change in use of qualified property, 50-percent bonus depreciation property, or Liberty Zone property; (7) the computation of earnings and profits; (8) the increase in the limitation of the amount of depreciation for passenger automobiles; and (9) the step-up in basis due to a section 754 election.

With respect to qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service and disposed of in the same taxable year, the regulations provide that the additional first year depreciation deduction is not allowed. This rule is consistent with the general rule in §1.168(d)-1(b)(3)(ii) for MACRS property placed in service and disposed of in the same taxable year. However, as previously discussed, the additional first year depreciation deduction is allowable for qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service by a terminated partnership in the same taxable year in which a technical termination of the partnership occurs. In this case, the new partnership, and not the terminated partnership, claims the additional first year depreciation deduction. Similarly,

the additional first year depreciation deduction is allowable for qualified property, 50-percent bonus depreciation property, or Liberty Zone property placed in service by a transferor in the same taxable year in which the property is transferred in a step-in-the-shoes transaction described in section 168(i)(7). In this case, the additional first year depreciation deduction for the transferor's taxable year in which the property is placed in service is allocated between the transferor and the transferee on a monthly basis. The allocation shall be made in accordance with the rules in §1.168(d)-1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee.

The regulations also provide rules for a redetermination of basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property (for example, due to a contingent purchase price or a discharge of indebtedness). If the unadjusted depreciable basis of the property is redetermined by the date on which the property must be last placed in service to meet the placed-in-service date requirement in section 168(k)(2)(A)(iv), 168(k)(4)(B)(iii), or 1400L(b)(2)(A)(v), the additional first year depreciation deduction allowable for the property is redetermined. If the redetermination of basis occurs after that date, the additional first year depreciation deduction is not redetermined. The regulations instruct taxpayers how to determine the depreciation adjustment for an increase or decrease in basis. If there is an increase in basis, the taxpayer claims the additional first year depreciation deduction attributable to the increase in the taxable year in which the increase occurs. If there is a decrease in basis, the taxpayer includes in its income the excess additional first year depreciation deduction attributable to the decrease in the taxable year in which the decrease occurs.

Because the additional first year depreciation deduction is not a ratable method of computing depreciation, the regulations provide that the additional first year depreciation deduction is not a straight line method for purposes of section 1250. Thus, the additional first year depreciation deduction is an accelerated depreciation method for purposes of determining recapture under section 1250. For purposes of

section 1245, all depreciation deductions are subject to recapture.

With respect to a certified pollution control facility that is qualified property, 50-percent bonus depreciation property, or Liberty Zone property, the regulations provide that the additional first year depreciation deduction is allowable in the facility's placed in service year even if the taxpayer elects to amortize the basis of the facility under section 169 in the placed-in-service year. The regulations also amend the regulations under section 169 to provide that the amortizable basis under section 169 must be reduced by the additional first year depreciation deduction allowed or allowable, whichever is greater, applicable to the facility.

With respect to MACRS property or computer software acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033, the regulations provide that the carryover basis and the excess basis, if any, of the acquired MACRS property or acquired computer software are eligible for the additional first year depreciation deduction if the acquired MACRS property or acquired computer software is qualified property, 50-percent bonus depreciation property, or Liberty Zone property. However, if qualified property, 50-percent bonus depreciation property, or Liberty Zone property is placed in service and then disposed of in an exchange or involuntary conversion in the same taxable year, the unadjusted depreciable basis of the exchanged or involuntarily converted property is not eligible for the additional first year depreciation deduction.

The regulations also provide rules when the use of qualified property, 50-percent bonus depreciation property, or Liberty Zone property changes in the hands of the same taxpayer during the placed-in-service year or a subsequent taxable year. The regulations provide that no additional first year depreciation deduction is allowed for qualified property, 50-percent bonus depreciation property, or Liberty Zone property converted to personal use in the placed-in-service year. However, property converted to business or income-producing use is eligible for the additional first year depreciation deduction in the taxable year the property is converted to business or income-producing use (assuming all the requirements are met). With respect to a

change in the use of depreciable property subsequent to the placed-in-service year, the regulations provide that the change in the use will not affect the determination of whether the property was eligible for the additional first year depreciation deduction in the taxable year the property was originally placed-in-service. Thus, if property is not qualified property in its placed-in-service year and a change in the use in a subsequent taxable year would result in the property being qualified property, no additional first year depreciation deduction is allowed for the property. Likewise, if property is qualified property in its placed-in-service year and a change in the use in a subsequent taxable year would result in the property no longer being qualified property, the additional first year depreciation deduction allowable for the property in its placed-in-service year is not redetermined.

Furthermore, the regulations provide that the additional first year depreciation deduction is not allowable for purposes of computing earnings and profits. Pursuant to section 168(k)(2)(E) and (4)(D), the regulations also provide the increase in the limitation under section 280F(a)(1) of the amount of depreciation for certain passenger automobiles that are qualified property or 50-percent bonus depreciation property. Finally, the regulations provide that any increase in basis of qualified property, 50-percent bonus depreciation property, or Liberty Zone property due to a section 754 election generally is not eligible for the additional first year depreciation deduction because any such increase in basis of property does not satisfy the original use requirement.

### Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility

Analysis is not required. Pursuant to section 7805(f) of the Code, these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Drafting Information

The principal author of these regulations is Douglas H. Kim, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

### Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.167(a)–14 is amended by:

1. Revising paragraphs (b)(1) and (e)(2).
2. Revising paragraph heading (e).
3. Adding paragraph (e)(3).

The additions and revisions read as follows:

#### *§1.167(a)–14 Treatment of certain intangible property excluded from section 197.*

\* \* \* \* \*

(b) \* \* \*

(1) *In general.* [Reserved]. For further guidance, see §1.167(a)–14T(b)(1).

\* \* \* \* \*

(e) *Effective dates* \* \* \*

(2) *Change in method of accounting.* [Reserved]. For further guidance, see §1.167(a)–14T(e)(2).

(3) *Qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or section 179 property.* [Reserved]. For further guidance, see §1.167(a)–14T(e)(3).

Par. 3. Section 1.167(a)–14T is added to read as follows:

#### *§1.167(a)–14T Treatment of certain intangible property excluded from section 197 (temporary).*

(a) For further guidance, see §1.167(a)–14(a).

(b) *Computer software—(1) In general.* The amount of the deduction for computer software described in section 167(f)(1) and §1.197–2(c)(4) is determined by amortizing the cost or other basis of the computer software using the straight line method described in §1.167(b)–1 (except that its salvage value is treated as zero) and an amortization period of 36 months beginning on the first day of the month that the computer software is placed in service. Before determining the amortization deduction allowable under this paragraph (b), the cost or other basis of computer software that is section 179 property, as defined in section 179(d)(1)(A)(ii), must be reduced for any portion of the basis the taxpayer properly elects to treat as an expense under section 179. In addition, the cost or other basis of computer software that is qualified property under section 168(k)(2) or §1.168(k)–1T, 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)–1T, or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)–1T, must be reduced by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k) or section 1400L(b) for the computer software. If costs for developing computer software that the taxpayer properly elects to defer under section 174(b) result in the development of property subject to the allowance for depreciation under section 167, the rules of this paragraph (b) will apply to the unrecovered costs. In addition, this paragraph (b) applies to the cost of separately acquired computer software if the cost to acquire the software is separately stated and the cost is required to be capitalized under section 263(a).

(b)(2) through (e)(1) For further guidance, see §1.167(a)–14(b)(2) through (e)(1).

(e)(2) *Change in method of accounting.* See §1.197–2(l)(4) for rules relating to changes in method of accounting for property to which §1.167(a)–14T applies. However, see §1.168(k)–1T(g)(4) or 1.1400L(b)–1T(g)(4) for rules relating to

changes in method of accounting for computer software to which the third sentence in §1.167(a)-14T(b)(1) applies.

(3) *Qualified property, 50-percent bonus depreciation property, qualified New York Liberty Zone property, or section 179 property.* This section also applies to computer software that is qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to computer software that is 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. This section also applies to computer software that is section 179 property placed in service by a taxpayer in a taxable year beginning after 2002 and before 2006. This section expires on September 4, 2006.

Par. 4. Section 1.168(d)-1 is amended by:

1. Revising paragraph (b)(3)(ii).

2. Paragraph heading (d) is revised and the text of paragraph (d) is redesignated as paragraph (d)(1).

3. Adding paragraph (d)(2).

The additions and revisions read as follows:

*§1.168(d)-1 Applicable conventions—half-year and mid-quarter conventions.*

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(ii) [Reserved]. For further guidance, see §1.168(d)-1T(b)(3)(ii).

\* \* \* \* \*

(d) *Effective dates—(1) In general.*

(2) *Qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property.* [Reserved]. For further guidance, see §1.168(d)-1T(d).

Par. 5. Section 1.168(d)-1T is added to read as follows:

*§1.168(d)-1T Applicable conventions—half-year and mid-quarter conventions (temporary).*

(a) through (b)(3)(i) For further guidance, see §1.168(d)-1(a) through (b)(3)(i).

(b)(3)(ii) The applicable convention, as determined under this section, applies to all depreciable property (except non-residential real property, residential rental property, and any railroad grading or tunnel bore) placed in service during the taxable year, excluding property placed in service and disposed of in the same taxable year. No depreciation deduction is allowed for property placed in service and disposed of during the same taxable year. However, see §1.168(k)-1T(f)(1) for qualified property or 50-percent bonus depreciation property, and §1.1400L(b)-1T(f)(1) for qualified New York Liberty Zone property, that is placed in service in the same taxable year in which either a partnership is terminated as a result of a technical termination under section 708(b)(1)(B) or the property is transferred in a transaction described in section 168(i)(7).

(b)(3)(iii) through (d)(1) For further guidance, see §1.168(d)-1(b)(3)(iii) through (d)(1).

(d)(2) *Qualified property, 50-percent bonus depreciation property, or qualified New York Liberty Zone property.* This section also applies to qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. This section expires on September 4, 2006.

Par. 6. Section 1.168(k)-0T is added to read as follows:

*§1.168(k)-0T Table of contents (temporary).*

This section lists the headings that appear in §1.168(k)-1T.

§1.168(k)-1T Additional first year depreciation deduction (temporary).

(a) Scope and definitions.

(1) Scope.

(2) Definitions.

(b) Qualified property or 50-percent bonus depreciation property.

(1) In general.

(2) Description of qualified property or 50-percent bonus depreciation property.

(i) In general.

(ii) Property not eligible for additional first year depreciation deduction.

(A) Property that is not qualified property.

(B) Property that is not 50-percent bonus depreciation property.

(3) Original use.

(i) In general.

(ii) Conversion to business or income-producing use.

(iii) Sale-leaseback and syndication transactions.

(A) Sale-leaseback transaction.

(B) Syndication transaction.

(C) Sale-leaseback transaction followed by a syndication transaction.

(iv) Fractional interests in property.

(v) Examples.

(4) Acquisition of property.

(i) In general.

(A) Qualified property.

(B) 50-percent bonus depreciation property.

(ii) Definition of binding contract.

(A) In general.

(B) Conditions.

(C) Options.

(D) Supply agreements.

(E) Components.

(iii) Self-constructed property.

(A) In general.

(B) When does construction begin.

(C) Components of self-constructed property.

(1) Acquired components.

(2) Self-constructed components.

(iv) Disqualified transactions.

(A) In general.

(B) Related party defined.

(v) Examples.

(5) Placed-in-service date.

(i) In general.

(ii) Sale-leaseback and syndication transactions.

(A) Sale-leaseback transaction.

(B) Syndication transaction.

(C) Sale-leaseback transaction followed by a syndication transaction.

(iii) Technical termination of a partnership.

(iv) Section 168(i)(7) transactions.

(c) Qualified leasehold improvement property.

(1) In general.

(2) Certain improvements not included.

(3) Definitions.

(d) Computation of depreciation deduction for qualified property or 50-percent bonus depreciation property.

(1) Additional first year depreciation deduction.

(i) In general.

- (ii) Property having a longer production period.
- (iii) Alternative minimum tax.
- (2) Otherwise allowable depreciation deduction.
  - (i) In general.
  - (ii) Alternative minimum tax.
  - (3) Examples.
- (e) Election not to deduct additional first year depreciation.
  - (1) In general.
  - (i) Qualified property.
  - (ii) 50-percent bonus depreciation property.
    - (2) Definition of class of property.
    - (3) Time and manner for making election.
      - (i) Time for making election.
      - (ii) Manner of making election.
    - (4) Special rules for 2000 or 2001 returns.
    - (5) Failure to make election.
    - (f) Special rules.
      - (1) Property placed in service and disposed of in the same taxable year.
        - (i) In general.
        - (ii) Technical termination of a partnership.
        - (iii) Section 168(i)(7) transactions.
        - (iv) Examples.
      - (2) Redetermination of basis.
        - (i) Increase in basis.
        - (ii) Decrease in basis.
        - (iii) Definition.
        - (iv) Examples.
      - (3) Section 1245 and 1250 depreciation recapture.
      - (4) Coordination with section 169.
      - (5) Like-kind exchanges and involuntary conversions.
        - (i) Scope.
        - (ii) Definitions.
        - (iii) Computation.
          - (A) In general.
          - (B) Year of disposition and year of replacement.
        - (iv) Sale-leasebacks.
        - (v) Examples.
      - (6) Change in use.
        - (i) Change in use of depreciable property.
        - (ii) Conversion to personal use.
        - (iii) Conversion to business or income-producing use.
          - (A) During the same taxable year.
          - (B) Subsequent to the acquisition year.
        - (iv) Depreciable property changes use subsequent to the placed-in-service year.
        - (v) Examples.
      - (7) Earnings and profits.
      - (8) Limitation of amount of depreciation for certain passenger automobiles.

- (9) Section 754 election.
- (g) Effective date.
  - (1) In general.
  - (2) Technical termination of a partnership or section 168(i)(7) transactions.
  - (3) Like-kind exchanges and involuntary conversions.
  - (4) Change in method of accounting.
    - (i) Special rules for 2000 or 2001 returns.
    - (ii) Like-kind exchanges and involuntary conversions.

Par. 7. Section 1.168(k)-1T is added to read as follows:

*§1.168(k)-1T Additional first year depreciation deduction (temporary).*

(a) *Scope and definitions*—(1) *Scope*. This section provides the rules for determining the 30-percent additional first year depreciation deduction allowable under section 168(k)(1) for qualified property and the 50-percent additional first year depreciation deduction allowable under section 168(k)(4) for 50-percent bonus depreciation property.

(2) *Definitions*. For purposes of section 168(k) and this section, the following definitions apply:

(i) *Depreciable property* is property that is of a character subject to the allowance for depreciation as determined under section 167 and the regulations thereunder.

(ii) *MACRS property* is tangible, depreciable property that is placed in service after December 31, 1986 (or after July 31, 1986, if the taxpayer made an election under section 203(a)(1)(B) of the Tax Reform Act of 1986; 100 Stat. 2143) and subject to section 168, except for property excluded from the application of section 168 as a result of section 168(f) or as a result of a transitional rule.

(iii) *Unadjusted depreciable basis* is the basis of property for purposes of section 1011 without regard to any adjustments described in section 1016(a)(2) and (3). This basis reflects the reduction in basis for the percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income), for any portion of the basis the taxpayer properly elects to treat as an expense under section 179, and for any adjustments to basis provided by other provisions of the Internal Revenue Code and the regulations thereunder (other than section 1016(a)(2) and (3)) (for example,

a reduction in basis by the amount of the disabled access credit pursuant to section 44(d)(7)). For property subject to a lease, see section 167(c)(2).

(iv) *Adjusted depreciable basis* is the unadjusted depreciable basis of the property, as defined in §1.168(k)-1T(a)(2)(iii), less the adjustments described in section 1016(a)(2) and (3).

(b) *Qualified property or 50-percent bonus depreciation property*—(1) *In general*. Qualified property or 50-percent bonus depreciation property is depreciable property that—

(i) Meets the requirements in §1.168(k)-1T(b)(2) (description of property);

(ii) Meets the requirements in §1.168(k)-1T(b)(3) (original use);

(iii) Meets the requirements in §1.168(k)-1T(b)(4) (acquisition of property); and

(iv) Meets the requirements in §1.168(k)-1T(b)(5) (placed-in-service date).

(2) *Description of qualified property or 50-percent bonus depreciation property*—(i) *In general*. Depreciable property will meet the requirements of this paragraph (b)(2) if the property is—

(A) MACRS property (as defined in §1.168(k)-1T(a)(2)(ii)) that has a recovery period of 20 years or less. For purposes of this paragraph (b)(2)(i)(A) and section 168(k)(2)(B)(i)(II) and 168(k)(4)(C), the recovery period is determined in accordance with section 168(c) regardless of any election made by the taxpayer under section 168(g)(7);

(B) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder;

(C) Water utility property as defined in section 168(e)(5) and depreciated under section 168; or

(D) Qualified leasehold improvement property as defined in paragraph (c) of this section and depreciated under section 168.

(ii) *Property not eligible for additional first year depreciation deduction*—(A) *Property that is not qualified property*. For purposes of the 30-percent additional first year depreciation deduction, depreciable property will not meet the requirements of this paragraph (b)(2) if the property is—

(1) Described in section 168(f);

(2) Required to be depreciated under the alternative depreciation system of section

168(g) pursuant to section 168(g)(1)(A) through (D) or other provisions of the Internal Revenue Code (for example, property described in section 263A(e)(2)(A) or section 280F(b)(1));

(3) Included in any class of property for which the taxpayer elects not to deduct the 30-percent additional first year depreciation (for further guidance, see paragraph (e) of this section); or

(4) Qualified New York Liberty Zone leasehold improvement property as defined in section 1400L(c)(2).

(B) *Property that is not 50-percent bonus depreciation property.* For purposes of the 50-percent additional first year depreciation deduction, depreciable property will not meet the requirements of this paragraph (b)(2) if the property is—

(1) Described in paragraph (b)(2)(ii)(A)(1), (2), or (4) of this section; or

(2) Included in any class of property for which the taxpayer elects the 30-percent, instead of the 50-percent, additional first year depreciation deduction or elects not to deduct any additional first year depreciation (for further guidance, see paragraph (e) of this section).

(3) *Original use*—(i) *In general.* For purposes of the 30-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(3) if the original use of the property commences with the taxpayer after September 10, 2001. For purposes of the 50-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(3) if the original use of the property commences with the taxpayer after May 5, 2003. Except as provided in paragraph (b)(3)(iii) and (iv) of this section, original use means the first use to which the property is put, whether or not that use corresponds to the use of the property by the taxpayer. Thus, additional capital expenditures incurred by a taxpayer to recondition or rebuild property acquired or owned by the taxpayer satisfies the original use requirement. However, the cost of reconditioned or rebuilt property acquired by the taxpayer does not satisfy the original use requirement. The question of whether property is reconditioned or rebuilt property is a question of fact. For purposes of this paragraph (b)(3)(i), property that contains used parts will not be treated as reconditioned or rebuilt if the cost of the used

parts is not more than 20 percent of the total cost of the property.

(ii) *Conversion to business or income-producing use.* If a taxpayer initially acquires new property for personal use and subsequently uses the property in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is considered as the original user of the property. If a person initially acquires new property for personal use and a taxpayer subsequently acquires the property from the person for use in the taxpayer's trade or business or for the taxpayer's production of income, the taxpayer is not considered the original user of the property.

(iii) *Sale-leaseback and syndication transactions*—(A) *Sale-leaseback transaction.* If new property is originally placed in service by a person after September 10, 2001 (for qualified property), or after May 5, 2003 (for 50-percent bonus depreciation property), and is sold to a taxpayer and leased back to the person by the taxpayer within three months after the date the property was originally placed in service by the person, the taxpayer-lessor is considered the original user of the property.

(B) *Syndication transaction.* If new property is originally placed in service by a lessor (including by operation of paragraph (b)(5)(ii)(A) of this section) after September 10, 2001 (for qualified property), or after May 5, 2003 (for 50-percent bonus depreciation property), and is sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor, and the user of the property after the last sale during the three-month period remains the same as when the property was originally placed in service by the lessor, the purchaser of the property in the last sale during the three-month period is considered the original user of the property.

(C) *Sale-leaseback transaction followed by a syndication transaction.* If a sale-leaseback transaction that satisfies the requirements in paragraph (b)(3)(iii)(A) of this section is followed by a syndication transaction that satisfies the requirements in paragraph (b)(3)(iii)(B) of this section, the original user of the property is determined in accordance with paragraph (b)(3)(iii)(B) of this section.

(iv) *Fractional interests in property.* If, in the ordinary course of its business, a

taxpayer sells fractional interests in property to unrelated third parties, each first fractional owner of the property is considered as the original user of its proportionate share of the property. Furthermore, if the taxpayer uses the property before all of the fractional interests of the property are sold but the property continues to be held primarily for sale by the taxpayer, the original use of any fractional interest sold to an unrelated third party subsequent to the taxpayer's use of the property begins with the first purchaser of that fractional interest. For purposes of this paragraph (b)(3)(iv), persons are not related if they do not have a relationship described in section 267(b) or 707(b) and the regulations thereunder.

(v) *Examples.* The application of this paragraph (b)(3) is illustrated by the following examples:

*Example 1.* On August 1, 2002, A buys from B for \$20,000 a machine that has been previously used by B in B's trade or business. On March 1, 2003, A makes a \$5,000 capital expenditure to recondition the machine. The \$20,000 purchase price does not qualify for the additional first year depreciation deduction because the original use requirement of this paragraph (b)(3) is not met. However, the \$5,000 expenditure satisfies the original use requirement of this paragraph (b)(3) and, assuming all other requirements are met, qualifies for the 30-percent additional first year depreciation deduction, regardless of whether the \$5,000 is added to the basis of the machine or is capitalized as a separate asset.

*Example 2.* C, an automobile dealer, uses some of its automobiles as demonstrators in order to show them to prospective customers. The automobiles that are used as demonstrators by C are held by C primarily for sale to customers in the ordinary course of its business. On September 1, 2002, D buys from C an automobile that was previously used as a demonstrator by C. D will use the automobile solely for business purposes. The use of the automobile by C as a demonstrator does not constitute a "use" for purposes of the original use requirement and, therefore, D will be considered the original user of the automobile for purposes of this paragraph (b)(3). Assuming all other requirements are met, D's purchase price of the automobile qualifies for the 30-percent additional first year depreciation deduction for D, subject to any limitation under section 280F.

*Example 3.* On April 1, 2000, E acquires a horse to be used in E's thoroughbred racing business. On October 1, 2003, F buys the horse from E and will use the horse in F's horse breeding business. The use of the horse by E in its racing business prevents the original use of the horse from commencing with F. Thus, F's purchase price of the horse does not qualify for the additional first year depreciation deduction.

*Example 4.* In the ordinary course of its business, G sells fractional interests in its aircraft to unrelated parties. G holds out for sale eight equal fractional interests in an aircraft. On January 1, 2003, G sells five of the eight fractional interests in the aircraft to H, an

unrelated party, and *H* begins to use its proportionate share of the aircraft immediately upon purchase. On June 1, 2003, *G* sells to *I*, an unrelated party to *G* and *H*, the remaining unsold  $\frac{3}{8}$  fractional interests in the aircraft. *H* is considered the original user as to its  $\frac{5}{8}$  fractional interest in the aircraft and *I* is considered the original user as to its  $\frac{3}{8}$  fractional interest in the aircraft. Thus, assuming all other requirements are met, *H*'s purchase price for its  $\frac{5}{8}$  fractional interest in the aircraft qualifies for the 30-percent additional first year depreciation deduction and *I*'s purchase price for its  $\frac{3}{8}$  fractional interest in the aircraft qualifies for the 50-percent additional first year depreciation deduction.

(4) *Acquisition of property*—(i) *In general*—(A) *Qualified property*. For purposes of the 30-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(4) if the property is—

(1) Acquired by the taxpayer after September 10, 2001, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001; or

(2) Acquired by the taxpayer pursuant to a written binding contract that was entered into after September 10, 2001, and before January 1, 2005.

(B) *50-percent bonus depreciation property*. For purposes of the 50-percent additional first year depreciation deduction, depreciable property will meet the requirements of this paragraph (b)(4) if the property is acquired by the taxpayer after May 5, 2003, and before January 1, 2005, but only if no written binding contract for the acquisition of the property was in effect before May 6, 2003.

(ii) *Definition of binding contract*—(A) *In general*. A contract is binding only if it is enforceable under State law against the taxpayer or a predecessor, and does not limit damages to a specified amount (for example, by use of a liquidated damages provision). For this purpose, a contractual provision that limits damages to an amount equal to at least 5 percent of the total contract price will not be treated as limiting damages to a specified amount. In determining whether a contract limits damages, the fact that there may be little or no damages because the contract price does not significantly differ from fair market value will not be taken into account. For example, if a taxpayer entered into an irrevocable written contract to purchase an asset for \$100 and the contract contained no provision for liquidated damages, the contract

is considered binding notwithstanding the fact that the asset had a fair market value of \$99 and under local law the seller would only recover the difference in the event the purchaser failed to perform. If the contract provided for a full refund of the purchase price in lieu of any damages allowable by law in the event of breach or cancellation by the seller, the contract is not considered binding.

(B) *Conditions*. A contract is binding even if subject to a condition, as long as the condition is not within the control of either party or a predecessor. A contract will continue to be binding if the parties make insubstantial changes in its terms and conditions or because any term is to be determined by a standard beyond the control of either party. A contract that imposes significant obligations on the taxpayer or a predecessor will be treated as binding notwithstanding the fact that insubstantial terms remain to be negotiated by the parties to the contract.

(C) *Options*. An option to either acquire or sell property is not a binding contract.

(D) *Supply agreements*. A binding contract does not include a supply or similar agreement if the amount and design specifications of the property to be purchased have not been specified. The contract will not be a binding contract for the property to be purchased until both the amount and the design specifications are specified. For example, if the provisions of a supply or similar agreement state the design specifications of, and the pricing for, the property to be purchased, a purchase order under the agreement for a specific number of assets is treated as a binding contract.

(E) *Components*. A binding contract to acquire one or more components of a larger property will not be treated as a binding contract to acquire the larger property. If a binding contract to acquire the component does not satisfy the requirements of this paragraph (b)(4), the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable.

(iii) *Self-constructed property*—(A) *In general*. If a taxpayer manufactures, constructs, or produces property for use by the taxpayer in its trade or business (or for its production of income), the acquisition rules in paragraph (b)(4)(i) of this section are treated as met for qualified property if the taxpayer begins manufacturing,

constructing, or producing the property after September 10, 2001, and before January 1, 2005, and for 50-percent bonus depreciation property if the taxpayer begins manufacturing, constructing, or producing the property after May 5, 2003, and before January 1, 2005. Property that is manufactured, constructed, or produced for the taxpayer by another person under a written binding contract (as defined in paragraph (b)(4)(ii) of this section) that is entered into prior to the manufacture, construction, or production of the property for use by the taxpayer in its trade or business (or for its production of income) is considered to be manufactured, constructed, or produced by the taxpayer.

(B) *When does construction begin*. For purposes of paragraph (b)(4)(iii) of this section, construction of property begins when physical work of a significant nature begins. Physical work does not include preliminary activities such as planning or designing, securing financing, exploring, or researching. The determination of when physical work of a significant nature begins depends on the facts and circumstances. For purposes of this paragraph (b)(4)(iii)(B), physical work of a significant nature will not be considered to begin before the taxpayer incurs (in the case of an accrual basis taxpayer) or pays (in the case of a cash basis taxpayer) more than 10 percent of the total cost of the property (excluding the cost of any land and preliminary activities such as planning or designing, securing financing, exploring, or researching). For example, if a retail motor fuels outlet is to be constructed on-site, construction begins when physical work of a significant nature commences at the site; that is, when work begins on the excavation for footings, pouring the pads for the outlet, or the driving of foundation pilings into the ground. Preliminary work, such as clearing a site, test drilling to determine soil condition, or excavation to change the contour of the land (as distinguished from excavation for footings) does not constitute the beginning of construction. However, if a retail motor fuels outlet is to be assembled on-site from modular units constructed off-site and delivered to the site where the outlet will be used, construction begins when physical work of a significant nature commences at the off-site location.

(C) *Components of self-constructed property*—(1) *Acquired components*. If a



binding contract (as defined in paragraph (b)(4)(ii) of this section) to acquire a component does not satisfy the requirements of paragraph (b)(4)(i) of this section, the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. A binding contract (as defined in paragraph (b)(4)(ii) of this section) to acquire one or more components of a larger self-constructed property will not preclude the larger self-constructed property from satisfying the acquisition rules in paragraph (b)(4)(iii)(A) of this section. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the 30-percent or 50-percent additional first year depreciation deduction, as applicable (assuming all other requirements are met), must not include the unadjusted depreciable basis of any component that does not satisfy the requirements of paragraph (b)(4)(i) of this section. If the manufacture, construction, or production of the larger self-constructed property begins before September 11, 2001, for qualified property, or before May 6, 2003, for 50-percent bonus depreciation property, the larger self-constructed property and any acquired components related to the larger self-constructed property do not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. If a binding contract to acquire the component is entered into after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2005, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not.

(2) *Self-constructed components.* If the manufacture, construction, or production of a component does not satisfy the requirements of paragraph (b)(4)(iii)(A) of this section, the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. However, if the manufacture, construction, or production of a component does not satisfy the requirements of paragraph (b)(4)(iii)(A) of

this section, but the manufacture, construction, or production of the larger self-constructed property satisfies the requirements of paragraph (b)(4)(iii)(A) of this section, the larger self-constructed property qualifies for the 30-percent or 50-percent additional first year depreciation deduction, as applicable (assuming all other requirements are met) even though the component does not qualify for the 30-percent or 50-percent additional first year depreciation deduction. Accordingly, the unadjusted depreciable basis of the larger self-constructed property that is eligible for the 30-percent or 50-percent additional first year depreciation deduction, as applicable (assuming all other requirements are met), must not include the unadjusted depreciable basis of any component that does not qualify for the 30-percent or 50-percent additional first year depreciation deduction. If the manufacture, construction, or production of the larger self-constructed property began before September 11, 2001, for qualified property, or before May 6, 2003, for 50-percent bonus depreciation property, the larger self-constructed property and any self-constructed components related to the larger self-constructed property do not qualify for the 30-percent or 50-percent additional first year depreciation deduction, as applicable. If the manufacture, construction, or production of a component begins after September 10, 2001, for qualified property, or after May 5, 2003, for 50-percent bonus depreciation property, and before January 1, 2005, but the manufacture, construction, or production of the larger self-constructed property does not begin before January 1, 2005, the component qualifies for the additional first year depreciation deduction (assuming all other requirements are met) but the larger self-constructed property does not.

(iv) *Disqualified transactions—(A) In general.* Property does not satisfy the requirements of this paragraph (b)(4) if the user of the property as of the date on which the property was originally placed in service (including by operation of paragraph (b)(5)(ii), (iii), and (iv) of this section), or a related party to the user, acquired, or had a written binding contract (as defined in paragraph (b)(4)(ii) of this section) in effect for the acquisition of, the property at any time before September 11, 2001 (for qualified property), or before May 6, 2003

(for 50-percent bonus depreciation property). In addition, property manufactured, constructed, or produced for the taxpayer or a related party does not satisfy the requirements of this paragraph (b)(4) if the manufacture, construction, or production of the property for the taxpayer or a related party began at any time before September 11, 2001 (for qualified property), or before May 6, 2003 (for 50-percent bonus depreciation property).

(B) *Related party defined.* For purposes of this paragraph (b)(4)(iv), persons are related if they have a relationship specified in section 267(b) or 707(b) and the regulations thereunder.

(v) *Examples.* The application of this paragraph (b)(4) is illustrated by the following examples:

*Example 1.* On September 1, 2001, *J*, a corporation, entered into a written agreement with *K*, a manufacturer, to purchase 20 new lamps for \$100 each within the next two years. Although the agreement specifies the number of lamps to be purchased, the agreement does not specify the design of the lamps to be purchased. Accordingly, the agreement is not a binding contract pursuant to paragraph (b)(4)(ii)(D) of this section.

*Example 2.* Same facts as *Example 1*. On December 1, 2001, *J* placed a purchase order with *K* to purchase 20 new model XPC5 lamps for \$100 each for a total amount of \$2,000. Because the agreement specifies the number of lamps to be purchased and the purchase order specifies the design of the lamps to be purchased, the purchase order placed by *J* with *K* on December 1, 2001, is a binding contract pursuant to paragraph (b)(4)(ii)(D) of this section. Accordingly, the cost of the 20 lamps qualifies for the 30-percent additional first year depreciation deduction.

*Example 3.* Same facts as *Example 1* except that the written agreement between *J* and *K* is to purchase 100 model XPC5 lamps for \$100 each within the next two years. Because this agreement specifies the amount and design of the lamps to be purchased, the agreement is a binding contract pursuant to paragraph (b)(4)(ii)(D) of this section. Accordingly, because the agreement was entered into before September 11, 2001, any lamp acquired by *J* under this contract does not qualify for the additional first year depreciation deduction.

*Example 4.* On September 1, 2001, *L* began constructing an electric generation power plant for its own use. On November 1, 2002, *L* ceases construction of the power plant prior to its completion. Between September 1, 2001, and November 1, 2002, *L* incurred \$3,000,000 for the construction of the power plant. On May 6, 2003, *L* resumed construction of the power plant and completed its construction on August 31, 2003. Between May 6, 2003, and August 31, 2003, *L* incurred another \$1,600,000 to complete the construction of the power plant and, on September 1, 2003, *L* placed the power plant in service. None of *L*'s total expenditures of \$4,600,000 qualify for the additional first year depreciation deduction because, pursuant to paragraph (b)(4)(iii)(A) of this section, *L*

began constructing the power plant before September 11, 2001.

*Example 5.* Same facts as *Example 4* except that *L* began constructing the electric generation power plant for its own use on October 1, 2001. *L*'s total expenditures of \$4,600,000 qualify for the additional first year depreciation deduction because, pursuant to paragraph (b)(4)(iii)(A) of this section, *L* began constructing the power plant after September 10, 2001, and placed the power plant in service before January 1, 2005. Accordingly, the additional first year depreciation deduction for the power plant will be \$1,380,000, computed as \$4,600,000 multiplied by 30 percent.

*Example 6.* On August 1, 2001, *M* entered into a written binding contract to acquire a new turbine. The new turbine is a component part of a new electric generation power plant that is being constructed on *M*'s behalf. The construction of the new electric generation power plant commenced in November 2001, and the new electric generation power plant was completed in November 2002. Because *M* entered into a written binding contract to acquire a component part (the new turbine) prior to September 11, 2001, pursuant to paragraph (b)(4)(iii)(C) of this section, the component part does not qualify for the additional first year depreciation deduction. However, pursuant to paragraphs (b)(4)(iii)(A) and (C) of this section, the new plant constructed for *M* will qualify for the 30-percent additional first year depreciation deduction because construction of the new plant began after September 10, 2001, and before May 6, 2003. Accordingly, the unadjusted depreciable basis of the new plant that is eligible for the 30-percent additional first year depreciation deduction must not include the unadjusted depreciable basis of the new turbine.

*Example 7.* Same facts as *Example 6* except that *M* entered into the written binding contract to acquire the new turbine on September 30, 2002, and construction of the new plant commenced on August 1, 2001. Because *M* began construction of the new plant prior to September 11, 2001, pursuant to paragraphs (b)(4)(iii)(A) and (C) of this section, neither the new plant constructed for *M* nor the turbine will qualify for the additional first year depreciation deduction because self-construction of the new plant began prior to September 11, 2001.

*Example 8.* On September 1, 2001, *N* began constructing property for its own use. On October 1, 2001, *N* sold its rights to the property to *O*, a related party under section 267(b). Pursuant to paragraph (b)(4)(iv) of this section, the property is not eligible for the additional first year depreciation deduction because *N* and *O* are related parties and construction of the property by *N* began prior to September 11, 2001.

*Example 9.* On September 1, 2001, *P* entered into a written binding contract to acquire property. On October 1, 2001, *P* sold its rights to the property to *Q*, a related party under section 267(b). Pursuant to paragraph (b)(4)(iv) of this section, the property is not eligible for the additional first year depreciation deduction because *P* and *Q* are related parties and a written binding contract for the acquisition of the property was in effect prior to September 11, 2001.

*Example 10.* Prior to September 11, 2001, *R* began constructing an electric generation power plant for its own use. On May 1, 2003, prior to the completion of the power plant, *R* transferred the rights to own and use this power plant to *S*, an unrelated party,

for \$6,000,000. Between May 6, 2003, and June 30, 2003, *S*, a calendar-year taxpayer, incurred another \$1,200,000 to complete the construction of the power plant and, on August 1, 2003, *S* placed the power plant in service. Because *R* and *S* are not related parties, the transaction between *R* and *S* will not be a disqualified transaction pursuant to paragraph (b)(4)(iv) of this section. Accordingly, *S*'s total expenditures of \$7,200,000 for the power plant qualify for the additional first year depreciation deduction. *S*'s additional first year depreciation deduction for the power plant will be \$2,400,000, computed as \$6,000,000 multiplied by 30 percent, plus \$1,200,000 multiplied by 50 percent. The \$6,000,000 portion of the total \$7,200,000 unadjusted depreciable basis qualifies for the 30-percent additional first year depreciation deduction because that portion of the total unadjusted depreciable basis was acquired by *S* after September 10, 2001, and before May 6, 2003. However, because *S* began construction to complete the power plant after May 5, 2003, the \$1,200,000 portion of the total \$7,200,000 unadjusted depreciable basis qualifies for the 50-percent additional first year depreciation deduction.

*Example 11.* On September 1, 2001, *T* acquired and placed in service equipment. On October 15, 2001, *T* sells the equipment to *U*, an unrelated party, and leases the property back from *U* in a sale-leaseback transaction. Pursuant to paragraph (b)(4)(iv) of this section, the equipment does not qualify for the additional first year depreciation deduction because *T*, the user of the equipment, acquired the equipment prior to September 11, 2001.

(5) *Placed-in-service date*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (b)(5) if the property is placed in service by the taxpayer before January 1, 2005, or, in the case of property described in section 168(k)(2)(B), is placed in service by the taxpayer before January 1, 2006.

(ii) *Sale-leaseback and syndication transactions*—(A) *Sale-leaseback transaction.* If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a person and sold to a taxpayer and leased back to the person by the taxpayer within three months after the date the property was originally placed in service by the person, the property is treated as originally placed in service by the taxpayer-lessor not earlier than the date on which the property is used by the lessee under the leaseback.

(B) *Syndication transaction.* If qualified property is originally placed in service after September 10, 2001, or 50-percent bonus depreciation property is originally placed in service after May 5, 2003, by a lessor (including by operation of paragraph (b)(5)(ii)(A) of this section) and is

sold by the lessor or any subsequent purchaser within three months after the date the property was originally placed in service by the lessor, and the user of the property after the last sale during this three-month period remains the same as when the property was originally placed in service by the lessor, the property is treated as originally placed in service by the purchaser of the property in the last sale during the three-month period but not earlier than the date of the last sale.

(C) *Sale-leaseback transaction followed by a syndication transaction.* If a sale-leaseback transaction that satisfies the requirements in paragraph (b)(5)(ii)(A) of this section is followed by a syndication transaction that satisfies the requirements in paragraph (b)(5)(ii)(B) of this section, the placed-in-service date of the property is determined in accordance with paragraph (b)(5)(ii)(B) of this section.

(iii) *Technical termination of a partnership.* For purposes of this paragraph (b)(5), in the case of a technical termination of a partnership under section 708(b)(1)(B), qualified property or 50-percent bonus depreciation property placed in service by the terminated partnership during the taxable year of termination is treated as originally placed in service by the new partnership on the date the qualified property or the 50-percent bonus depreciation property is contributed by the terminated partnership to the new partnership.

(iv) *Section 168(i)(7) transactions.* For purposes of this paragraph (b)(5), if qualified property or 50-percent bonus depreciation property is transferred in a transaction described in section 168(i)(7) in the same taxable year that the qualified property or the 50-percent bonus depreciation property is placed in service by the transferor, the transferred property is treated as originally placed in service on the date the transferor placed in service the qualified property or the 50-percent bonus depreciation property, as applicable. In the case of multiple transfers of qualified property or 50-percent bonus depreciation property in multiple transactions described in section 168(i)(7) in the same taxable year, the placed in service date of the transferred property is deemed to be the date on which the first transferor placed in service the qualified property or the 50-percent bonus depreciation property, as applicable.

(c) *Qualified leasehold improvement property*—(1) *In general.* For purposes of section 168(k), qualified leasehold improvement property means any improvement, which is section 1250 property, to an interior portion of a building that is nonresidential real property if—

(i) The improvement is made under or pursuant to a lease by the lessee (or any sublessee) of the interior portion, or by the lessor of that interior portion;

(ii) The interior portion of the building is to be occupied exclusively by the lessee (or any sublessee) of that interior portion; and

(iii) The improvement is placed in service more than 3 years after the date the building was first placed in service by any person.

(2) *Certain improvements not included.* Qualified leasehold improvement property does not include any improvement for which the expenditure is attributable to:

(i) The enlargement of the building;

(ii) Any elevator or escalator;

(iii) Any structural component benefiting a common area; or

(iv) The internal structural framework of the building.

(3) *Definitions.* For purposes of this paragraph (c), the following definitions apply:

(i) *Building* has the same meaning as that term is defined in §1.48-1(e)(1).

(ii) *Common area* means any portion of a building that is equally available to all users of the building on the same basis for uses that are incidental to the primary use of the building. For example, stairways, hallways, lobbies, common seating areas, interior and exterior pedestrian walkways and pedestrian bridges, loading docks and areas, and rest rooms generally are treated as common areas if they are used by different lessees of a building.

(iii) *Elevator* and *escalator* have the same meanings as those terms are defined in §1.48-1(m)(2).

(iv) *Enlargement* has the same meaning as that term is defined in §1.48-12(c)(10).

(v) *Internal structural framework* has the same meaning as that term is defined in §1.48-12(b)(3)(i)(D)(iii).

(vi) *Lease* has the same meaning as that term is defined in section 168(h)(7). In addition, a commitment to enter into a lease is treated as a lease, and the parties to the commitment are treated as lessor and

lessee. However, a lease between related persons is not considered a lease. For purposes of the preceding sentence, related persons are—

(A) Members of an affiliated group (as defined in section 1504 and the regulations thereunder); and

(B) Persons having a relationship described in section 267(b) and the regulations thereunder. For purposes of applying section 267(b), the language “80 percent or more” is used instead of “more than 50 percent.”

(vii) *Nonresidential real property* has the same meaning as that term is defined in section 168(e)(2)(B).

(viii) *Structural component* has the same meaning as that term is defined in §1.48-1(e)(2).

(d) *Computation of depreciation deduction for qualified property or 50-percent bonus depreciation property*—(1) *Additional first year depreciation deduction*—(i) *In general.* Except as provided in paragraph (f)(5) of this section, the allowable additional first year depreciation deduction for qualified property is determined by multiplying the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the qualified property by 30 percent. Except as provided in paragraph (f)(5) of this section, the allowable additional first year depreciation deduction for 50-percent bonus depreciation property is determined by multiplying the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of the 50-percent bonus depreciation property by 50 percent. Except as provided in paragraph (f)(1) of this section, the 30-percent or 50-percent additional first year depreciation deduction is not affected by a taxable year of less than 12 months. See paragraph (f)(1) of this section for qualified property or 50-percent bonus depreciation property placed in service and disposed of in the same taxable year. See paragraph (f)(5) of this section for qualified property or 50-percent bonus depreciation property acquired in a like-kind exchange or as a result of an involuntary conversion.

(ii) *Property having a longer production period.* For purposes of paragraph (d)(1)(i) of this section, the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of qualified property or 50-percent bonus depreciation property described in section 168(k)(2)(B)

is limited to the property’s unadjusted depreciable basis attributable to the property’s manufacture, construction, or production after September 10, 2001 (for qualified property), or May 5, 2003 (for 50-percent bonus depreciation property), and before January 1, 2005.

(iii) *Alternative minimum tax.* The 30-percent or 50-percent additional first year depreciation deduction is allowed for alternative minimum tax purposes for the taxable year in which the qualified property or the 50-percent bonus depreciation property is placed in service by the taxpayer. The 30-percent or 50-percent additional first year depreciation deduction for alternative minimum tax purposes is based on the unadjusted depreciable basis of the property for alternative minimum tax purposes.

(2) *Otherwise allowable depreciation deduction.* Before determining the amount otherwise allowable as a depreciation deduction for the qualified property or the 50-percent bonus depreciation property for the placed-in-service year and any subsequent taxable year, the taxpayer must determine the remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property. This remaining adjusted depreciable basis is equal to the unadjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property reduced by the amount of the additional first year depreciation allowed or allowable, whichever is greater. The remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property is then depreciated using the applicable depreciation provisions under the Internal Revenue Code for the qualified property or the 50-percent bonus depreciation property. The remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property that is MACRS property is also the basis to which the annual depreciation rates in the optional depreciation tables apply (for further guidance, see section 8 of Rev. Proc. 87-57, 1987-2 C.B. 687, and §601.601(d)(2)(ii)(b) of this chapter). The depreciation deduction allowable for the remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property is affected by a taxable year of less than 12 months.

(ii) *Alternative minimum tax.* For alternative minimum tax purposes, the depreciation deduction allowable for the remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciation property is based on the remaining adjusted depreciable basis for alternative minimum tax purposes. The remaining adjusted depreciable basis of the qualified property or the 50-percent bonus depreciable property for alternative minimum tax purposes is depreciated using the same depreciation method, recovery period (or useful life in the case of computer software), and convention that apply to the qualified property or the 50-percent bonus depreciation property for regular tax purposes.

(3) *Examples.* This paragraph (d) is illustrated by the following examples:

*Example 1.* On March 1, 2003, V, a calendar-year taxpayer, purchased and placed in service qualified property that costs \$1 million and is 5-year property under section 168(e). V depreciates its 5-year property placed in service in 2003 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. For 2003, V is allowed a 30-percent additional first year depreciation deduction of \$300,000 (the unadjusted depreciable basis of \$1 million multiplied by .30). Next, V must reduce the unadjusted depreciable basis of \$1 million by the additional first year depreciation deduction of \$300,000 to determine the remaining adjusted depreciable basis of \$700,000. Then, V's depreciation deduction allowable in 2003 for the remaining adjusted depreciable basis of \$700,000 is \$140,000 (the remaining adjusted depreciable basis of \$700,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

*Example 2.* On June 1, 2003, W, a calendar-year taxpayer, purchased and placed in service 50-percent bonus depreciation property that costs \$126,000. The property qualifies for the expensing election under section 179 and is 5-year property under section 168(e). W did not purchase any other section 179 property in 2003. W makes the election under section 179 for the property and depreciates its 5-year property placed in service in 2003 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. For 2003, W is first allowed a \$100,000 deduction under section 179. Next, W must reduce the cost of \$126,000 by the section 179 deduction of \$100,000 to determine the unadjusted depreciable basis of \$26,000. Then, for 2003, W is allowed a 50-percent additional first year depreciation deduction of \$13,000 (the unadjusted depreciable basis of \$26,000 multiplied by .50). Next, W must reduce the unadjusted depreciable basis of \$26,000 by the additional first year depreciation deduction of \$13,000 to determine the remaining

adjusted depreciable basis of \$13,000. Then, W's depreciation deduction allowable in 2003 for the remaining adjusted depreciable basis of \$13,000 is \$2,600 (the remaining adjusted depreciable basis of \$13,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(e) *Election not to deduct additional first year depreciation—(1) In general.* If a taxpayer makes an election under this paragraph (e), the election applies to all qualified property or 50-percent bonus depreciation property, as applicable, that is in the same class of property and placed in service in the same taxable year. The rules of this paragraph (e) apply to the following elections provided under section 168(k):

(i) *Qualified property.* A taxpayer may make an election not to deduct the 30-percent additional first year depreciation for any class of property that is qualified property placed in service during the taxable year. If this election is made, no additional first year depreciation deduction is allowable for the property placed in service during the taxable year in the class of property.

(ii) *50-percent bonus depreciation property.* For any class of property that is 50-percent bonus depreciation property placed in service during the taxable year, a taxpayer may make an election—

(A) To deduct the 30-percent, instead of the 50-percent, additional first year depreciation. If this election is made, the allowable additional first year depreciation deduction is determined as though the class of property is qualified property under section 168(k)(2); or

(B) Not to deduct any additional first year depreciation. If this election is made, no additional first year depreciation deduction is allowable for the class of property.

(2) *Definition of class of property.* For purposes of this paragraph (e), the term class of property means:

(i) Except for the property described in paragraphs (e)(2)(ii) and (iv) of this section, each class of property described in section 168(e) (for example, 5-year property);

(ii) Water utility property as defined in section 168(e)(5) and depreciated under section 168;

(iii) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder; or

(iv) Qualified leasehold improvement property as defined in paragraph (c) of this section and depreciated under section 168.

(3) *Time and manner for making election—(i) Time for making election.* Except as provided in paragraph (e)(4) of this section, any election specified in paragraph (e)(1) of this section must be made by the due date (including extensions) of the Federal tax return for the taxable year in which the qualified property or the 50-percent bonus depreciation property, as applicable, is placed in service by the taxpayer.

(ii) *Manner of making election.* Except as provided in paragraph (e)(4) of this section, any election specified in paragraph (e)(1) of this section must be made in the manner prescribed on Form 4562, "Depreciation and Amortization," and its instructions. The election is made separately by each person owning qualified property or 50-percent bonus depreciation property (for example, for each member of a consolidated group by the common parent of the group, by the partnership, or by the S corporation). If Form 4562 is revised or renumbered, any reference in this section to that form shall be treated as a reference to the revised or renumbered form.

(4) *Special rules for 2000 or 2001 returns.* For the election specified in paragraph (e)(1)(i) of this section for qualified property placed in service by the taxpayer during the taxable year that included September 11, 2001, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of making this election on the 2000 or 2001 Federal tax return for the taxable year that included September 11, 2001 (for further guidance, see sections 3.03(3) and 4 of Rev. Proc. 2002-33, 2002-1 C.B. 963, Rev. Proc. 2003-50, 2003-29 I.R.B. 119, and §601.601(d)(2)(ii)(b) of this chapter).

(5) *Failure to make election.* If a taxpayer does not make the applicable election specified in paragraph (e)(1) of this section within the time and in the manner prescribed in paragraph (e)(3) or (4) of this section, the amount of depreciation allowable for that property under section 167(f)(1) or under section 168, as applicable, must be determined for the placed-in-service year and for all subsequent taxable years by taking into account the additional first year depreciation deduction. Thus, any election specified in paragraph (e)(1) of this section shall not be made by the taxpayer in any other manner (for example, the election cannot be made through a

request under section 446(e) to change the taxpayer's method of accounting).

(f) *Special rules*—(1) *Property placed in service and disposed of in the same taxable year*—(i) *In general*. Except as provided in paragraphs (f)(1)(ii) and (iii) of this section, the additional first year depreciation deduction is not allowed for qualified property or 50-percent bonus depreciation property placed in service and disposed of during the same taxable year.

(ii) *Technical termination of a partnership*. In the case of a technical termination of a partnership under section 708(b)(1)(B), the additional first year depreciation deduction is allowable for any qualified property or 50-percent bonus depreciation property placed in service by the terminated partnership during the taxable year of termination and contributed by the terminated partnership to the new partnership. The allowable additional first year depreciation deduction for the qualified property or the 50-percent bonus depreciation property shall not be claimed by the terminated partnership but instead shall be claimed by the new partnership for the new partnership's taxable year in which the qualified property or the 50-percent bonus depreciation property was contributed by the terminated partnership to the new partnership. However, if qualified property or 50-percent bonus depreciation property is both placed in service and contributed to a new partnership in a transaction described in section 708(b)(1)(B) by the terminated partnership during the taxable year of termination, and if such property is disposed of by the new partnership in the same taxable year the new partnership received such property from the terminated partnership, then no additional first year depreciation deduction is allowable to either partnership.

(iii) *Section 168(i)(7) transactions*. If any qualified property or 50-percent bonus depreciation property is transferred in a transaction described in section 168(i)(7) in the same taxable year that the qualified property or the 50-percent bonus depreciation property is placed in service by the transferor, the additional first year depreciation deduction is allowable for the qualified property or the 50-percent bonus depreciation property. The allowable additional first year depreciation deduction for the qualified property or

the 50-percent bonus depreciation property for the transferor's taxable year in which the property is placed in service is allocated between the transferor and the transferee on a monthly basis. This allocation shall be made in accordance with the rules in §1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee. However, if qualified property or 50-percent bonus depreciation property is both placed in service and transferred in a transaction described in section 168(i)(7) by the transferor during the same taxable year, and if such property is disposed of by the transferee (other than by a transaction described in section 168(i)(7)) during the same taxable year the transferee received such property from the transferor, then no additional first year depreciation deduction is allowable to either party.

(iv) *Examples*. The application of this paragraph (f)(1) is illustrated by the following examples:

*Example 1.* *X* and *Y* are equal partners in *Partnership XY*, a general partnership. On February 1, 2002, *Partnership XY* purchased and placed in service new equipment at a cost of \$30,000. On March 1, 2002, *X* sells its entire 50 percent interest to *Z* in a transfer that terminates the partnership under section 708(b)(1)(B). As a result, terminated *Partnership XY* is deemed to have contributed the equipment to new *Partnership XY*. Pursuant to paragraph (f)(1)(ii) of this section, new *Partnership XY*, not terminated *Partnership XY*, is eligible to claim the 30-percent additional first year depreciation deduction allowable for the equipment for the taxable year 2002 (assuming all other requirements are met).

*Example 2.* On January 5, 2002, *BB* purchased and placed in service new office desks for a total amount of \$8,000. On August 20, 2002, *BB* transferred the office desks to *Partnership BC* in a transaction described in section 721. *BB* and *Partnership BC* are calendar-year taxpayers. Because the transaction between *BB* and *Partnership BC* is a transaction described in section 168(i)(7), pursuant to paragraph (f)(1)(iii) of this section the 30-percent additional first year depreciation deduction allowable for the desks is allocated between *BB* and *Partnership BC* in accordance with the rules in §1.168(d)–1(b)(7)(ii) for allocating the depreciation deduction between the transferor and the transferee. Accordingly, the 30-percent additional first year depreciation deduction allowable for the desks for 2002 of \$2,400 (the unadjusted depreciable basis of \$8,000 multiplied by .30) is allocated between *BB* and *Partnership BC* based on the number of months that *BB* and *Partnership BC* held the desks in service. Thus, because the desks were held in service by *BB* for 7 of 12 months, which includes the month in which *BB* placed the desks in service but does not include the month in which the desks were transferred, *BB* is allocated \$1,400 (7/12 x \$2,400 additional first year depreciation deduction). *Partnership BC* is allocated \$1,000, the remaining

5/12 of the \$2,400 additional first year depreciation deduction allowable for the desks.

(2) *Redetermination of basis*. If the unadjusted depreciable basis (as defined in §1.168(k)–1T(a)(2)(iii)) of qualified property or 50-percent bonus depreciation property is redetermined (for example, due to contingent purchase price or discharge of indebtedness) by January 1, 2005 (or January 1, 2006, for property described in section 168(k)(2)(B)), the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property is redetermined as follows:

(i) *Increase in basis*. For the taxable year in which an increase in basis of qualified property or 50-percent bonus depreciation property occurs, the taxpayer shall claim an additional first year depreciation deduction for qualified property by multiplying the amount of the increase in basis for this property by 30 percent or, for 50-percent bonus depreciation property, by multiplying the amount of the increase in basis for this property by 50 percent. For purposes of this paragraph (f)(2)(i), the 30-percent additional first year depreciation deduction applies to the increase in basis if the underlying property is qualified property and the 50-percent additional first year depreciation deduction applies to the increase in basis if the underlying property is 50-percent bonus depreciation property. To determine the amount otherwise allowable as a depreciation deduction for the increase in basis of qualified property or 50-percent bonus depreciation property, the amount of the increase in basis of the qualified property or the 50-percent bonus depreciation property must be reduced by the additional first year depreciation deduction allowed or allowable, whichever is greater, for the increase in basis and the remaining increase in basis of—

(A) Qualified property or 50-percent bonus depreciation property (except for computer software described in paragraph (b)(2)(i)(B) of this section) is depreciated over the recovery period of the qualified property or the 50-percent bonus depreciation property, as applicable, remaining as of the beginning of the taxable year in which the increase in basis occurs, and using the same depreciation method and convention applicable to the qualified property or 50-percent bonus depreciation property, as applicable, that applies for the

taxable year in which the increase in basis occurs; and

(B) Computer software (as defined in paragraph (b)(2)(i)(B) of this section) that is qualified property or 50-percent bonus depreciation property is depreciated ratably over the remainder of the 36-month period (the useful life under section 167(f)(1)) as of the beginning of the first day of the month in which the increase in basis occurs.

(ii) *Decrease in basis.* For the taxable year in which a decrease in basis of qualified property or 50-percent bonus depreciation property occurs, the taxpayer shall include in the taxpayer's income the excess additional first year depreciation deduction previously claimed for the qualified property or the 50-percent bonus depreciation property. This excess additional first year depreciation deduction for qualified property is determined by multiplying the amount of the decrease in basis for this property by 30 percent. The excess additional first year depreciation deduction for 50-percent bonus depreciation property is determined by multiplying the amount of the decrease in basis for this property by 50 percent. For purposes of this paragraph (f)(2)(ii), the 30-percent additional first year depreciation deduction applies to the decrease in basis if the underlying property is qualified property and the 50-percent additional first year depreciation deduction applies to the decrease in basis if the underlying property is 50-percent bonus depreciation property. Also, if the taxpayer establishes by adequate records or other sufficient evidence that the taxpayer claimed less than the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property before the decrease in basis or if the taxpayer claimed more than the additional first year depreciation deduction allowable for the qualified property or the 50-percent bonus depreciation property before the decrease in basis, the excess additional first year depreciation deduction is determined by multiplying the amount of the decrease in basis by the additional first year depreciation deduction percentage actually claimed by the taxpayer for the qualified property or the 50-percent bonus depreciation property, as applicable, before the decrease in basis. To determine the amount includible in the taxpayer's

income for the excess depreciation previously claimed (other than the additional first year depreciation deduction) resulting from the decrease in basis of the qualified property or the 50-percent bonus depreciation property, the amount of the decrease in basis of the qualified property or the 50-percent bonus depreciation property must be adjusted by the excess additional first year depreciation deduction includible in the taxpayer's income (as determined under this paragraph) and the remaining decrease in basis of—

(A) Qualified property or 50-percent bonus depreciation property (except for computer software described in paragraph (b)(2)(i)(B) of this section) is included in the taxpayer's income over the recovery period of the qualified property or the 50-percent bonus depreciation property, as applicable, remaining as of the beginning of the taxable year in which the decrease in basis occurs, and using the same depreciation method and convention of the qualified property or 50-percent bonus depreciation property, as applicable, that applies in the taxable year in which the decrease in basis occurs; and

(B) Computer software (as defined in paragraph (b)(2)(i)(B) of this section) that is qualified property or 50-percent bonus depreciation property is included in the taxpayer's income ratably over the remainder of the 36-month period (the useful life under section 167(f)(1)) as of the beginning of the first day of the month in which the decrease in basis occurs.

(iii) *Definition.* For purposes of this paragraph (f)(2)—

(A) An increase in basis occurs in the taxable year an amount is taken into account under section 461; and

(B) A decrease in basis occurs in the taxable year an amount would be taken into account under section 451.

(iv) *Examples.* The application of this paragraph (f)(2) is illustrated by the following examples:

*Example 1.* (i) On May 15, 2002, CC, a cash-basis taxpayer, purchased and placed in service qualified property that is 5-year property at a cost of \$200,000. In addition to the \$200,000, CC agrees to pay the seller 25 percent of the gross profits from the operation of the property in 2002. On May 15, 2003, CC paid to the seller an additional \$10,000. CC depreciates the 5-year property placed in service in 2002 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention.

(ii) For 2002, CC is allowed a 30-percent additional first year depreciation deduction of \$60,000 (the unadjusted depreciable basis of \$200,000 multiplied by .30). In addition, CC's depreciation deduction for 2002 for the remaining adjusted depreciable basis of \$140,000 (the unadjusted depreciable basis of \$200,000 reduced by the additional first year depreciation deduction of \$60,000) is \$28,000 (the remaining adjusted depreciable basis of \$140,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, CC's depreciation deduction for the remaining adjusted depreciable basis of \$140,000 is \$44,800 (the remaining adjusted depreciable basis of \$140,000 multiplied by the annual depreciation rate of .32 for recovery year 2). In addition, pursuant to paragraph (f)(2)(i) of this section, CC is allowed an additional first year depreciation deduction for 2003 for the \$10,000 increase in basis of the qualified property. Consequently, CC is allowed an additional first year depreciation deduction of \$3,000 (the increase in basis of \$10,000 multiplied by .30). Also, CC is allowed a depreciation deduction for 2003 attributable to the remaining increase in basis of \$7,000 (the increase in basis of \$10,000 reduced by the additional first year depreciation deduction of \$3,000). The depreciation deduction allowable for 2003 attributable to the remaining increase in basis of \$7,000 is \$3,111 (the remaining increase in basis of \$7,000 multiplied by .4444, which is equal to 1/remaining recovery period of 4.5 years at January 1, 2003, multiplied by 2). Accordingly, for 2003, CC's total depreciation deduction allowable for the qualified property is \$50,911.

*Example 2.* (i) On May 15, 2002, DD purchased and placed in service qualified property that is 5-year property at a cost of \$400,000. To purchase the property, DD borrowed \$250,000 from Bank2. On May 15, 2003, Bank2 forgives \$50,000 of the indebtedness. DD makes the election provided in section 108(b)(5) to apply any portion of the reduction under section 1017 to the basis of the depreciable property of the taxpayer. DD depreciates the 5-year property placed in service in 2002 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention.

(ii) For 2002, DD is allowed a 30-percent additional first year depreciation deduction of \$120,000 (the unadjusted depreciable basis of \$400,000 multiplied by .30). In addition, DD's depreciation deduction allowable for 2002 for the remaining adjusted depreciable basis of \$280,000 (the unadjusted depreciable basis of \$400,000 reduced by the additional first year depreciation deduction of \$120,000) is \$56,000 (the remaining adjusted depreciable basis of \$280,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, DD's deduction for the remaining adjusted depreciable basis of \$280,000 is \$89,600 (the remaining adjusted depreciable basis of \$280,000 multiplied by the annual depreciation rate of .32 for recovery year 2). However, pursuant to paragraph (f)(2)(ii) of this section, DD must include in its taxable income for 2003 the excess depreciation previously claimed for the \$50,000 decrease in basis of the qualified property. Consequently, DD must include in its taxable income for 2003 the

excess additional first year depreciation of \$4,500 (the decrease in basis of \$50,000 multiplied by .30). Also, *DD* must include in its taxable income for 2003 the excess depreciation attributable to the remaining decrease in basis of \$45,500 (the decrease in basis of \$50,000 reduced by the excess additional first year depreciation of \$4,500). The amount includible in taxable income for 2003 for the remaining decrease in basis of \$45,500 is \$20,222 (the remaining decrease in basis of \$45,500 multiplied by .4444, which is equal to 1/remaining recovery period of 4.5 years at January 1, 2003, multiplied by 2). Accordingly, for 2003, *DD*'s total depreciation deduction allowable for the qualified property is \$64,878 (\$89,600 minus \$4,500 minus \$20,222).

(3) *Section 1245 and 1250 depreciation recapture.* For purposes of section 1245 and the regulations thereunder, the additional first year depreciation deduction is an amount allowed or allowable for depreciation. Further, for purposes of section 1250(b) and the regulations thereunder, the additional first year depreciation deduction is not a straight line method.

(4) *Coordination with section 169.* The additional first year depreciation deduction is allowable in the placed-in-service year of a certified pollution control facility (as defined in §1.169-2(a)) that is qualified property or 50-percent bonus depreciation property, even if the taxpayer makes the election to amortize the certified pollution control facility under section 169 and the regulations thereunder in the certified pollution control facility's placed-in-service year.

(5) *Like-kind exchanges and involuntary conversions—(i) Scope.* The rules of this paragraph (f)(5) apply to acquired MACRS property or acquired computer software that is eligible for the additional first year depreciation deduction under section 168(k) at the time of replacement provided the time of replacement is after September 10, 2001, and before January 1, 2005, or, in the case of acquired MACRS property or acquired computer software that is qualified property, or 50-percent bonus depreciation property, described in section 168(k)(2)(B), the time of replacement is after September 10, 2001, and before January 1, 2006.

(ii) *Definitions.* For purposes of this paragraph (f)(5), the following definitions apply:

(A) *Acquired MACRS property* is MACRS property in the hands of the acquiring taxpayer that is acquired in a transaction described in section 1031(a), (b), or (c) for other MACRS property or

that is acquired in connection with an involuntary conversion of other MACRS property in a transaction to which section 1033 applies.

(B) *Exchanged or involuntarily converted MACRS property* is MACRS property that is transferred by the taxpayer in a transaction described in section 1031(a), (b), or (c), or that is converted as a result of an involuntary conversion to which section 1033 applies.

(C) *Acquired computer software* is computer software (as defined in paragraph (b)(2)(i)(B) of this section) in the hands of the acquiring taxpayer that is acquired in a like-kind exchange under section 1031 or as a result of an involuntary conversion under section 1033.

(D) *Exchanged or involuntarily converted computer software* is computer software (as defined in paragraph (b)(2)(i)(B) of this section) that is transferred by the taxpayer in a like-kind exchange under section 1031 or that is converted as a result of an involuntary conversion under section 1033.

(E) *Time of disposition* is when the disposition of the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software, as applicable, takes place.

(F) *Time of replacement* is the later of:

(1) when the property received in the exchange or involuntary conversion is placed in service; or

(2) the time of disposition of involuntarily converted property.

(G) *Carryover basis* is the lesser of:

(1) the basis in the acquired MACRS property or acquired computer software, as applicable and as determined under section 1031(d) or 1033(b) and the regulations thereunder; or

(2) the adjusted depreciable basis of the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software, as applicable.

(H) *Excess basis* is any excess of the basis in the acquired MACRS property or acquired computer software, as applicable and as determined under section 1031(d) or 1033(b) and the regulations thereunder, over the carryover basis as determined under paragraph (f)(5)(ii)(G) of this section.

(I) *Remaining carryover basis* is the carryover basis as determined under paragraph (f)(5)(ii)(G) of this section reduced by—

(1) The percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income); and

(2) Any adjustments to basis provided by other provisions of the Code and the regulations thereunder (including section 1016(a)(2) and (3)) for periods prior to the disposition of the exchanged or involuntarily converted property.

(J) *Remaining excess basis* is the excess basis as determined under paragraph (f)(5)(ii)(H) of this section reduced by—

(1) The percentage of the taxpayer's use of property for the taxable year other than in the taxpayer's trade or business (or for the production of income);

(2) Any portion of the basis the taxpayer properly elects to treat as an expense under section 179; and

(3) Any adjustments to basis provided by other provisions of the Code and the regulations thereunder.

(iii) *Computation—(A) In general.* Assuming all other requirements are met, the remaining carryover basis for the year of replacement and the remaining excess basis, if any, for the year of replacement for the acquired MACRS property or the acquired computer software, as applicable, are eligible for the additional first year depreciation deduction. The 30-percent additional first year depreciation deduction applies to the remaining carryover basis and the remaining excess basis, if any, of the acquired MACRS property or the acquired computer software if the time of replacement is after September 10, 2001, and before May 6, 2003, or if the taxpayer made the election provided in paragraph (e)(1)(ii)(A) of this section. The 50-percent additional first year depreciation deduction applies to the remaining carryover basis and the remaining excess basis, if any, of the acquired MACRS property or the acquired computer software if the time of replacement is after May 5, 2003, and before January 1, 2005, or before January 1, 2006, for 50-percent bonus depreciation property described in section 168(k)(2)(B). The additional first year depreciation deduction is computed separately for the remaining carryover basis and the remaining excess basis. Rules

similar to the rules provided in paragraph (d) of this section apply to property described in section 168(k)(2)(B) and for alternative minimum tax purposes (for example, use the remaining carryover basis as determined for alternative minimum tax purposes).

(B) *Year of disposition and year of replacement.* The additional first year depreciation deduction is allowable for the acquired MACRS property or acquired computer software in the year of replacement. However, the additional first year depreciation deduction is not allowable for the exchanged or involuntarily converted MACRS property or the exchanged or involuntarily converted computer software if the MACRS property or computer software, as applicable, is placed in service and disposed of in an exchange or involuntary conversion in the same taxable year.

(iv) *Sale-leaseback transaction.* For purposes of this paragraph (f)(5), if MACRS property or computer software is sold to a taxpayer and leased back to a person by the taxpayer within three months after the time of disposition of the MACRS property or computer software, as applicable, the time of replacement for this MACRS property or computer software, as applicable, shall not be earlier than the date on which the MACRS property or computer software, as applicable, is used by the lessee under the leaseback.

(v) *Examples.* The application of this paragraph (f)(5) is illustrated by the following examples:

*Example 1.* (i) In December 2002, *EE*, a calendar-year corporation, acquired for \$200,000 and placed in service Canopy V1, a gas station canopy. Canopy V1 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). *EE* depreciated Canopy V1 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *EE* elected to use the optional depreciation tables to compute the depreciation allowance for Canopy V1. On January 1, 2003, Canopy V1 was destroyed in a fire and was no longer usable in *EE*'s business. On June 1, 2003, in a transaction described in section 1033(a)(2), *EE* acquired and placed in service Canopy W1 with all of the \$160,000 of insurance proceeds *EE* received due to the loss of Canopy V1. Canopy W1 is 50-percent bonus depreciation property under section 168(k)(4) and is 5-year property under section 168(e).

(ii) For 2002, *EE* is allowed a 30-percent additional first year depreciation deduction of \$60,000 for Canopy V1 (the unadjusted depreciable basis of \$200,000 multiplied by .30), and a regular MACRS depreciation deduction of \$28,000 for Canopy V1 (the remaining adjusted depreciable basis of

\$140,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) Pursuant to paragraph (f)(5)(iii)(A) of this section, the additional first year depreciation deduction allowable for Canopy W1 equals \$56,000 (.50 of Canopy W1's remaining carryover basis of \$112,000 (Canopy V1's remaining adjusted depreciable basis of \$140,000 minus 2002 regular MACRS depreciation deduction of \$28,000).

*Example 2.* (i) Same facts as in *Example 1*, except *EE* elected not to deduct the additional first year depreciation for 5-year property placed in service in 2002. *EE* deducted the additional first year depreciation for 5-year property placed in service in 2003.

(ii) For 2002, *EE* is allowed a regular MACRS depreciation deduction of \$40,000 for Canopy V1 (the unadjusted depreciable basis of \$200,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) Pursuant to paragraph (f)(5)(iii)(A) of this section, the additional first year depreciation deduction allowable for Canopy W1 equals \$80,000 (.50 of Canopy W1's remaining carryover basis of \$160,000 (Canopy V1's unadjusted depreciable basis of \$200,000 minus 2002 regular MACRS depreciation deduction of \$40,000).

*Example 3.* (i) In December 2001, *FF*, a calendar year corporation, acquired for \$10,000 and placed in service Computer X2. Computer X2 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). *FF* depreciated Computer X2 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *FF* elected to use the optional depreciation tables to compute the depreciation allowance for Computer X2. On January 1, 2002, *FF* acquired Computer Y2 by exchanging Computer X2 and \$1,000 cash in a transaction described in section 1031(a). Computer Y2 is qualified property under section 168(k)(1) and is 5-year property under section 168(e).

(ii) For 2001, *FF* is allowed a 30-percent additional first year depreciation deduction of \$3,000 for Computer X2 (unadjusted basis of \$10,000 multiplied by .30), and a regular MACRS depreciation deduction of \$1,400 for Computer X2 (the remaining adjusted depreciable basis of \$7,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) Pursuant to paragraph (f)(5)(iii)(A) of this section, the 30-percent additional first year depreciation deduction for Computer Y2 is allowable for the remaining carryover basis of \$5,600 (Computer X2's unadjusted depreciable basis of \$10,000 minus additional first year depreciation deduction allowable of \$3,000 minus 2001 regular MACRS depreciation deduction of \$1,400) and for the remaining excess basis of \$1,000 (cash paid for Computer Y2). Thus, the 30-percent additional first year depreciation deduction for the remaining carryover basis equals \$1,680 (\$5,600 multiplied by .30) and for the remaining excess basis equals \$300 (\$1,000 multiplied by .30), which totals \$1,980.

*Example 4.* (i) In September 2002, *GG*, a June 30 year-end corporation, acquired for \$20,000 and placed in service Equipment X3. Equipment X3 is qualified property under section 168(k)(1) and is 5-year property under section 168(e). *GG* depreciated Equipment X3 under the general depreciation

system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *GG* elected to use the optional depreciation tables to compute the depreciation allowance for Equipment X3. In December 2002, *GG* acquired Equipment Y3 by exchanging Equipment X3 and \$5,000 cash in a transaction described in section 1031(a). Equipment Y3 is qualified property under section 168(k)(1) and is 5-year property under section 168(e).

(ii) Pursuant to paragraph (f)(5)(iii)(B) of this section, no additional first year depreciation deduction is allowable for Equipment X3 and, pursuant to § 1.168(d)-1T(b)(3)(ii), no regular depreciation deduction is allowable for Equipment X3.

(iii) Pursuant to paragraph (f)(5)(iii)(A) of this section, the 30-percent additional first year depreciation deduction for Equipment Y3 is allowable for the remaining carryover basis of \$20,000 (Equipment X3's unadjusted depreciable basis of \$20,000) and for the remaining excess basis of \$5,000 (cash paid for Equipment Y3). Thus, the 30-percent additional first year depreciation deduction for the remaining carryover basis equals \$6,000 (\$20,000 multiplied by .30) and for the remaining excess basis equals \$1,500 (\$5,000 multiplied by .30), which totals \$7,500.

*Example 5.* (i) Same facts as in *Example 4*. *GG* depreciated Equipment Y3 under the general depreciation system of section 168(a) by using the 200-percent declining balance method of depreciation, a 5-year recovery period, and the half-year convention. *GG* elected to use the optional depreciation tables to compute the depreciation allowance for Equipment Y3. On July 1, 2003, *GG* acquired Equipment Z1 by exchanging Equipment Y3 in a transaction described in section 1031(a). Equipment Z1 is 50-percent bonus depreciation property under section 168(k)(4) and is 5-year property under section 168(e).

(ii) For the taxable year ending June 30, 2003, the regular MACRS depreciation deduction allowable for the remaining carryover basis of Equipment Y3 is \$2,800 (the remaining carryover basis of \$14,000 multiplied by the annual depreciation rate of .20 for recovery year 1) and for the remaining excess basis of Equipment Y3 is \$700 (the remaining excess basis of \$3,500 multiplied by the annual depreciation rate of .20 for recovery year 1), which totals \$3,500.

(iii) For the taxable year ending June 30, 2004, pursuant to paragraph (f)(5)(iii)(A) of this section, the 50-percent additional first year depreciation deduction allowable for Equipment Z1 is \$7,000 (.50 of Equipment Z1's remaining carryover basis of \$14,000 (Equipment Y3's total unadjusted depreciable basis of \$25,000 minus the total additional first year depreciation deduction of \$7,500 minus the total regular MACRS depreciation deduction of \$3,500).

(6) *Change in use*—(i) *Change in use of depreciable property.* The determination of whether the use of depreciable property changes is made in accordance with section 168(i)(5) and regulations thereunder.

(ii) *Conversion to personal use.* If qualified property or 50-percent bonus depreciation property is converted from business or income-producing use to personal use



in the same taxable year in which the property is placed in service by a taxpayer, the additional first year depreciation deduction is not allowable for the property.

(iii) *Conversion to business or income-producing use*—(A) *During the same taxable year.* If, during the same taxable year, property is acquired by a taxpayer for personal use and is converted by the taxpayer from personal use to business or income-producing use, the additional first year depreciation deduction is allowable for the property in the taxable year the property is converted to business or income-producing use (assuming all of the requirements in paragraph (b) of this section are met). See paragraph (b)(3)(ii) of this section relating to the original use rules for a conversion of property to business or income-producing use.

(B) *Subsequent to the acquisition year.* If property is acquired by a taxpayer for personal use and, during a subsequent taxable year, is converted by the taxpayer from personal use to business or income-producing use, the additional first year depreciation deduction is allowable for the property in the taxable year the property is converted to business or income-producing use (assuming all of the requirements in paragraph (b) of this section are met). For purposes of paragraphs (b)(4) and (5) of this section, the property must be acquired by the taxpayer for personal use after September 10, 2001 (for qualified property), or after May 5, 2003 (for 50-percent bonus depreciation property), and converted by the taxpayer from personal use to business or income-producing use by January 1, 2005. See paragraph (b)(3)(ii) of this section relating to the original use rules for a conversion of property to business or income-producing use.

(iv) *Depreciable property changes use subsequent to the placed-in-service year*—(A) If the use of qualified property or 50-percent bonus depreciation property changes in the hands of the same taxpayer subsequent to the taxable year the qualified property or the 50-percent bonus depreciation property, as applicable, is placed in service and, as a result of the change in use, the property is no longer qualified property or 50-percent bonus depreciation property, as applicable, the additional first year depreciation deduction allowable for the qualified property or the 50-percent

bonus depreciation property, as applicable, is not redetermined.

(B) If depreciable property is not qualified property or 50-percent bonus depreciation property in the taxable year the property is placed in service by the taxpayer, the additional first year depreciation deduction is not allowable for the property even if a change in the use of the property subsequent to the taxable year the property is placed in service results in the property being qualified property or 50-percent bonus depreciation property in the taxable year of the change in use.

(v) *Examples.* The application of this paragraph (f)(6) is illustrated by the following examples:

*Example 1.* (i) On January 1, 2002, *HH*, a calendar year corporation, purchased and placed in service several new computers at a total cost of \$100,000. *HH* used these computers within the United States for 3 months in 2002 and then moved and used the computers outside the United States for the remainder of 2002. On January 1, 2003, *HH* permanently returns the computers to the United States for use in its business.

(ii) For 2002, the computers are considered as used predominantly outside the United States in 2002 pursuant to §1.48-1(g)(1)(i). As a result, the computers are required to be depreciated under the alternative depreciation system of section 168(g). Pursuant to paragraph (b)(2)(ii)(A)(2) of this section, the computers are not qualified property in 2002, the placed-in-service year. Thus, pursuant to (f)(6)(iv)(B) of this section, no additional first year depreciation deduction is allowed for these computers, regardless of the fact that the computers are permanently returned to the United States in 2003.

*Example 2.* (i) On February 8, 2002, *II*, a calendar year corporation, purchased and placed in service new equipment at a cost of \$1,000,000 for use in its California plant. The equipment is 5-year property under section 168(e) and is qualified property under section 168(k). *II* depreciates its 5-year property placed in service in 2002 using the optional depreciation table that corresponds with the general depreciation system, the 200-percent declining balance method, a 5-year recovery period, and the half-year convention. On June 4, 2003, due to changes in *II*'s business circumstances, *II* permanently moves the equipment to its plant in Mexico.

(ii) For 2002, *II* is allowed a 30-percent additional first year depreciation deduction of \$300,000 (the adjusted depreciable basis of \$1,000,000 multiplied by .30). In addition, *II*'s depreciation deduction allowable in 2002 for the remaining adjusted depreciable basis of \$700,000 (the unadjusted depreciable basis of \$1,000,000 reduced by the additional first year depreciation deduction of \$300,000) is \$140,000 (the remaining adjusted depreciable basis of \$700,000 multiplied by the annual depreciation rate of .20 for recovery year 1).

(iii) For 2003, the equipment is considered as used predominantly outside the United States pursuant to §1.48-1(g)(1)(i). As a result of this change in use, the

adjusted depreciable basis of \$560,000 for the equipment is required to be depreciated under the alternative depreciation system of section 168(g) beginning in 2003. However, the additional first year depreciation deduction of \$300,000 allowed for the equipment in 2002 is not redetermined.

(7) *Earnings and profits.* The additional first year depreciation deduction is not allowable for purposes of computing earnings and profits.

(8) *Limitation of amount of depreciation for certain passenger automobiles.* For a passenger automobile as defined in section 280F(d)(5), the limitation under section 280F(a)(1)(A)(i) is increased by—

(i) \$4,600 for qualified property acquired by a taxpayer after September 10, 2001, and before May 6, 2003; and

(ii) \$7,650 for qualified property or 50-percent bonus depreciation property acquired by a taxpayer after May 5, 2003.

(9) *Section 754 election.* In general, for purposes of section 168(k) any increase in basis of qualified property or 50-percent bonus depreciation property due to a section 754 election is not eligible for the additional first year depreciation deduction. However, if qualified property or 50-percent bonus depreciation property is placed in service by a partnership in the taxable year the partnership terminates under section 708(b)(1)(B), any increase in basis of the qualified property or the 50-percent bonus depreciation property due to a section 754 election is eligible for the additional first year depreciation deduction.

(g) *Effective date*—(1) *In general.* Except as provided in paragraphs (g)(2) and (3) of this section, this section applies to qualified property under section 168(k)(2) acquired by a taxpayer after September 10, 2001, and to 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. This section expires on September 4, 2006.

(2) *Technical termination of a partnership or section 168(i)(7) transactions.* If qualified property or 50 percent bonus depreciation property is transferred in a technical termination of a partnership under section 708(b)(1)(B) or in a transaction described in section 168(i)(7) for a taxable year ending on or before September 8, 2003, and the additional first year depreciation deduction allowable for the property was not determined in accordance with paragraph (f)(1)(ii) or (iii) of this section, as applicable, the Internal Revenue Service

will allow any reasonable method of determining the additional first year depreciation deduction allowable for the property in the year of the transaction that is consistently applied to the property by all parties to the transaction.

(3) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for a taxable year ending on or before September 8, 2003, the additional first year depreciation deduction for the remaining carryover basis of qualified property or 50-percent bonus depreciation property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the Internal Revenue Service will treat the taxpayer's method of not claiming the additional first year depreciation deduction for the remaining carryover basis as a permissible method of accounting and will treat the amount of the additional first year depreciation deduction allowable for the remaining carryover basis as being equal to zero, provided the taxpayer does not claim the additional first year depreciation deduction for the remaining carryover basis in accordance with paragraph (g)(4)(ii) of this section.

(4) *Change in method of accounting—(i) Special rules for 2000 or 2001 returns.* If a taxpayer did not claim on the Federal tax return for the taxable year that included September 11, 2001, any additional first year depreciation deduction for a class of property that is qualified property and did not make an election not to deduct the additional first year depreciation deduction for that class of property, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of claiming the additional first year depreciation deduction for the class of property (for further guidance, see section 4 of Rev. Proc. 2002-33, 2002-1 C.B. 963, Rev. Proc. 2003-50, 2003-29 I.R.B. 119, and §601.601(d)(2)(ii)(b) of this chapter).

(ii) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for any taxable year ending on or before September

8, 2003, the additional first year depreciation deduction allowable for the remaining carryover basis of qualified property or 50-percent bonus depreciation property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the taxpayer may claim the additional first year depreciation deduction allowable for the remaining carryover basis in accordance with paragraph (f)(5) of this section either:

(A) by filing an amended return (or a qualified amended return, if applicable (for further guidance, see Rev. Proc. 94-69, 1994-2 C.B. 804, and §601.601(d)(2)(ii)(b) of this chapter)) on or before December 31, 2003, for the year of replacement and any affected subsequent taxable year; or,

(B) by following the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002-9, 2002-1 C.B. 327, and §601.601(d)(2)(ii)(b) of this chapter).

Par. 8. Section 1.169-3 is amended by:

1. Revising paragraphs (a) and (b)(2).
2. Adding paragraph (g).

The additions and revisions read as follows:

*§1.169-3 Amortizable basis.*

\* \* \* \* \*

(a) [Reserved]. For further guidance, see §1.169-3T(a).

\* \* \* \* \*

(b) \* \* \*

(2) [Reserved]. For further guidance, see §1.169-3T(b)(2).

\* \* \* \* \*

(g) *Effective date for qualified property, 50-percent bonus depreciation property, and qualified New York Liberty Zone property.* [Reserved]. For further guidance, see §1.169-3T(g).

Par. 9. Section 1.169-3T is added to read as follows:

*§1.169-3T Amortizable basis (temporary).*

(a) *In general.* The amortizable basis of a certified pollution control facility for the purpose of computing the amortization deduction under section 169 is the adjusted basis of the facility for purposes of determining gain (see part II (section 1011 and following), subchapter O, chapter 1 of the Internal Revenue Code), as modified by paragraphs (b), (c), and (d) of this section. The adjusted basis for purposes of determining gain (computed without regard to these modifications) of a facility that performs a function in addition to pollution control, or that is used in connection with more than one plant or other property, or both, is determined under §1.169-2(a)(3). For rules as to additions and improvements to such a facility, see paragraph (f) of this section. Before computing the amortization deduction allowable under section 169, the adjusted basis for purposes of determining gain for a facility that is placed in service by a taxpayer after September 10, 2001, and that is qualified property under section 168(k)(2) or §1.168(k)-1T, 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)-1T, or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)-1T must be reduced by the amount of the additional first year depreciation deduction allowed or allowable, whichever is greater, under section 168(k) or section 1400L(b), as applicable, for the facility.

(b) *Limitation on post-1968 construction, reconstruction, or erection.* (1) For further guidance, see §1.169-3(b)(1).

(2) If the taxpayer elects to begin the 60-month amortization period with the first month of the taxable year succeeding the taxable year in which the facility is completed or acquired and a depreciation deduction is allowable under section 167 (including an additional first-year depreciation allowance under former section 179; for a facility that is acquired by the taxpayer after September 10, 2001, and that is qualified property under section 168(k)(2) or §1.168(k)-1T or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)-1T, the additional first year depreciation deduction under section 168(k)(1) or 1400L(b), as applicable; and for a facility that is acquired by the taxpayer after May 5,

2003, and that is 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)-1T, the additional first year depreciation deduction under section 168(k)(4) with respect to the facility for the taxable year in which it is completed or acquired, the amount determined under paragraph (b)(1) of this section shall be reduced by an amount equal to the amount of the depreciation deduction allowed or allowable, whichever is greater, multiplied by a fraction the numerator of which is the amount determined under paragraph (b)(1) of this section, and the denominator of which is the facility's total cost. The additional first-year allowance for depreciation under former section 179 will be allowable only for the taxable year in which the facility is completed or acquired and only if the taxpayer elects to begin the amortization deduction under section 169 with the taxable year succeeding the taxable year in which such facility is completed or acquired. For a facility that is acquired by a taxpayer after September 10, 2001, and that is qualified property under section 168(k)(2) or §1.168(k)-1T or qualified New York Liberty Zone property under section 1400L(b) or §1.1400L(b)-1T, see §1.168(k)-1T(f)(4) or §1.1400L(b)-1T(f)(4), as applicable, with respect to when the additional first year depreciation deduction under section 168(k)(1) or 1400L(b) is allowable. For a facility that is acquired by a taxpayer after May 5, 2003, and that is 50-percent bonus depreciation property under section 168(k)(4) or §1.168(k)-1T, see §1.168(k)-1T(f)(4) with respect to when the additional first year depreciation deduction under section 168(k)(4) is allowable.

(c) through (f) For further guidance, see §1.169-3(c) through (f).

(g) *Effective date for qualified property, 50-percent bonus depreciation property, and qualified New York Liberty Zone property.* This section applies to a certified pollution control facility. This section also applies to a certified pollution control facility that is qualified property under section 168(k)(2) or qualified New York Liberty Zone property under section 1400L(b) acquired by a taxpayer after September 10, 2001, and to a certified pollution control

facility that is 50-percent bonus depreciation property under section 168(k)(4) acquired by a taxpayer after May 5, 2003. This section expires on September 4, 2006.

Par. 10. Section 1.1400L(b)-1T is added to read as follows:

*§1.1400L(b)-1T Additional first year depreciation deduction for qualified New York Liberty Zone property (temporary).*

(a) *Scope.* This section provides the rules for determining the 30-percent additional first year depreciation deduction allowable under section 1400L(b) for qualified New York Liberty Zone property.

(b) *Definitions.* For purposes of section 1400L(b) and this section, the definitions of the terms in §1.168(k)-1T(a)(2) apply and the following definitions also apply:

(1) *Building and structural components* have the same meanings as those terms are defined in §1.48-1(e).

(2) *New York Liberty Zone* is the area located on or south of Canal Street, East Broadway (east of its intersection with Canal Street), or Grand Street (east of its intersection with East Broadway) in the Borough of Manhattan in the City of New York, New York.

(3) *Nonresidential real property and residential rental property* have the same meanings as those terms are defined in section 168(e)(2).

(4) *Real property* is a building or its structural components, or other tangible real property except property described in section 1245(a)(3)(B) (relating to depreciable property used as an integral part of a specified activity or as a specified facility), section 1245(a)(3)(D) (relating to single purpose agricultural or horticultural structure), or section 1245(a)(3)(E) (relating to a storage facility used in connection with the distribution of petroleum or any primary product of petroleum).

(c) *Qualified New York Liberty Zone property*—(1) *In general.* Qualified New York Liberty Zone property is depreciable property that—

(i) Meets the requirements in §1.1400L(b)-1T(c)(2) (description of property);

(ii) Meets the requirements in §1.1400L(b)-1T(c)(3) (substantial use);

(iii) Meets the requirements in §1.1400L(b)-1T(c)(4) (original use);

(iv) Meets the requirements in §1.1400L(b)-1T(c)(5) (acquisition of property by purchase); and

(v) Meets the requirements in §1.1400L(b)-1T(c)(6) (placed-in-service date).

(2) *Description of qualified New York Liberty Zone property*—(i) *In general.* Depreciable property will meet the requirements of this paragraph (c)(2) if the property is—

(A) Described in §1.168(k)-1T(b)(2)(i); or

(B) Nonresidential real property or residential rental property depreciated under section 168, but only to the extent it rehabilitates real property damaged, or replaces real property destroyed or condemned, as a result of the terrorist attacks of September 11, 2001. Property is treated as replacing destroyed or condemned property if, as part of an integrated plan, the property replaces real property that is included in a continuous area that includes real property destroyed or condemned. For purposes of this section, real property is considered as destroyed or condemned only if an entire building or structure was destroyed or condemned as a result of the terrorist attacks of September 11, 2001. Otherwise, the real property is considered damaged real property. For example, if certain structural components (for example, walls, floors, and plumbing fixtures) of a building are damaged or destroyed as a result of the terrorist attacks of September 11, 2001, but the building is not destroyed or condemned, then only costs related to replacing the damaged or destroyed structural components qualify under this paragraph (c)(2)(i)(B).

(ii) *Property not eligible for additional first year depreciation deduction.* Depreciable property will not meet the requirements of this paragraph (c)(2) if—

(A) Section 168(k) or §1.168(k)-1T applies to the property; or

(B) The property is described in section §1.168(k)-1T(b)(2)(ii).

(3) *Substantial use.* Depreciable property will meet the requirements of this paragraph (c)(3) if substantially all of the use of the property is in the New York Liberty Zone and is in the active conduct of a trade or business by the taxpayer in New York Liberty Zone. For purposes of this paragraph (c)(3), “substantially all” means 80 percent or more.

(4) *Original use.* Depreciable property will meet the requirements of this paragraph (c)(4) if the original use of the property commences with the taxpayer in the New York Liberty Zone after September 10, 2001. The original use rules in §1.168(k)-1T(b)(3) apply for purposes of this paragraph (c)(4). In addition, used property will satisfy the original use requirement in this paragraph (c)(4) so long as the property has not been previously used within the New York Liberty Zone.

(5) *Acquisition of property by purchase—(i) In general.* Depreciable property will meet the requirements of this paragraph (c)(5) if the property is acquired by the taxpayer by purchase (as defined in section 179(d) and §1.179-4(c)) after September 10, 2001, but only if no written binding contract for the acquisition of the property was in effect before September 11, 2001. For purposes of this paragraph (c)(5), the rules in §1.168(k)-1T(b)(4)(ii) (binding contract), the rules in §1.168(k)-1T(b)(4)(iii) (self-constructed property), and the rules in §1.168(k)-1T(b)(4)(iv) (disqualified transactions) apply. For purposes of the preceding sentence, the rules in §1.168(k)-1T(b)(4)(iii) shall be applied without regard to ‘and before January 1, 2005.’

(ii) *Exception for certain transactions.* For purposes of this section, the new partnership of a transaction described in §1.168(k)-1T(f)(1)(ii) (technical termination of a partnership) or the transferee of a transaction described in §1.168(k)-1T(f)(1)(iii) (section 168(i)(7) transactions) is deemed to acquire the depreciable property by purchase.

(6) *Placed-in-service date.* Depreciable property will meet the requirements of this paragraph (c)(6) if the property is placed in service by the taxpayer on or before December 31, 2006. However, nonresidential real property and residential rental property described in paragraph (c)(2)(i)(B) of this section must be placed in service by the taxpayer on or before December 31, 2009. The rules in §1.168(k)-1T(b)(5)(ii) (relating to sale-leaseback and syndication transactions), the rules in §1.168(k)-1T(b)(5)(iii) (relating to a technical termination of a partnership under section 708(b)(1)(B)), and the rules in §1.168(k)-1T(b)(5)(iv)

(relating to section 168(i)(7) transactions) apply for purposes of this paragraph (c)(6).

(d) *Computation of depreciation deduction for qualified New York Liberty Zone property.* The computation of the allowable additional first year depreciation deduction and the otherwise allowable depreciation deduction for qualified New York Liberty Zone property is made in accordance with the rules for qualified property in §1.168(k)-1T(d)(1)(i) and (2).

(e) *Election not to deduct additional first year depreciation—(1) In general.* A taxpayer may make an election not to deduct the 30-percent additional first year depreciation for any class of property that is qualified New York Liberty Zone property placed in service during the taxable year. If a taxpayer makes an election under this paragraph (e), the election applies to all qualified New York Liberty Zone property that is in the same class of property and placed in service in the same taxable year, and no additional first year depreciation deduction is allowable for the class of property.

(2) *Definition of class of property.* For purposes of this paragraph (e), the term class of property means—

(i) Except for the property described in paragraphs (e)(2)(ii), (iv), and (v) of this section, each class of property described in section 168(e) (for example, 5-year property);

(ii) Water utility property as defined in section 168(e)(5) and depreciated under section 168;

(iii) Computer software as defined in, and depreciated under, section 167(f)(1) and the regulations thereunder;

(iv) Nonresidential real property as defined in paragraph (b)(3) of this section and as described in paragraph (c)(2)(B) of this section; or

(v) Residential rental property as defined in paragraph (b)(3) of this section and as described in paragraph (c)(2)(B) of this section

(3) *Time and manner for making election—(i) Time for making election.* Except as provided in paragraph (e)(4) of this section, the election specified in paragraph (e)(1) of this section must be made by the due date (including extensions) of the federal tax return for the taxable year in which the qualified New York Liberty Zone property is placed in service by the taxpayer

(ii) *Manner of making election.* Except as provided in paragraph (e)(4) of this section, the election specified in paragraph (e)(1) of this section must be made in the manner prescribed on Form 4562, “*Depreciation and Amortization*,” and its instructions. The election is made separately by each person owning qualified New York Liberty Zone property (for example, for each member of a consolidated group by the common parent of the group, by the partnership, or by the S corporation). If Form 4562 is revised or renumbered, any reference in this section to that form shall be treated as a reference to the revised or renumbered form.

(4) *Special rules for 2000 or 2001 returns.* For the election specified in paragraph (e)(1) of this section for qualified New York Liberty Zone property placed in service by the taxpayer during the taxable year that included September 11, 2001, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time and manner of making this election on the 2000 or 2001 federal tax return for the taxable year that included September 11, 2001 (for further guidance, see sections 3.03(3) and 4 of Rev. Proc. 2002-33, 2002-1 C.B. 963, Rev. Proc. 2003-50, 2003-29 I.R.B. 119, and §601.601(d)(2)(ii)(b) of this chapter).

(5) *Failure to make election.* If a taxpayer does not make the election specified in paragraph (e)(1) of this section within the time and in the manner prescribed in paragraph (e)(3) or (e)(4) of this section, the amount of depreciation allowable for that property under section 167(f)(1) or under section 168, as applicable, must be determined for the placed-in-service year and for all subsequent taxable years by taking into account the additional first year depreciation deduction. Thus, the election specified in paragraph (e)(1) of this section shall not be made by the taxpayer in any other manner (for example, the election cannot be made through a request under section 446(e) to change the taxpayer’s method of accounting).

(f) *Special rules—(1) Property placed in service and disposed of in the same taxable year.* Rules similar to those provided in §1.168(k)-1T(f)(1) apply for purposes of this paragraph (f)(1).

(2) *Redetermination of basis.* If the unadjusted depreciable basis (as defined in §1.168(k)-1T(a)(2)(iii)) of qualified

New York Liberty Zone property is redetermined (for example, due to contingent purchase price or discharge of indebtedness) on or before December 31, 2006 (or on or before December 31, 2009, for nonresidential real property and residential rental property described in paragraph (c)(2)(i)(B) of this section), the additional first year depreciation deduction allowable for the qualified New York Liberty Zone property is redetermined in accordance with the rules provided in §1.168(k)-1T(f)(2).

(3) *Section 1245 and 1250 depreciation recapture.* The rules provided in §1.168(k)-1T(f)(3) apply for purposes of this paragraph (f)(3).

(4) *Coordination with section 169.* Rules similar to those provided in §1.168(k)-1T(f)(4) apply for purposes of this paragraph (f)(4).

(5) *Like-kind exchanges and involuntary conversions.* This paragraph (f)(5) applies to acquired MACRS property (as defined in §1.168(k)-1T(f)(5)(ii)(A)) or acquired computer software (as defined in §1.168(k)-1T(f)(5)(ii)(C)) that is eligible for the additional first year depreciation deduction under section 1400L(b) at the time of replacement provided the time of replacement is after September 10, 2001, and on or before December 31, 2006, or in the case of acquired MACRS property or acquired computer software that is qualified New York Liberty Zone property described in paragraph (c)(2)(i)(B) of this section, the time of replacement is after September 10, 2001, and on or before December 31, 2009. The rules and definitions similar to those provided in §1.168(k)-1T(f)(5) apply for purposes of this paragraph (f)(5).

(6) *Change in use.* Rules similar to those provided in §1.168(k)-1T(f)(6) apply for purposes of this paragraph (f)(6).

(7) *Earnings and profits.* The rule provided in §1.168(k)-1T(f)(7) applies for purposes of this paragraph (f)(7).

(8) *Section 754 election.* Rules similar to those provided in §1.168(k)-1T(f)(9) apply for purposes of this paragraph (f)(8).

(g) *Effective date*—(1) *In general.* Except as provided in paragraphs (g)(2) and (3) of this section, this section applies to qualified New York Liberty Zone property acquired by a taxpayer after September 10, 2001. This section expires on September 4, 2006.

(2) *Technical termination of a partnership or section 168(i)(7) transactions.* If qualified New York Liberty Zone property is transferred in a technical termination of a partnership under section 708(b)(1)(B) or in a transaction described in section 168(i)(7) for a taxable year ending on or before September 8, 2003, and the additional first year depreciation deduction allowable for the property was not determined in accordance with paragraph (f)(1) of this section, the Internal Revenue Service will allow any reasonable method of determining the additional first year depreciation deduction allowable for the property in the year of the transaction that is consistently applied to the property by all parties to the transaction.

(3) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for a taxable year ending on or before September 8, 2003, the additional first year depreciation deduction for the remaining carryover basis of qualified New York Liberty Zone property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the Internal Revenue Service will treat the taxpayer's method of not claiming the additional first year depreciation deduction for the remaining carryover basis as a permissible method of accounting and will treat the amount of the additional first year depreciation deduction allowable for the remaining carryover basis as being equal to zero, provided the taxpayer does not claim the additional first year depreciation deduction for the remaining carryover basis in accordance with paragraph (g)(4)(ii) of this section.

(4) *Change in method of accounting*—(i) *Special rules for 2000 or 2001 returns.* If a taxpayer did not claim on the federal tax return for the taxable year that included September 11, 2001, any additional first year depreciation deduction for a class of property that is qualified New York Liberty Zone property and did not make an election not to deduct the additional first year depreciation deduction for that class of property, the taxpayer should refer to the guidance provided by the Internal Revenue Service for the time

and manner of claiming the additional first year depreciation deduction for the class of property (for further guidance, see section 4 of Rev. Proc. 2002-33, 2002-1 C.B. 963, Rev. Proc. 2003-50, 2003-29 I.R.B. 119, and §601.601(d)(2)(ii)(b) of this chapter).

(ii) *Like-kind exchanges and involuntary conversions.* If a taxpayer did not claim on a federal tax return for any taxable year ending on or before September 8, 2003, the additional first year depreciation deduction allowable for the remaining carryover basis of qualified New York Liberty Zone property acquired in a transaction described in section 1031(a), (b), or (c), or in a transaction to which section 1033 applies and the taxpayer did not make an election not to deduct the additional first year depreciation deduction for the class of property applicable to the remaining carryover basis, the taxpayer may claim the additional first year depreciation deduction allowable for the remaining carryover basis in accordance with paragraph (f)(5) of this section either—

(A) By filing an amended return (or a qualified amended return, if applicable (for further guidance, see Rev. Proc. 94-69, 1994-2 C.B. 804, and §601.601(d)(2)(ii)(b) of this chapter)) on or before December 31, 2003, for the year of replacement and any affected subsequent taxable year; or,

(B) By following the applicable administrative procedures issued under §1.446-1(e)(3)(ii) for obtaining the Commissioner's automatic consent to a change in method of accounting (for further guidance, see Rev. Proc. 2002-9, 2002-1 C.B. 327, and §601.601(d)(2)(ii)(b) of this chapter).

Robert E. Wenzel,  
*Deputy Commissioner for  
Services and Enforcement.*

Approved August 29, 2003.

Gregory F. Jenner,  
*Assistant Secretary of the  
Treasury (Tax Policy).*

(Filed by the Office of the Federal Register for September 5, 2003, 8:45 a.m., and published in the issue of the Federal Register for September 8, 2003, 68 F.R. 52985)

## Section 472.—Last-in, First-out Inventories

26 CFR 1.472-1: Last-in, first-out inventories.

**LIFO; price indexes; department stores.** The August 2003 Bureau of Labor Statistics price indexes are accepted for use by department stores employing the retail inventory and last-in, first-out inventory methods for valuing inventories for tax years ended on, or with reference to, August 31, 2003.

## Rev. Rul. 2003-113

The following Department Store Inventory Price Indexes for August 2003 were issued by the Bureau of Labor Statistics. The indexes are accepted by the Internal Revenue Service, under § 1.472-1(k) of the Income Tax Regulations and Rev. Proc. 86-46, 1986-2 C.B. 739, for appropriate application to inventories of department stores employing the retail inventory and last-in, first-out inventory

methods for tax years ended on, or with reference to, August 31, 2003.

The Department Store Inventory Price Indexes are prepared on a national basis and include (a) 23 major groups of departments, (b) three special combinations of the major groups — soft goods, durable goods, and miscellaneous goods, and (c) a store total, which covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco, and contract departments.

### BUREAU OF LABOR STATISTICS, DEPARTMENT STORE INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS (January 1941 = 100, unless otherwise noted)

Groups	Aug. 2002	Aug. 2003	Percent Change from Aug. 2002 to Aug. 2003 <sup>1</sup>
1. Piece Goods . . . . .	481.8	488.9	1.5
2. Domestic and Draperies . . . . .	577.9	568.7	-1.6
3. Women's and Children's Shoes . . . . .	634.4	631.4	-0.5
4. Men's Shoes . . . . .	892.1	838.8	-6.0
5. Infants' Wear . . . . .	600.1	589.1	-1.8
6. Women's Underwear . . . . .	532.7	510.7	-4.1
7. Women's Hosiery . . . . .	342.7	347.8	1.5
8. Women's and Girls' Accessories . . . . .	523.9	551.0	5.2
9. Women's Outerwear and Girls' Wear . . . . .	361.5	350.2	-3.1
10. Men's Clothing . . . . .	563.8	528.7	-6.2
11. Men's Furnishings . . . . .	589.4	565.6	-4.0
12. Boys' Clothing and Furnishings . . . . .	439.2	423.3	-3.6
13. Jewelry . . . . .	887.0	880.6	-0.7
14. Notions . . . . .	793.2	787.1	-0.8
15. Toilet Articles and Drugs . . . . .	969.2	979.8	1.1
16. Furniture and Bedding . . . . .	623.9	619.8	-0.7
17. Floor Coverings . . . . .	621.3	588.7	-5.2
18. Housewares . . . . .	749.4	720.4	-3.9
19. Major Appliances . . . . .	221.8	209.7	-5.5
20. Radio and Television . . . . .	47.9	45.0	-6.1
21. Recreation and Education <sup>2</sup> . . . . .	85.7	82.3	-4.0
22. Home Improvements <sup>2</sup> . . . . .	125.4	124.2	-1.0
23. Automotive Accessories <sup>2</sup> . . . . .	111.8	111.7	-0.1
Groups 1-15: Soft Goods . . . . .	565.9	553.5	-2.2
Groups 16-20: Durable Goods . . . . .	408.4	392.1	-4.0
Groups 21-23: Misc. Goods <sup>2</sup> . . . . .	96.2	93.8	-2.5
Store Total <sup>3</sup> . . . . .	508.3	495.2	-2.6

(Footnotes are on the following page.)

BUREAU OF LABOR STATISTICS, DEPARTMENT STORE  
INVENTORY PRICE INDEXES BY DEPARTMENT GROUPS  
(January 1941 = 100, unless otherwise noted)

Groups	Aug. 2002	Aug. 2003	Percent Change from Aug. 2002 to Aug. 2003 <sup>1</sup>
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<sup>1</sup>Absence of a minus sign before the percentage change in this column signifies a price increase.

<sup>2</sup>Indexes on a January 1986 = 100 base.

<sup>3</sup>The store total index covers all departments, including some not listed separately, except for the following: candy, food, liquor, tobacco and contract departments.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Michael Burkom of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Burkom at (202) 622-7924 (not a toll-free call).

### Section 2702.—Special Valuation Rules in Case of Transfers of Interests in Trusts

26 CFR 25.2702-3: *Qualified interests.*

The Internal Revenue Service will follow the Tax Court's decision in *Walton v. Commissioner*, 115 T.C. 589 (2000), holding that section 25.2702-3(e), *Example 5*, of the Gift Tax Regulations is invalid. See Notice 2003-72, page 964.

### Section 6323(a).—Validity and Priority Against Certain Persons

26 CFR 301.6323(a)-1: *Purchasers, holders of security interests, mechanic's lienors, and judgment lien creditors.*

**Tax lien.** This ruling under section 6323(a) of the Code concludes that actual notice or knowledge of the existence of a section 6321 federal tax lien is irrelevant for purposes of section 6323(a) lien priority.

#### Rev. Rul. 2003-108

#### ISSUE

When a notice of federal tax lien has not been filed, does actual knowledge of a

statutory tax lien affect the lien priority of a purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor?

#### FACTS

Prior to becoming a purchaser, security interest holder, mechanic's lienor, or judgment lien creditor, a third party has actual knowledge of a statutory tax lien, with respect to which no notice of federal tax lien has been filed.

#### LAW AND ANALYSIS

Section 6323(a) of the Internal Revenue Code provides that the statutory tax lien imposed by I.R.C. § 6321 shall not be valid as against any purchaser, holder of a security interest, mechanic's lienor, or judgment lien creditor until notice thereof has been filed. Section 6323(a) is silent as to the effect of actual knowledge of a statutory tax lien upon this priority when a notice of federal tax lien has not been filed.

In *United States v. Beaver Run Coal Co.*, 99 F.2d 610 (3d Cir. 1938), the issue was whether a mortgage lien had priority over the Government's statutory tax lien as to particular property in the taxpayer's possession. The court held that the mortgagee was protected against the statutory tax lien even though the mortgagee had actual knowledge of a possible tax liability because a notice of federal tax lien was not filed.

In enacting the Federal Tax Lien Act of 1966, Congress had the opportunity to overrule *Beaver Run Coal Co.*, or to otherwise indicate that actual knowledge of a statutory tax lien is relevant for purposes of section 6323(a), but did not do so. See

*TKB International, Inc. v. United States*, 995 F.2d 1460, 1466 n. 4 (9th Cir. 1993) (noting that Congress in 1954 declined to limit the protections of section 6323(a) to parties without notice or knowledge of the statutory tax lien). Cf. I.R.C. § 6323(b) (actual notice or knowledge of existence of statutory tax lien relevant for certain superpriority provisions).

#### HOLDING

For purposes of I.R.C. § 6323(a), a purchaser, holder of a security interest, mechanic's lienor or judgment lien creditor is protected against a statutory tax lien for which a notice of federal tax lien has not been filed notwithstanding actual knowledge of the statutory tax lien.

#### DRAFTING INFORMATION

The principal author of this revenue ruling is Robin Ferguson of the Office of the Associate Chief Counsel, Procedure and Administration (Collection, Bankruptcy & Summonses Division). For further information regarding this revenue ruling, contact Branch 1 of the Collection, Bankruptcy & Summonses Division at (202) 622-3610 (not a toll-free call).

### Section 6694.—Understatement of Taxpayer's Liability by Income Tax Return Preparer

Guidance is provided concerning when information shown on a return in accordance with the applicable forms and instructions will be adequate disclosure under section 6694(a) for purposes of reducing an understatement of income tax due to a return preparer's unrealistic position. See Rev. Proc. 2003-77, page 964.

# Part III. Administrative, Procedural, and Miscellaneous

## Qualified Interests

### Notice 2003-72

#### PURPOSE

This notice announces that the Internal Revenue Service will follow the Tax Court's decision in *Walton v. Commissioner*, 115 T.C. 589 (2000), holding that § 25.2702-3(e), *Example 5*, of the Gift Tax Regulations is invalid.

#### BACKGROUND

Section 2702 provides special rules for valuing gifts in trust when the donor or an applicable family member retains an interest in the trust. If the retained interest is not a qualified interest, the interest is valued at zero, and the amount of the gift is the entire value of the transferred property. If the retained interest is a qualified interest, the interest is valued under § 7520 using prescribed actuarial tables and interest rates, and the amount of the gift is the value of the transferred property reduced by the value of the retained interest. Under § 2702(b), a qualified interest is: (1) an interest that consists of a right to receive fixed amounts payable not less frequently than annually (a qualified annuity interest); (2) an interest that consists of a right, payable at least annually, to receive a fixed percentage of the net fair market value of the trust corpus determined annually (a qualified unitrust interest); and (3) a right to receive a non-contingent remainder interest if all other interests in the trust are qualified annuity or unitrust interests (a qualified remainder interest). Under § 25.2702-3(d)(3), the qualified annuity or unitrust interest must be payable, "for the life of the term holder, for a specified term of years, or for the shorter (but not longer) of those periods."

In *Example 5* of § 25.2702-3(e), *A* transfers property to an irrevocable trust, retaining the right to receive a unitrust amount for 10 years. If *A* dies within the 10-year term, the unitrust amount is to be paid to *A*'s estate for the balance of the term. The example concludes that *A*'s interest is a qualified unitrust interest to the extent of the right to receive the unitrust amount for 10 years or until *A*'s prior death. However, the unitrust amount

payable to *A*'s estate if *A* dies within the term of the trust is not a qualified interest.

In *Walton v. Commissioner*, the Tax Court considered a situation similar to that presented in *Example 5*. In *Walton*, the grantor established a grantor retained annuity trust, pursuant to which the grantor was to receive an annuity for a term of 2 years. If the grantor died before the expiration of the 2-year term, the annuity was to be paid to the grantor's estate for the balance of the term. Upon expiration of the 2-year term, the trust corpus was to be distributed to a designated remainder beneficiary. After considering the legislative history and purpose of § 2702, the Court held that *Example 5* is an unreasonable interpretation and invalid extension of § 2702. The Court concluded that a retained annuity payable for a specified term of years to the grantor, or to the grantor's estate if the grantor dies prior to expiration of the term, is a qualified interest under § 2702 for the specified term of years.

#### IRS ACQUIESCENCE

The IRS acquiesces in the Tax Court's decision. Accordingly, in the fact situation presented in § 25.2702-3(e), *Example 5*, the Internal Revenue Service will treat the retained unitrust interest payable to *A* or *A*'s estate as a qualified interest payable for a 10-year term. The regulations will be revised to conform to this notice.

#### DRAFTING INFORMATION

The principal author of this notice is Scott S. Landes of the Office of Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Mr. Landes at (202) 622-3090 (not a toll-free call).

*26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.*  
(Also Part I, §§ 6662, 6694; 1.6662-4, 1.6694-2.)

### Rev. Proc. 2003-77

#### SECTION 1. PURPOSE

This revenue procedure updates Rev. Proc. 2002-66, 2002-2 C.B. 724, and

identifies circumstances under which the disclosure on a taxpayer's return with respect to an item or a position is adequate for the purpose of reducing the understatement of income tax under § 6662(d) of the Internal Revenue Code (relating to the substantial understatement aspect of the accuracy-related penalty), and for the purpose of avoiding the preparer penalty under § 6694(a) (relating to understatements due to unrealistic positions). This revenue procedure does not apply with respect to any other penalty provisions (including the negligence or disregard provisions of the § 6662 accuracy-related penalty).

This revenue procedure applies to any return filed on 2003 tax forms for a taxable year beginning in 2003, and to any return filed on 2003 tax forms in 2004 for short taxable years beginning in 2004.

#### SECTION 2. CHANGES FROM REV. PROC. 2002-66

Section 4.01(4)(a) concerning Form 5713, *International Boycott Report*, has been revised and editorial changes have been made in updating Rev. Proc. 2002-66.

#### SECTION 3. BACKGROUND

.01 If § 6662 applies to any portion of an underpayment of tax required to be shown on a return, an amount equal to 20 percent of the portion of the underpayment to which the section applies is added to the tax. (The penalty rate is 40 percent in the case of gross valuation misstatements under § 6662(h).) Under § 6662(b)(2), § 6662 applies to the portion of an underpayment of tax that is attributable to a substantial understatement of income tax.

.02 Section 6662(d)(1) provides that there is a substantial understatement of income tax if the amount of the understatement exceeds the greater of 10 percent of the amount of tax required to be shown on the return for the taxable year or \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company). Section 6662(d)(2) defines an understatement as the excess of the amount of tax required to be shown on the return for the taxable year over the amount of the tax that is shown on the



return reduced by any rebate (within the meaning of § 6211(b)(2)).

.03 In the case of an item not attributable to a tax shelter, § 6662(d)(2)(B)(ii) provides that the amount of the understatement is reduced by the portion of the understatement attributable to any item with respect to which the relevant facts affecting the item's tax treatment are adequately disclosed in the return or in a statement attached to the return, and there is a reasonable basis for the tax treatment of such item by the taxpayer.

.04 Section 6694 imposes a penalty of \$250 on an income tax return preparer for filing a return or claim for refund that results in an understatement of liability due to a position for which the preparer knew or should have known that there was not a realistic possibility of being sustained on the merits and such position was not disclosed in accordance with § 6662(d)(2)(B)(ii).

.05 In general, this revenue procedure provides guidance for determining when disclosure is adequate for purposes of § 6662(d)(2)(B)(ii) and § 6694(a)(3). For purposes of this revenue procedure, the taxpayer must furnish all required information in accordance with the applicable forms and instructions, and the money amounts entered on these forms must be verifiable. Guidance under § 6662(d)(2)(B)(ii) and § 6694(a)(3) for returns filed for 2002, 2001, and 2000 is provided in Rev. Proc. 2002-66; Rev. Proc. 2001-52, 2001-2 C.B. 491; and Rev. Proc. 2001-11, 2001-1 C.B. 275, respectively.

## SECTION 4. PROCEDURE

.01 Additional disclosure of facts relevant to, or positions taken with respect to, issues involving any of the items set forth below is unnecessary for purposes of reducing any understatement of income tax under § 6662(d), provided that the forms and attachments are completed in a clear manner and in accordance with their instructions. The money amounts entered on the forms must be verifiable, and the information on the return must be disclosed in the manner described below. For purposes of this revenue procedure, a number is verifiable if, on audit, the taxpayer can demonstrate the origin of the number (even if that number is not ultimately accepted by

the Internal Revenue Service) and the taxpayer can show good faith in entering that number on the applicable form.

(1) Form 1040, Schedule A, *Itemized Deductions*:

(a) Medical and Dental Expenses: Complete lines 1 through 4, supplying all required information.

(b) Taxes: Complete lines 5 through 9, supplying all required information. Line 8 must list each type of tax and the amount paid.

(c) Interest Expenses: Complete lines 10 through 14, supplying all required information. This section 4.01(1)(c) does not apply to (i) amounts disallowed under § 163(d) unless Form 4952, *Investment Interest Expense Deduction*, is completed, or (ii) amounts disallowed under § 265.

(d) Contributions: Complete lines 15 through 18, supplying all required information. Enter the amount of the gift reduced by the value of any substantial benefit (goods or services) provided by the donee organization in consideration, in whole or in part. Entering the amount of the gift unreduced by the value of the benefit received will not constitute adequate disclosure. If a contribution of \$250 or more is made, this section 4.01(1)(d) will not apply unless a contemporaneous written acknowledgment, as required by § 170(f)(8), is obtained from the donee organization. If a contribution of property other than cash is made and the amount claimed as a deduction exceeds \$500, attach a properly completed Form 8283, *Noncash Charitable Contributions*, to the return.

(e) Casualty and Theft Losses: Complete Form 4684, *Casualties and Thefts*, and attach to the return. Each item or article for which a casualty or theft loss is claimed must be listed on Form 4684.

(2) Certain Trade or Business Expenses (including, for purposes of this section 4.01(2), the following six expenses as they relate to the rental of property):

(a) Casualty and Theft Losses: The procedure outlined in section 4.01(1)(e) above must be followed.

(b) Legal Expenses: The amount claimed must be stated. This section 4.01(2)(b) does not apply, however, to amounts properly characterized as capital expenditures, personal expenses, or non-deductible lobbying or political expenditures, including amounts that are

required to be (or that are) amortized over a period of years.

(c) Specific Bad Debt Charge-off: The amount written off must be stated.

(d) Reasonableness of Officers' Compensation: Form 1120, Schedule E, *Compensation of Officers*, must be completed when required by its instructions. The time devoted to business must be expressed as a percentage as opposed to "part" or "as needed." This section 4.01(2)(d) does not apply to "golden parachute" payments, as defined under § 280G. This section 4.01(2)(d) will not apply to the extent that remuneration paid or incurred exceeds the \$1 million-employee-remuneration limitation, if applicable.

(e) Repair Expenses: The amount claimed must be stated. This section 4.01(2)(e) does not apply, however, to any repair expenses properly characterized as capital expenditures or personal expenses.

(f) Taxes (other than foreign taxes): The amount claimed must be stated.

(3) Form 1120, Schedule M-1, *Reconciliation of Income (Loss) per Books With Income per Return*, provided:

(a) The amount of the deviation from the financial books and records is not the result of a computation that includes the netting of items; and

(b) The information provided reasonably may be expected to apprise the Internal Revenue Service of the nature of the potential controversy concerning the tax treatment of the item.

(4) Foreign Tax Items:

(a) International Boycott Transactions: Transactions disclosed on Form 5713, *International Boycott Report*. Schedule A, *International Boycott Factor (Section 999(c)(1))*; Schedule B, *Specifically Attributable Taxes and Income (Section 999(c)(2))*; and Schedule C, *Tax Effect of the International Boycott Provisions*, must be completed when required by their instructions.

(b) Treaty-Based Return Position: Transactions and amounts under § 6114 or § 7701(b) as disclosed on Form 8833, *Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)*.

(5) Other:

(a) Moving Expenses: Complete Form 3903, *Moving Expenses*, and attach to the return.

(b) Employee Business Expenses: Complete Form 2106, *Employee Business*

*Expenses*, or Form 2106-EZ, *Unreimbursed Employee Business Expenses*, and attach to the return. This section 4.01(5)(b) does not apply to club dues, or to travel expenses for any non-employee accompanying the taxpayer on the trip.

(c) Fuels Credit: Complete Form 4136, *Credit for Federal Tax Paid on Fuels*, and attach to the return.

(d) Investment Credit: Complete Form 3468, *Investment Credit*, and attach to the return.

#### SECTION 5. EFFECTIVE DATE

This revenue procedure applies to any return filed on 2003 tax forms for a taxable year beginning in 2003, and to any return filed on 2003 tax forms in 2004 for short taxable years beginning in 2004.

#### SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is John Moran of the Office

of Associate Chief Counsel, Procedure & Administration (Administrative Provisions & Judicial Practice Division). For further information regarding this revenue procedure, contact Branch 2 of the Administrative Provisions & Judicial Practice Division at (202) 622-4940 (not a toll-free call).

## Part IV. Items of General Interest

### Notice of Proposed Rulemaking and Notice of Public Hearing

#### Treatment of Services Under Section 482; Allocation of Income and Deductions From Intangibles

**REG-146893-02;**  
**REG-115037-00**

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance regarding the treatment of controlled services transactions under section 482 and the allocation of income from intangibles, in particular with respect to contributions by a controlled party to the value of an intangible that is owned by another controlled party. These proposed regulations potentially affect controlled taxpayers within the meaning of section 482. The proposed regulations provide updated guidance that is necessary to reflect economic and legal developments since the issuance of the current guidance. This document also provides a notice of public hearing on these proposed regulations.

DATES: Written or electronic comments must be received December 9, 2003. Outlines of topics to be discussed at the public hearing scheduled for January 14, 2004, at 10 a.m. must be received by December 23, 2003.

ADDRESSES: Send submissions to CC:PA:LPD:PR (REG-146893-02 and REG-115037-00), room 5203, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to: CC:PA:LPD:PR (REG-146893-02 and REG-115037-00), Courier's desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20044. Alternatively, taxpayers may submit electronic comments directly to the IRS Internet site at

[www.irs.gov/regs](http://www.irs.gov/regs). The public hearing will be held in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, J. Peter Luedtke or Helen Hong-George, (202) 435-5265; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Sonya M. Cruse, (202) 622-7180 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background

Section 482 of the Internal Revenue Code generally provides that the Secretary may allocate gross income, deductions and credits between or among two or more taxpayers owned or controlled by the same interests in order to prevent evasion of taxes or to clearly reflect income of a controlled taxpayer. Comprehensive regulations under section 482 published in the **Federal Register** (T.D. 6952, 1968-1 C.B. 218 [33 FR 5849]) on April 16, 1968, provided guidance with respect to a wide range of controlled transactions, including transfers of tangible and intangible property and the provision of services. Revised and updated transfer pricing regulations were published in the **Federal Register** (T.D. 8552, 1994-2 C.B. 93 [59 FR 34971], T.D. 8632, 1996-1 C.B. 85 [60 FR 65553], and T.D. 8670, 1996-1 C.B. 99 [61 FR 21955]) on July 8, 1994, December 20, 1995, and May 13, 1996.

##### A. Services Transactions

While comprehensive in other respects, the regulations issued in the mid-1990s did not modify substantively the 1968 regulations relating to controlled services transactions. The current services regulations at §1.482-2(b) provide generally that where one member of a controlled group performs services for the benefit of another member without charge, or at a charge that is not equal to an arm's length charge, the Commissioner may make appropriate allocations to reflect an arm's length charge for such services. The determination of the arm's length

charge depends on whether the services transaction is an "integral part" of the business of the renderer or recipient of the services. The current services regulations provide several overlapping quantitative and qualitative tests to determine whether a services transaction is integral.

Under the current services regulations, the arm's length charge for non-integral services is deemed to be equal to the "costs or deductions" incurred with respect to the services, unless the taxpayer establishes that another charge is more appropriate. General guidance is provided regarding the definition of cost and the appropriate allocation of costs to particular services.

The arm's length charge for integral services under the current services regulations is "the amount which was charged or would have been charged for the same or similar services in independent transactions with or between unrelated parties under similar circumstances considering all relevant facts." No guidance is provided regarding the methods that may be used to determine whether a charge is consistent with an arm's length charge.

##### B. Income Attributable to Intangibles

The Treasury Department and the IRS issued final regulation §1.482-4(f)(3) as part of the 1994 regulations. The preamble to those regulations states that the rules of §1.482-4(f)(3) were necessary in order "to identify the controlled taxpayer that should recognize the income attributable to intangible property." Section 1.482-4(f)(3) identifies that party by providing rules to determine the owner, for section 482 purposes, of the rights to exploit an intangible to which income was attributable. Under those rules, the legal owner of an intangible, the taxpayer with a right to exploit the intangible, and even a taxpayer that contributes to the development or enhancement of the intangible could be deemed "owners" of that intangible, entitled to a portion of the income attributable to the intangible.

#### Explanation of Provisions

##### A. Overview

These proposed regulations provide updated guidance under section 482

that replaces existing guidance under §1.482–2(b) relating to controlled services transactions and existing guidance under §1.482–4(f)(3) relating to the allocation of income attributable to intangible property. These proposed regulations also make conforming and other changes to provisions of the current regulations under sections 482 and 6662 that are related to this guidance.

### *1. Services Transactions*

These proposed regulations provide updated guidance under section 482 relating to controlled services transactions. The Treasury Department and the IRS believe that such guidance is necessary to reflect economic and legal developments since the issuance of the 1968 regulations. In the last 35 years, cross-border services have become an increasingly large and important segment of the U.S. and global economies. In particular, cross-border services transactions make up an increasingly significant segment of cross-border transactions among members of controlled groups.

Legal developments in the transfer pricing area since 1968 include the amendment of section 482 in 1986 to provide for the commensurate with income standard in the context of transfers of intangible property and the issuance in the mid-1990s of updated transfer pricing regulations addressing transactions other than services transactions. In addition, also in the mid-1990s, the OECD published updated transfer pricing guidelines for use by countries in the resolution of transfer pricing cases in mutual agreement proceedings under tax treaties.

These proposed regulations provide generally that the arm's length amount charged in a controlled services transaction must be determined under one of the transfer pricing methods provided for or referenced in the proposed regulations. The guidance regarding transfer pricing methods provided for in the proposed regulations generally is consistent with the current regulatory guidance regarding the transfer pricing methods applicable to transfers of tangible or intangible property and is consistent with international standards in this area. In addition, the proposed regulations provide a new cost-based method that may be used

to price low-margin controlled services transactions that meet certain quantitative and qualitative conditions and requirements. This simplified cost-based method generally requires a less robust analysis of services transactions within its scope than would be required under the other pricing methods. The simplified method is intended to preserve aspects of the current rules that provide appropriately reduced administrative and compliance burdens for low-margin services while bringing the current rules more into line with the arm's length standard and eliminating aspects of the current rules that have proved problematic.

The proposed regulations provide updated guidance consistent with international standards in this area on the threshold issue of whether activities constitute the rendering of services for the benefit of another member of a controlled group.

The proposed regulations provide guidance to better coordinate and harmonize the rules applicable to services transactions with the rules for other types of transactions under section 482, in particular transfers of intangible property. The Treasury Department and the IRS believe that such guidance is necessary to mitigate the extent to which the form or characterization of a transfer of intangibles as the rendering of services can lead to inappropriate results. The Treasury Department and the IRS believe that the transfer pricing rules should reach similar results in the case of economically similar transactions, regardless of the characterization or structuring of such transactions. Thus, several provisions of the proposed regulations are intended to minimize or to eliminate the differences between the transfer pricing analysis of services transactions related to intangibles and the analysis of transfers of intangible property. In particular, the proposed regulations provide that the arm's length result for a services transaction that effects the transfer of intangible property must be determined or corroborated by an analysis under the transfer pricing rules for transfers of intangible property. In addition, the proposed regulations limit the use of the simplified cost-based method in the case of services that involve the use of valuable intangibles. The proposed regulations also provide guidance regarding

the use or imputation of contingent-payment arrangements in the context of services transactions, and provide generally applicable guidance on the application of the residual profit split method to make that method more suitable to the analysis of services transactions where appropriate. The cumulative effect of these provisions is to make available in connection with the transfer pricing of controlled services relating to intangibles the analytical tools that are available in connection with the transfer pricing of transfers of intangible property, including the possibility of analyzing transactions as multi-year arrangements in which the consideration for services rendered in one tax accounting period may be due in later periods.

### *2. Income Attributable to Intangibles*

These proposed regulations also update guidance under existing §1.482–4(f)(3) relating to the allocation of income attributable to intangible property. The taxpayers and other commentators have criticized the framework of §1.482–4(f)(3). In particular, commentators have questioned the use of ownership for purposes of section 482, as distinct from legal ownership or ownership for tax purposes more generally, as an analytical tool for determining the appropriate allocation of income attributable to an intangible. The Treasury Department and the IRS believe that existing §1.482–4(f)(3), when properly applied, generally reaches appropriate results in allocating income attributable to intangible property. However, the Treasury Department and the IRS are concerned that the regulation may be misapplied to reach “all or nothing” results based on a determination of ownership in cases where an arm's length analysis in accordance with the section 482 regulations would require that the income attributable to an intangible be divided among the controlled taxpayers that made significant contributions to develop or enhance that intangible, and that hold legal rights with respect to that intangible.

As a result, the Treasury Department and the IRS believe that the analytical framework of §1.482–4(f)(3) should be modified. The rules for determining the ownership of an intangible generally should be distinct from the rules for determining the allocation of income from an intangible. The income attributable to

an intangible should be allocated among controlled taxpayers under the arm's length standard, in accordance with each party's contributions to the development or enhancement of that intangible and its ownership interests (if any). This analysis generally will preclude "all or nothing" results. The proposed modifications to §1.482-4(f)(3) are possible because of proposed changes to the treatment of controlled services transactions, in particular the conditions and requirements on the use of the simplified cost-based method and the provisions intended to better coordinate and harmonize the rules applicable to services transactions with the rules for transfers of intangible property (including guidance on services that effect transfers of intangible property and guidance on the residual profit split method and contingent payment arrangements).

## *B. Services Transactions—§1.482-9*

### *1. General Rule—§1.482-9(a)*

Consistent with the rules governing transfers of tangible and intangible property under existing §§1.482-3 and 1.482-4, respectively, proposed §1.482-9(a) provides that the arm's length amount charged in a controlled services transaction must be determined under one of the methods described or referenced in the proposed regulations. Also consistent with the rules governing transfers of tangible and intangible property, the proposed regulations provide guidance concerning selection and application of the appropriate method by explicitly incorporating the general rules in §1.482-1 (including the best method rule of §1.482-1(c), the comparability analysis of §1.482-1(d), and the arm's length range of §1.482-1(e)) of the existing regulations.

The proposed regulations specify six methods applicable to controlled services transactions. Proposed §1.482-9(a) sets out four new methods applicable to services: the comparable uncontrolled services price method, the gross services margin method, the cost of services plus method, and the simplified cost-based method. The first three methods are direct analogs of methods provided for transfers of tangible property under existing §1.482-3, tailored to account for

particular circumstances in services transactions. The fourth method, the simplified cost-based method, is set forth in proposed §1.482-9(f). Proposed §1.482-9(a) also specifies that the comparable profits method under existing §1.482-5 and the profit split methods under existing §1.482-6, as modified by proposed §1.482-9(e) and (g) respectively, are applicable to services. Finally, proposed §1.482-9(a)(7) indicates that unspecified methods also may be used in appropriate circumstances, as prescribed by proposed §1.482-9(h).

Proposed §1.482-9(a)(1) provides that the general rules under §1.482-1 of the existing regulations, including the best method rule of existing §1.482-1(c), the comparability standards of existing §1.482-1(d), and the rules regarding determination of an arm's length range under existing §1.482-1(e), generally apply to the determination of an appropriate arm's length charge for controlled services transactions. The best method rule under existing §1.482-1(c) provides that an arm's length result must be determined under the method that, given the facts and circumstances, provides the most reliable measure of an arm's length result. Existing §1.482-1(c)(2) provides two primary factors to consider in determining which method is the most reliable: the degree of comparability between the controlled transactions and any uncontrolled comparables, and the quality of data and assumptions used in the analysis.

The proposed regulations incorporate the comparability factors in existing §1.482-1(d) because these factors generally are relevant under all methods. In addition, the description of each of the methods set out in the proposed regulations provides other comparability factors that may be of particular importance in the context of that method as applied to a controlled services transaction.

### *2. Comparable Uncontrolled Services Price Method—§1.482-9(b)*

Proposed §1.482-9(b) sets forth the comparable uncontrolled services price method. This method evaluates whether a controlled services transaction satisfies the arm's length standard by comparing the price of a controlled services transaction with the price charged in a comparable

uncontrolled services transaction. This method is analogous to the comparable uncontrolled price method of §1.482-3(b) in the context of transfers of tangible property. Proposed §1.482-9(b)(1) provides that this method ordinarily is used where the controlled services are identical to or have a high degree of similarity to the services in the uncontrolled transaction.

The proposed regulations provide that all of the comparability factors described in existing §1.482-1(d) must be considered, but emphasize that similarity in the nature of the services and valuable intangibles used, if any, in providing the services are the most important factors in determining comparability under this method. Consistent with the best method rule, proposed §1.482-9(b)(2)(ii) provides that the comparable uncontrolled services price method generally provides the most direct and reliable measure of an arm's length result if an uncontrolled transaction either has no differences from the controlled services transaction or has only minor differences that have a definite and reasonably ascertainable effect on price, and appropriate adjustments may be made for such differences. Proposed §1.482-9(b)(4) provides several examples that illustrate the application of the comparable uncontrolled services price method to cases in which the comparable uncontrolled transactions are internal or external.

The Treasury Department and the IRS recognize that, under certain circumstances, uncontrolled parties may use proprietary pricing models or other indirect methods to establish the price charged to uncontrolled parties in a services transaction. Proposed §1.482-9(b)(5) provides that such data may be used as indirect evidence of a comparable uncontrolled services price if certain requirements are met. This provision is analogous to the provision regarding indirect evidence of comparable uncontrolled prices in §1.482-3(b)(5) in the context of transfers of tangible property.

### *3. Gross Services Margin Method—§1.482-9(c)*

Proposed §1.482-9(c) sets forth the gross services margin method. This method evaluates the arm's length price

charged in a controlled services transaction by reference to the gross services profit margin realized in uncontrolled transactions that involve similar services. Similar to the resale price method provided for in §1.482-3(c) in the context of transfers of tangible property, the charge under this method is calculated based on the price paid in an underlying and related uncontrolled transaction undertaken by the controlled group.

Proposed §1.482-9(c)(1) provides guidance regarding the circumstances in which this method ordinarily would be used. This method ordinarily is used in cases where a controlled taxpayer performs functions or services in connection with a “related uncontrolled transaction” between a member of the controlled group and an uncontrolled taxpayer. For example, this method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with a transaction between that other member and an uncontrolled taxpayer. This method also may be used in cases where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer (intermediary function) and another member of the controlled group actually performs the services provided.

Proposed §1.482-9(c)(2)(i) provides that the gross services margin method evaluates whether the price charged or amount retained by a controlled taxpayer is arm’s length by determining the “appropriate gross services profit” of the controlled taxpayer. If one controlled taxpayer renders services to another member of a controlled group with respect to a transaction between that other member of the controlled group and an uncontrolled taxpayer, the price charged to the other member under the gross services margin method is the appropriate gross services profit of the controlled taxpayer that performed the agent services. In cases where one controlled taxpayer contracts to provide services to an uncontrolled taxpayer and another member of the controlled group actually performs those services, the price charged to the controlled intermediary under the gross services margin method is determined by subtracting from the “applicable uncontrolled price” the appropriate gross services profit of the intermediary controlled taxpayer.

Proposed §1.482-9(c)(2)(ii) and (iii) define the terms “related uncontrolled transaction,” “applicable uncontrolled price” and “appropriate gross services profit,” which are necessary to determine the arm’s length price under proposed §1.482-9(c)(2)(i). The related uncontrolled transaction is a transaction between a member of the controlled group and an uncontrolled taxpayer as to which a controlled taxpayer performs agent services or an intermediary function. The applicable uncontrolled price is the final sales price paid by the uncontrolled party in the related uncontrolled transaction. Proposed §1.482-9(c)(2)(iii) provides that the appropriate gross services profit is calculated by multiplying the applicable uncontrolled price by the gross services profit margin earned in comparable uncontrolled services transactions. The gross services profit margin takes into account all functions performed by other members of the controlled group and any other relevant factors.

The proposed regulations incorporate the general comparability factors of existing §1.482-1(d) in determining comparability under this method. Proposed §1.482-9(c)(3)(ii)(A) emphasizes that comparability under the gross services margin method is particularly dependent on similarity of functions performed, risks borne, intangibles used (if any), and contractual terms, as all these factors may materially affect the gross services profit margin.

In determining comparability, the proposed regulations state that where the controlled taxpayer provides services similar to a sales or purchasing agent, this method is less dependent on close similarity in the underlying property transferred or the services provided to the uncontrolled party. However, substantial differences in the nature of the property transferred or the services provided to the uncontrolled party may indicate significant differences in the functions performed by the controlled taxpayer. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve agent or intermediary services involving the transfer of goods within the same product categories, or the provision of services of the same general type.

In addition, the proposed regulations provide that if the functions performed by

a controlled taxpayer are similar to those performed by an uncontrolled taxpayer, then the gross profit margin earned by the uncontrolled taxpayer may be used as a comparable gross services profit margin regardless of the structure of the uncontrolled services transaction. For example, proposed §1.482-9(c)(3)(ii)(D) provides that if a controlled taxpayer that functions as a sales or purchasing agent for transfers of tangible property is comparable to a distributor that takes title to goods and resells them (*i.e.*, a buy-sell distributor), then the gross profit margin earned by the uncontrolled distributor on sales, stated as a percentage of the uncontrolled price paid for the goods, may be used as the comparable gross services profit margin.

Proposed §1.482-9(c)(4) provides examples that illustrate various aspects of the application of the gross services margin method.

#### 4. *Cost of Services Plus Method—§1.482-9(d)*

Proposed §1.482-9(d) sets forth the cost of services plus method. This method evaluates whether the amount charged in a controlled services transaction is arm’s length by reference to the gross services profit markup in comparable uncontrolled services transactions. The proposed regulations provide that this method is most reliably applied when the renderer in the controlled services transaction provides the same or similar services to both controlled and uncontrolled parties.

The cost of services plus method under proposed §1.482-9(d) is similar to the cost plus method applicable to transfers of tangible property under existing §1.482-3(d). The proposed regulations, however, incorporate certain modifications that are necessary because the manner in which the costs of providing services are presented for financial accounting purposes is less uniform than the manner in which costs of goods sold are presented for such purposes. The proposed regulations refer to the costs to be taken into account in evaluating controlled services transactions as “comparable transactional costs.” Proposed §1.482-9(d)(2)(ii) defines comparable transactional costs to include all costs of providing the services that are taken into account as the basis for determining the gross services profit markup in

comparable uncontrolled services transactions. The Treasury Department and the IRS intend this definition to be flexible to ensure that reasonably equivalent categories of costs will be used to determine gross services profit in particular cases. Consequently, the proposed regulations provide that in some circumstances comparable transactional costs may constitute a subset of the total services costs (as defined in proposed §1.482-9(j)). Generally accepted accounting principles or income tax accounting rules (where income tax data for comparable transactions are available) may provide a useful starting point but will not be conclusive.

The proposed regulations incorporate the general comparability factors of existing §1.482-1(d) and provide several specific rules to ensure appropriate results under this method. For example, proposed §1.482-9(d)(3)(ii)(A) provides that in determining functional comparability between the tested transaction and uncontrolled transactions, it may be necessary to consider the charge determined under the cost of services plus method expressed in the form of a markup on total services costs of the controlled taxpayer and uncontrolled parties. The Treasury Department and the IRS believe that this confirming analysis will prevent inappropriate results where the uncontrolled transactions incorporate functional differences that are reflected in costs that are not included in comparable transactional costs. In addition, proposed §1.482-9(d)(3)(ii)(B) states that reliability under this method will be reduced if a significant amount of the controlled taxpayer's comparable transactional costs consists of costs incurred in a tax accounting period other than the period under review. The Treasury Department and the IRS believe that in such cases application of this method may produce unreliable results.

The proposed regulations further provide that if, in applying this method, the controlled taxpayer and the comparable parties do not state their respective costs of providing the services on an equivalent basis, adjustments will be necessary to ensure reliability of the results. Proposed §1.482-9(d)(3)(iii)(B) notes that where such adjustments are not possible, the reliability of the results determined under this method will be reduced.

Proposed §1.482-9(d)(4) provides examples that illustrate various aspects of the application of the cost of services plus method.

#### 5. *Comparable Profits Method—§1.482-9(e)*

The proposed regulations specify that the comparable profits method may be applied to controlled services. The comparable profits method evaluates whether the amount charged in a controlled services transaction is arm's length based on analysis of objective measures of profitability (profit level indicators) derived from financial information regarding uncontrolled taxpayers that engage in similar business activities under similar circumstances.

The proposed regulations provide that the guidance in existing §1.482-5 generally is applicable to controlled services transactions. Proposed §1.482-9(e) provides specific guidance that tailors the application of §1.482-5 in cases in which the tested party under existing §1.482-5(b)(2) is the renderer of the services under review. In all other cases, including cases in which the tested party is the recipient of controlled services, the provisions of existing §1.482-5 apply without regard to §1.482-9(e).

Proposed §1.482-9(e) permits the application of the various profit level indicators provided in existing §1.482-5(b)(4)(ii) to controlled services transactions. As noted in existing §1.482-5(b)(4), whether the use of a particular profit level indicator is appropriate depends upon a number of factors, including the extent to which the profit level indicator is likely to produce a reliable measure of the income that the tested party would have earned had it dealt with controlled taxpayers at arm's length. In this regard, caution should be exercised in applying these profit level indicators to controlled services transactions. For example, application of the rate of return on capital employed profit level indicator may produce unreliable results because the reliability of this profit level indicator decreases as operating assets play a lesser role in generating operating profits for both the tested party and the uncontrolled comparable. In addition, reliability under this profit level indicator depends on the

extent to which the composition of the tested party's assets is similar to that of the uncontrolled comparable.

With respect to financial ratios, the lack of uniformity regarding the presentation for financial accounting purposes of costs of providing services (as noted in the description of cost of services plus method above) and the limited availability of detailed information regarding the cost accounting practices of uncontrolled parties suggest that the reliability of the profit level indicators that depend on segmentation of such costs may be reduced. Existing §1.482-5(c)(3) states that the reliability of results derived from the comparable profits method is affected by the quality of the data used to apply this method. Due to the lack of uniformity regarding the presentation for financial accounting purposes of costs of providing services, it may be difficult to determine, for example, whether costs included in costs of goods sold or operating expenses reported by uncontrolled taxpayers are in fact comparable to the corresponding costs incurred by the controlled taxpayer in the relevant business activity. Consequently, an arm's length charge determined by use of the ratio of gross profit to operating expenses as a profit level indicator may not be reliable.

Proposed §1.482-9(e)(2)(ii) describes a new profit level indicator that may be more reliable in the context of controlled services transactions. The proposed regulations define this profit level indicator as the ratio of operating profits to total services costs (defined in proposed §1.482-9(j)), or the markup on total costs (also referred to as the "net cost plus"). This new profit level indicator evaluates operating profits based on a markup on all costs related to the provision of services. This new profit level indicator is more likely to result in a cost base used to determine the controlled taxpayer's comparable operating profit that is comparable to the cost base used by uncontrolled parties to calculate their operating profits in similar business activities.

The proposed regulations state that the degree of consistency in accounting practices between the controlled services transaction and the uncontrolled transaction will affect the reliability of the results under this method. If appropriate adjustments to account for such differences are not possible, the reliability of the results

determined under this method will be reduced.

Proposed §1.482-9(e)(3) provides examples that illustrate various aspects of the application of the comparable profits methods to controlled services transactions.

## 6. Simplified Cost-Based Method—§1.482-9(f)

### a. Overview

The proposed regulation provides for a new simplified cost-based method for low-margin services, such as routine back-office services. This simplified method is intended by the Treasury Department and the IRS to serve the same purpose as the current regulations relating to the pricing of non-integral services by providing reduced compliance and administrative burdens with respect to the transfer pricing of low-margin services. Such reduced burdens allow both taxpayers and the IRS to direct their resources appropriately to other issues. The Treasury Department and the IRS believe, however, that certain aspects of the rules in the current regulations intended to deal with low-margin services are problematic and therefore should be modified. In particular, the current regulations in some cases have been interpreted or applied to reach inappropriate results from a policy perspective by allowing high-margin controlled services to be priced at cost. Further, the qualitative and subjective tests in the current regulations for determining whether a controlled service may be priced at cost have been difficult to apply and have led to disputes.

Therefore, while the simplified method is intended to maintain reduced compliance and administrative burdens with respect to the pricing of low-margin services, it differs from the current rules regarding the pricing of low-margin services in significant respects. In particular, the simplified method is based on comparability principles, and the administrative benefits of the simplified method decrease as the margins attributable to the service at issue increase. Thus, the simplified method is more consistent with the arm's length standard and will limit significantly the potential for arbitrariness and controversy that makes the current rules problematic.

### b. General Description of Method—§1.482-9(f)(1)

The simplified method allows services that meet certain requirements and conditions to be priced by reference to the markup on total services costs of uncontrolled taxpayers that engage in similar business activities under similar circumstances. The markup on total services costs under the simplified cost-based method corresponds to the profit level indicator of the ratio of operating profit to total services costs, or net cost plus, which is provided for under the comparable profits method for services in proposed §1.482-9(e). Proposed §1.482-9(f)(1)(i) provides that if a controlled services transaction that meets the conditions and requirements of proposed §1.482-9(f) is priced under the simplified method, that method will be considered the best method for purposes of §1.482-1(c). In effect, the conditions and requirements for the application of the simplified method are a substitute for a traditional best method analysis.

### c. Limitation on Allocations by the Commissioner—§1.482-9(f)(2)

The distinguishing feature of the simplified method is a limitation on the ability of the Commissioner to make allocations that he could otherwise make under the general transfer pricing rules. Proposed §1.482-9(f)(2)(i) provides generally that the Commissioner may make an allocation under the simplified method only if the arm's length markup on total costs, as determined by the Commissioner under the general transfer pricing rules, exceeds the markup charged by the taxpayer by at least a specified number of percentage points. This "applicable number of percentage points" is six if the amount charged by the taxpayer is equal to total costs, and it declines ratably to zero by one percentage point for every increase of two percentage points in the markup on total costs charged by the taxpayer. Thus, for example, if a taxpayer prices controlled services at cost under this method, the Commissioner may make an allocation only if the arm's length markup on total costs is at least 6 percent. As the markup charged by the taxpayer on the controlled

services approaches 10 percent, the applicable number of percentage points declines ratably to zero. This ensures that only relatively low-margin services benefit from the simplified method. Proposed §1.482-9(f)(2)(iii) also provides an upper bound for the application of the simplified method of 10 percent. Thus, in no event would the Commissioner be limited under this method in making an allocation if the arm's length markup on total costs exceeds 10 percent. Proposed §1.482-9(f)(2)(iv) provides equations and a table with respect to these rules, and proposed §1.482-9(f)(5) provides several examples that describe and illustrate the application of these rules.

The Treasury Department and the IRS intend these quantitative rules, applied in conjunction with the other requirements for and conditions on the application of the simplified method, to provide objective, administrable guidance for determining whether controlled services may be priced under the simplified method rather than subject to a full transfer pricing analysis, including an analysis under the best method rule. Further, because the benefits of the simplified method decline as the margin attributable to the service increases, the pricing of a relatively high-margin controlled service under the simplified method converges with that under a full transfer pricing analysis. The objective of these quantitative rules is to provide a sufficient range with respect to the pricing of low-margin services to maintain appropriately reduced compliance and administrative burdens with respect to such services, while safeguarding against the inappropriate application of the simplified method to services that should be subject to a more robust arm's length analysis.

The simplified method does not grant authority to the Commissioner to make allocations that could not be made under the general transfer pricing rules. Thus, the qualitative rules of the simplified method apply in conjunction with, and not in lieu of, the interquartile range that may be available under certain other transfer pricing methods. For example, if the markup charged by the taxpayer on a controlled services transaction exceeds the arm's length markup by more than the applicable number of percentage points but is within the interquartile range of results



under a best method analysis, the Commissioner may not make an allocation with respect to the underlying service. This interaction between the upper bound and the interquartile range further ensures that the benefits of the simplified method are focused on relatively low-margin services because the arm's length range can be expected to provide a wider tolerance band than the applicable number of percentage points as the markup on total services costs approaches 10 percent.

These limitations on the Commissioner's authority to make an allocation apply only if the markup charged in the controlled transaction is less than the arm's length markup. If instead the markup charged in the controlled transaction exceeds the arm's length markup, proposed §1.482-9(f)(2)(v) provides that the limitation on the Commissioner under the simplified method does not apply to prevent the Commissioner from making an allocation.

Further, proposed §1.482-9(f)(2)(v)(A) provides that the limitation on the Commissioner does not apply to prevent an allocation if the amount charged by the taxpayer is less than the "total services costs" in the controlled services transaction. The Treasury Department and the IRS believe that it is appropriate to subject controlled services that are priced at less than cost to a full transfer pricing analysis.

Finally, proposed §1.482-9(f)(2)(v)(B) provides that the Commissioner's authority to determine the cost base is not limited if the taxpayer's method of determining, allocating and apportioning costs is not consistent with the methods used by similar uncontrolled taxpayers in similar circumstances. This authority, which is similar to the Commissioner's authority under existing §1.482-2(b)(4) to make appropriate allocations of costs, constitutes an important safeguard on the reliability of the results determined under the simplified cost-based method. Consistent with the purpose of the simplified method — to provide certainty concerning the pricing of low-margin controlled services, and to reduce the number of disputes where taxpayers make a good faith effort to price qualifying services under this method — the Treasury Department and the IRS anticipate that the Commissioner will exercise

this authority to correct an erroneous allocation only where that allocation has a significant impact on the amount of consideration in the controlled transaction.

In all cases in which the Commissioner's authority to make an allocation is not limited by the simplified method, allocations nevertheless must be consistent with the arm's length standard and otherwise appropriate under the generally applicable transfer pricing rules.

Proposed §1.482-9(f)(5) provides examples that illustrate the application of the rules in proposed §1.482-9(f)(2).

#### *d. Conditions on Use of Simplified Method—§1.482-9(f)(3)*

There are two conditions on the application of the simplified method. Proposed §1.482-9(f)(3) provides that taxpayers must maintain adequate books and records with respect to the determination and allocation of total costs, and subject to a *de minimis* exception must have a written contract in place that provides for current compensation for the services. The written-contract requirement ensures that the controlled taxpayers allocate risks attributable to the services transaction before the relevant services are rendered, and ensure in particular that the service renderer does not bear risks in a manner that would be inconsistent with the charging of a relatively low margin on total costs. The Treasury Department and the IRS believe that many large and mid-size taxpayers already have in place such basic agreements for controlled services transactions, or can execute such contracts without incurring undue expense. Thus, the written-contract requirement is not intended to impose significant compliance burdens on such taxpayers, or to limit their ability to use this method in appropriate cases.

The Treasury Department and the IRS recognize that the written-contract requirement could impose an undue burden on smaller taxpayers or on taxpayers that choose to apply the simplified method to a limited amount of services. Accordingly, the proposed regulations provide that the written-contract requirement does not apply to taxpayers that are members of a U.S. controlled group with an annual gross income of less than \$200 million, or to taxpayers that apply the simplified method to services whose aggregate costs

are less than \$10 million. In order to apply the simplified method in the absence of a written contract, however, the conduct of the parties to the services transaction must be consistent with an agreement that provides for current compensation of the services.

#### *e. Transactions Not Eligible for Simplified Method—§1.482-9(f)(4)*

The Treasury Department and the IRS intend the simplified method to apply only to low-margin controlled services for which total costs constitute an appropriate reference point for determining profitability. The arm's length charge for other controlled transactions is more appropriately determined under another transfer pricing method, subject to the best method rule. The proposed regulations identify categories of transactions that are not eligible to be priced under this method. The Treasury Department and the IRS believe that the simplified method should not be available for such transactions because they tend to be high-margin transactions, transactions for which total costs constitute an inappropriate reference point for determining profitability, or other types of transactions that should be subject to the more robust arm's length analysis, including an analysis under the best method rule. The Treasury Department and the IRS anticipate that, in general, controlled services that are priced at cost under an application of the existing regulations that is consistent with the intent of those regulations should qualify to be analyzed under the simplified method.

Proposed §1.482-9(f)(4)(i) provides that controlled services that are similar to those provided to uncontrolled parties by either the renderer or the recipient are not eligible for the simplified cost-based method. This rule is similar to the rule of existing §1.482-2(b)(7)(i), which has not led to compliance or administrative difficulties because taxpayers generally will have access to internal information concerning the comparable uncontrolled price of such services.

Proposed §1.482-9(f)(4)(ii) provides that controlled services provided to a recipient that receives controlled services in significant amounts are not eligible to be evaluated under the simplified method. This rule is similar to the rule in existing

§1.482-2(b)(7)(iv) but has been simplified and narrowed in scope, and therefore should apply in fewer cases. The Treasury Department and the IRS believe that services routed through conduits or intermediaries should be subject to a full transfer pricing analysis.

Proposed §1.482-9(f)(4)(iii) provides that controlled services that involve the use of valuable or unique intangibles are ineligible for the simplified method if such intangibles contribute significantly to the value of the services and the costs associated with such intangibles are not reflected in the costs relating to the rendering of the services. The Treasury Department and the IRS believe that such services are likely to have values substantially in excess of their cost and therefore categorically should be subject to a full transfer pricing analysis. The Treasury Department and the IRS anticipate that there will be significant overlap between this rule and the 10 percent rule in proposed §1.482-9(f)(2)(iii); that is, the arm's length markup on total costs with respect to such services is likely to exceed 10 percent.

Proposed §1.482-9(f)(4)(iv) provides that controlled services that are combined with other types of controlled transactions, such as a transfer of tangible or intangible property, are not eligible for the simplified method to the extent of those other transactions. The Treasury Department and the IRS intend the application of the simplified method to be limited to low-margin services transactions.

Proposed §1.482-9(f)(4)(v) identifies several specific types of transactions that are not eligible for the simplified method. The first four types — manufacturing, production, extraction, and construction services — are identical to types of transactions excluded from eligibility for pricing at cost under existing §1.482-2(b)(7)(ii)(A). Such services generally constitute core profit-making functions of an enterprise. The Treasury Department and the IRS therefore believe that such services should continue to be subject to a full transfer pricing analysis.

Also not eligible for the simplified method are reselling, distribution, or similar activities conducted under a commission or other arrangement, as well as financial transactions, including guarantees, and insurance or reinsurance. The

Treasury Department and the IRS believe that it is not appropriate to apply the simplified method to such transactions because total costs generally constitute an inappropriate reference point for determining profitability with respect to such transactions.

Finally, research and development, experimentation, engineering or scientific services are excluded from the simplified method. The Treasury Department and the IRS believe that such services may in a significant number of cases involve valuable intangibles and therefore should be subject to a full transfer pricing analysis.

No inference is intended regarding either the arm's length markup on total services costs with respect to any of the excluded categories or types of transactions or the appropriate transfer pricing method for analyzing any particular transaction. In particular, no inference is intended that the arm's length markup for such transactions in a particular case will exceed 10 percent of total costs. Rather, these transactions are ineligible for the simplified cost-based method because the Treasury Department and the IRS have concluded that a full transfer pricing analysis is appropriate.

*f. Coordination with Documentation and Penalty Rules—§1.6662-6(d)(2)(ii)(B) and (iii)(B)*

Section 6662 imposes certain accuracy-related penalties on substantial valuation misstatements as described in section 6662(e)(1)(B) and gross valuation misstatements as described in section 6662(h)(2)(A). These accuracy-related penalties include two categories of transfer pricing penalties, referred to as the transactional and net section 482 transfer price adjustment penalties. These penalties are not applicable if the taxpayer prepares contemporaneous documentation indicating that the taxpayer reasonably selected and applied a transfer pricing method, and provides that documentation to the Commissioner upon request.

Existing §1.6662-6(d)(2) provides that an amount is excluded from the calculation of a net section 482 transfer price adjustment for purposes of applying the section 6662 penalty if the taxpayer establishes that both the specified method and documentation requirements are met with respect to that amount. Existing

§1.6662-6(d)(2)(ii) provides that the specified method requirement is met if the taxpayer selects and applies a specified method in a reasonable manner. A taxpayer meets this burden only if, given the available data and the applicable pricing methods, the taxpayer reasonably concluded that the method (and its application of that method) provided the most reliable measure of an arm's length result under the principles of the best method rule. Existing §1.6662-6(d)(2)(iii) provides rules with respect to the documentation requirement, and in particular contains a descriptive list of categories of documents that must be maintained and provided in order to meet the requirement. A taxpayer is not subject to the section 482 transactional penalty if it meets the requirements of §1.6662-6(d).

A significant purpose of the simplified cost-based method is to maintain appropriately reduced compliance and administrative burdens with respect to low-margin services. Consistent with that purpose, proposed §1.6662-6(d)(2)(ii)(B) provides that, for purposes of the specified method documentation requirement, a taxpayer's selection and application of the simplified method will be considered reasonable if the taxpayer reasonably concluded that the relevant transaction meets the conditions and requirements for application of that method, including the rule in proposed §1.482-9(f)(2)(iii) that provides that the simplified method shall not apply if the arm's length markup exceeds 10 percent of total costs. In addition, the proposed regulations clarify the description of the documents that must be maintained and provided in order to satisfy the documentation requirement. While these clarifications apply generally, they are particularly relevant where the simplified method is applied.

*7. Profit Split Method—§§1.482-9(g) and 1.482-6(c)(3)(i)(B)*

The proposed regulations provide guidance regarding the application of the comparable profit split and the residual profit split methods to controlled services transactions. Generally, both profit split methods evaluate whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's

“contributions” to the combined operating profit or loss.

The proposed regulations provide that the guidance regarding the profit split methods in existing §1.482-6, as amended by proposed §1.482-6(c)(3)(i)(B) and other conforming changes, generally is applicable to controlled services transactions. Proposed §1.482-9(g) also provides specific guidance on the application of §1.482-6 in the context of controlled services transactions. In particular, proposed §1.482-9(g)(1) provides that a profit split method may be appropriate when the controlled services transaction involves either high-value services or transactions that are highly integrated and cannot be reliably evaluated on a separate basis.

Proposed §1.482-6(c)(3)(i)(B) amends the residual profit split method in existing §1.482-6(c)(3). In general, existing §1.482-6(c)(3) provides that the residual profit split method allocates the combined operating profit or loss from the relevant business activity between controlled taxpayers according to a two-step process. Operating income first is allocated to each controlled taxpayer to provide a market return for its routine contributions to the relevant business activity. The residual profit then is divided among the controlled taxpayers based upon the relative value of each taxpayer’s contributions of intangible property. The proposed regulations amend existing §1.482-6(c)(3)(i)(B) by providing that residual profits will be divided based on the relative value of each taxpayer’s “nonroutine contributions,” which may include contributions of intangible property. Proposed §1.482-6(c)(3)(i)(B) defines nonroutine contributions as contributions by controlled taxpayers that cannot be accounted for by reference to market returns, or that are so interrelated with other transactions that the contributions cannot be reliably evaluated on a separate basis. The proposed regulations thus make the residual profit split method more suitable in the context of services transactions and highly integrated transactions where data relating to comparable transactions are unavailable, whether or not these transactions involve the technical transfer or use of intangible property.

Proposed §1.482-9(g)(2) provides examples that illustrate the application of the residual profit split method to controlled services transactions.

#### 8. *Unspecified Methods—§1.482-9(h)*

Proposed §1.482-9(h) provides that in addition to the specified methods in §1.482-9(a), an unspecified method may be used to determine an arm’s length charge if such a method will provide the most reliable measure of an arm’s length result under the best method rule. Proposed §1.482-9(h) emphasizes that an unspecified method should take into account that under the arm’s length standard uncontrolled taxpayers must compare the terms of a transaction to the realistic alternatives to entering into that transaction. Therefore, an unspecified method should provide information on the prices or profits that the controlled taxpayer might have realized by choosing a realistic alternative to the controlled transaction.

#### 9. *Contingent-Payment Contractual Terms—§1.482-9(i)*

Proposed §1.482-9(i) provides guidance on the treatment of contingent-payment arrangements. The Treasury Department and the IRS recognize that controlled taxpayers may allocate the risks associated with rendering services in a variety of ways, including by specifying that compensation for the services will be paid only in the event that the services yield certain results. For example, taxpayers may enter into a contingent-payment arrangement that provides that the renderer of research and development services will receive compensation only if the research and development results in sales of a commercially viable product. Proposed §1.482-9(i) provides specific guidance concerning the evaluation of such contractual arrangements in the context of controlled services.

Proposed §1.482-9(i)(1) provides that the arm’s length charge in a controlled services transaction is determined taking into account any contingent-payment terms. Proposed §1.482-9(i)(2) provides that a contingent-payment arrangement is recognized if the arrangement is set forth in a written contract entered into prior to the start of the activity; the contract explicitly states that payment is contingent upon the happening of a future benefit for the recipient directly related to the outcome of the controlled services transaction; and the contract provides for payment on a basis

that reflects the recipient’s benefit from the services rendered and the risks borne by the renderer. If these three conditions are satisfied, the arm’s length result for the controlled services transaction ordinarily would not require a payment to the renderer if the contingency does not occur. If, on the other hand, the contingency occurs, an arm’s length result would require payment reflecting the recipient’s benefit and the risks borne by the service renderer.

The proposed regulations incorporate the principles of existing §1.482-1(d)(3) and provide that a contingent-payment arrangement must be reasonable and consistent with the economic substance of the parties’ conduct, based on all facts and circumstances. Existing §1.482-1(d)(3)(ii)(B) provides that in evaluating reasonableness and economic substance, all facts and circumstances are relevant, but the actual conduct and the respective legal rights of the parties will be given greatest weight in the analysis. Proposed §1.482-9(i)(3) confirms explicitly that the Commissioner’s authority under existing §1.482-1(d)(3)(ii)(B) to impute contractual terms in appropriate cases extends to imputation of contingent-payment terms where such terms are consistent with the economic substance of the controlled services transaction.

Proposed §1.482-9(i)(4) provides that the arm’s length charge in a contingent-payment arrangement is evaluated in accordance with section 1.482-9 and other applicable rules under section 482. In the case of an arrangement for the manufacture, construction, or development of tangible or intangible property owned by the recipient, the arm’s length charge determined under the rules of §§1.482-3 and 1.482-4 for the transfer of similar property may be considered.

Examples are provided in proposed §1.482-9(i)(5) and under existing §1.482-1(d)(3) to illustrate the application of these rules.

#### 10. *Total Services Costs—§1.482-9(j)*

Proposed §1.482-9(j) defines the term “total services costs,” which is used to determine the arm’s length charge under the simplified cost-based method, the comparable profits method in cases where the ratio of operating profits to total services costs is used as the profit level indicator,

and in the cost of services plus method in cases where an analysis of the result expressed as ratio of operating profits to total services costs is necessary. Total services costs include all costs that can be directly identified with the act of providing the services, as well as all other costs reasonably allocable to the services as determined under proposed §1.482-9(k). The Treasury Department and the IRS intend the costs included to be comprehensive and to comprise full consideration for all resources expended, used, or made available to render the service. Generally accepted accounting principles or income tax accounting rules may provide a useful starting point for determination of total services costs, but neither will have conclusive effect. Consistent with the current regulations under the comparable profits method, proposed §1.482-9(j) excludes certain costs from total services costs, such as interest expense and other expenses not related to the controlled services transactions.

#### 11. Allocation of Costs—§1.482-9(k)

Existing §1.482-2(b)(3) through (6) provide that costs may be allocated and apportioned to a services transaction under “a method of allocation and apportionment which is reasonable and in keeping with sound accounting practices.” Proposed §1.482-9(k) retains the flexible approach of the current rule by allowing any reasonable method of allocation and apportionment of costs where such allocation and apportionment is relevant to determining an arm’s length charge for services. In establishing the appropriate method, the proposed regulations state that consideration should be given to all bases and factors, including the general practices used by taxpayers to apportion costs for other purposes. The proposed regulations provide, however, that such general practices need not be accorded conclusive weight by the Commissioner.

Proposed §1.482-9(k)(3) provides examples that illustrate the rules regarding the allocation and apportionment of costs.

#### 12. Controlled Services Transactions—§1.482-9(l)

Proposed §1.482-9(l) provides guidance regarding the threshold question of

whether an activity by one member of a controlled group constitutes a controlled services transaction, the arm’s length charge for which must be determined under proposed §1.482-9(l). This guidance updates and substantially modifies the guidance in existing §1.482-2(b)(3), and brings such guidance more into line with international standards in this area.

##### a. General Rule—§1.482-9(l)(1)

Proposed §1.482-9(l)(1) provides generally that a controlled services transaction includes any activity by one controlled taxpayer that results in a benefit to one or more other controlled taxpayers. The terms “activity” and “benefit” are further defined and described in proposed §1.482-9(l)(2) and (3).

##### b. Activity—§1.482-9(l)(2)

Proposed §1.482-9(l)(2) defines an activity to include the use by the renderer, or the making available to the recipient, of any property or other resources of the renderer. The Treasury Department and the IRS intend the broad scope of the term activity to allow transactions that are not subject to the existing section 482 regulations applicable to other types of transactions (e.g., transfers of tangible or intangible property, rentals, or loans) to be analyzed under proposed §1.482-9.

##### c. Benefit—§1.482-9(l)(3)

###### i. General Rule—§1.482-9(l)(3)(i)

Proposed §1.482-9(l)(3) specifies rules for determining whether an activity results in a benefit to one or more other members of the controlled group. Proposed §1.482-9(l)(3)(i) provides that, in general, an activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient’s commercial position, or that may be reasonably anticipated to do so. In cases where an activity may be reasonably anticipated to have a particular result or outcome, but that result or outcome in fact does not occur, the determination of whether a benefit is present is evaluated by reference to what it was reasonable to expect at the time the activity was performed.

Proposed §1.482-9(l)(3)(i) further provides that an activity is generally considered to confer a benefit if an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity, or if such uncontrolled taxpayer would be willing to perform for itself the same or similar activity. This proposed rule would replace the rule of existing §1.482-2(b)(2)(i), which provides that the relevant determination is whether an uncontrolled taxpayer in circumstances similar to the renderer would charge for the service. The Treasury Department and the IRS believe that the approach of the proposed regulations is more consistent with the arm’s length standard and is more in line with international standards in this area. In addition, this approach should be substantially easier to administer than the standard under existing §1.482-2(b)(2)(i), which in some cases has been interpreted as requiring a difficult analysis of the subjective intent of the renderer. While the focus of this aspect of the proposed regulations is on the recipient, the determination of the arm’s length charge may require a focus on the recipient, the renderer, or both, depending on the applicable method.

The proposed regulations and the examples set forth under §1.482-9(l)(4) do not adopt a so-called “general benefit” approach, under which certain activities in a corporate group were presumed to generate a benefit to the controlled group as a whole. This general benefit approach in some cases has been used to justify a charge to a group member for centralized activities performed by a corporate parent or service center, whether or not that particular member actually receives a benefit from those activities. The Treasury Department and the IRS believe that the general benefit concept is inconsistent with the arm’s length standard. In the controlled group context, the benefit analysis appropriately focuses on whether one or more controlled parties receive an identifiable benefit from an activity performed by another member of the group. Although the proposed regulations do not adopt the general benefit approach, in certain cases the allocation or sharing among

group members of expenses or charges relating to corporate headquarters-level activities or other centralized service activities may be consistent with the rules of the proposed regulations.

Proposed §1.482-9(l)(3)(i) clarifies that a benefit is received by the owner of an intangible when another controlled taxpayer performs an activity that contributes to the development or enhancement of the value of that intangible. This provision is consistent with proposed §1.482-4(f)(3) and (4).

*ii. Indirect or Remote Benefits and Duplicative Activities—§1.482-9(l)(3)(ii) and (iii)*

Proposed §1.482-9(l)(3)(ii) and (iii) retain, with modifications, two concepts that also appear in the existing regulations. First, an activity does not result in a benefit to the extent that the activity produces only indirect or remote benefits. Second, an activity does not produce a benefit where the underlying activity is duplicative of an activity performed by the putative recipient.

Under proposed §1.482-9(l)(3)(ii), an activity produces an indirect or remote benefit only if that activity is one for which an uncontrolled taxpayer operating under similar conditions would not be willing to pay, or would not itself undertake. Consistent with the general approach in proposed §1.482-9(l)(3)(i), the determination of whether a benefit is indirect or remote focuses on the recipient.

Under proposed §1.482-9(l)(3)(iii), an activity that is duplicative of an activity performed by another controlled taxpayer generally will not be considered to provide a benefit unless it yields an identifiable, additional benefit to one or more members of the controlled group.

*iii. Shareholder Activities—§1.482-9(l)(3)(iv)*

Substantial controversy has arisen under the existing regulations concerning whether activities performed by an owner-member in a controlled group may be classified as shareholder or stewardship activities that benefit the owner-member that renders such services and not other controlled parties. Stewardship or shareholder activities are activities performed

by reason of or on account of the renderer's status as a shareholder or as an investor of capital. The existing regulations do not provide specific guidance with respect to these issues.

Proposed §1.482-9(l)(3)(iv) provides that an activity whose primary benefit is to protect the renderer's capital investment in one or more members of the controlled group, or an activity relating primarily to compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, will not be considered to provide a benefit to another member of the controlled group. The proposed regulations further provide that activities in the nature of day-to-day management generally do not relate to the protection of the renderer's capital investment, and that activities performed in connection with a corporate reorganization (including payments to unrelated service providers) may be considered to provide a benefit to one or more controlled taxpayers.

In the view of the Treasury Department and the IRS, the relatively narrow definition of shareholder activities in the proposed regulations reflects the arm's length standard and is consistent with particular international standards in this area. The Treasury Department and the IRS recognize that there are a wide range of activities and factual scenarios within a multinational group to which this guidance will apply. For example, if an activity is performed in order to comply with legal requirements applicable to shareholders, or in order to preserve or safeguard the controlled taxpayer's equity investment in a subsidiary, such an activity should be properly viewed as a shareholder activity. It may be appropriate to conclude that other activities also provide no benefit to other members of the controlled group, but such conclusion would be based a detailed analysis of the facts and circumstances.

*iv. Passive Association—§1.482-9(l)(3)(v)*

Proposed §1.482-9(l)(3)(v) provides that a member of a controlled group that obtains a benefit solely on account of its status as a member of the group (for example, by obtaining favorable commercial terms from an uncontrolled party by reason of its membership in the controlled

group) is generally not considered to receive a benefit. A controlled taxpayer's status as a member of a controlled group may, however, be considered in evaluating comparability between controlled and uncontrolled transactions.

*d. Examples—§1.482-9(l)(4)*

Proposed §1.482-9(l)(4) provides a significant number of examples to illustrate the rules of §1.482-9(l). Like all examples in the proposed regulations, these examples are limited to an application of the substantive rules of the proposed regulations to the specific facts contained therein.

*13. Coordination with Other Transfer Pricing Rules—§1.482-9(m)*

Proposed §1.482-9(m) provides rules to coordinate the rules applicable to services with rules applicable to other categories of transactions under section 482. Generally, the section 482 regulations set forth specific transfer pricing methods for evaluating the results of controlled transactions under the arm's length standard. Certain methods apply only to specific types of transactions, while other methods apply more generally. Selection of a method for a particular type of transaction is subject to the best method rule of existing §1.482-1(c)(1), which states that the method selected should provide the most reliable measure of an arm's length result. The proposed regulations include coordination provisions that provide guidance on selection of an appropriate transfer pricing method when a controlled services transaction is combined with or has elements of another type of transaction. The proposed regulations provide examples that illustrate the application of these rules.

*a. Services Transactions that Include other Types of Transactions—§1.482-9(m)(1)*

A transaction structured as a services transaction may also include elements comprising a different type of transaction. In the case of such an integrated transaction, proposed §1.482-9(m)(1) provides that whether the integrated transaction may be evaluated by use of the transfer pricing methods in proposed §1.482-9 or whether one or more elements of the transaction should be evaluated separately

under the methods in other section 482 regulations depends on which approach will provide the most reliable measure of an arm's length result. In cases where the non-services element of an integrated transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables, the integrated transaction may be adequately evaluated under a single method provided under §1.482-9.

*b. Services Transactions that Effect a Transfer of Intangible Property—§1.482-9(m)(2)*

A transaction structured as a services transaction may result in a transfer of intangible property, may have an effect similar to the transfer of intangible property, or may include an element that constitutes the transfer of intangible property. In such cases, proposed §1.482-9(m)(2) provides that if the element that relates to the transfer of intangible property is material to the evaluation of the transaction, the arm's length result with respect to such element must be either determined under or corroborated by reference to a method under existing §1.482-4. The Treasury Department and the IRS believe that it is critical that economically similar transactions, in particular transactions that effect the transfer of intangible property, be evaluated consistently under the transfer pricing regulations.

*c. Services Subject to a Qualified Cost Sharing Arrangement—§1.482-9(m)(3)*

Proposed §1.482-9(m)(3) provides that services provided by a controlled participant under a qualified cost sharing arrangement are subject to existing §1.482-7. The Treasury Department and the IRS are reviewing the current regulatory guidance related to qualified cost sharing arrangements, and intend to issue proposed regulations in the near term.

*d. Other Types of Transaction That Include a Services Transaction—§1.482-9(m)(4)*

A transaction structured as a transaction other than a services transaction may also include elements comprising a services transaction. In the case of such an integrated transaction, proposed §1.482-9(m)(4) provides rules to

determine the manner in which such integrated transactions should be evaluated that are similar to the rules in proposed §1.482-9(m)(1) provided for integrated transactions structured as services transactions.

*e. Global Dealing Operations—§1.482-9(m)(5)*

Under proposed §1.482-9(m)(5), guidance concerning the treatment of global dealing operations is reserved, pending the issuance of transfer pricing guidance specifically applicable to global dealing operations.

*C. Income Attributable to Intangibles—§1.482-4(f)(3) and (4)*

The proposed regulations would replace the provisions of §1.482-4(f)(3), relating to the allocation of income from intangibles, with proposed §1.482-4(f)(3) and (4).

*1. Ownership of Intangible Property—§1.482-4(f)(3)*

Proposed §1.482-4(f)(3)(i)(A) provides guidance for determining the owner of an intangible. In general, the owner is the taxpayer identified as the owner of an intangible under the intellectual property laws of the relevant jurisdiction, or the taxpayer that holds rights constituting an intangible in accordance with contractual terms or other legal provision. For example, in the case of a typical license of an intangible between controlled parties, the proposed regulations treat the licensee as the owner of contractual rights pursuant to the license, and the licensor as the owner of the intangible subject to the license. The identification of a single owner for each discrete intangible replaces the provision in the existing regulations that under certain circumstances could be read to provide for multiple owners of an intangible. See existing §1.482-4(f)(3)(i) and §1.482-4(f)(3)(iv), *Example 4*. The ownership of an intangible must in all cases accord with the economic substance of the underlying transaction. See §1.482-1(d)(3). In the case of intangible property for which no owner can be identified under intellectual property law, contractual terms, or other legal provision,

the owner will be the controlled taxpayer that has control of the intangible, based on all the facts and circumstances.

Proposed §1.482-4(f)(3)(i)(B) generally excludes from the rules of proposed §1.482-4(f)(3)(i)(A) intangibles subject to the cost sharing provisions of §1.482-7. The Treasury Department and the IRS are reviewing the current regulatory guidance related to qualified cost sharing arrangements, and intend to issue proposed regulations in the near term.

Proposed §1.482-4(f)(3) does not include the rules in the existing regulations for allocations with respect to assistance provided to the owner of intangible property. These rules, in modified form, are provided in proposed §1.482-4(f)(4).

*2. Contributions to Develop or Enhance an Intangible—§1.482-4(f)(4)*

Proposed §1.482-4(f)(4)(i) provides that the arm's length consideration for a contribution by one controlled taxpayer to develop or enhance an intangible owned by another controlled taxpayer must be determined under the applicable rules of section 482.

The section 482 regulations generally give effect to the contractual terms specified for controlled transactions. Consistent with this principle, proposed §1.482-4(f)(4)(i) also provides rules for situations where controlled taxpayers "embed" compensation for a contribution in the contractual terms of a transaction involving an intangible. For instance, under a typical intangible license between controlled parties the licensee may render marketing services that are anticipated to enhance the intangible owned by the licensor. The licensor may compensate such services through a separately stated fee, or such compensation may be embedded within the royalty paid by the licensee (*i.e.*, through reduction of the royalty). In addition, the licensee may undertake marketing activities that are anticipated to enhance the value of its rights to exploit its license. Such activities do not require compensation by the licensor.

Proposed §1.482-4(f)(4)(i) provides that ordinarily no separate allocation is appropriate where compensation for a contribution is embedded within the terms of a related controlled transaction. The contribution, however, must be taken into

account in evaluating the comparability of the controlled transaction to any uncontrolled comparables and in determining the arm's length consideration for the controlled transaction that includes the embedded contribution. This rule is intended to reach a result that is implicit under the existing regulations.

In some cases, this rule may operate in conjunction with §1.482-3(f), which deals with transfers of tangible property that contains an embedded intangible. For example, in a typical distribution arrangement for the resale of trademarked goods, the distributor may perform marketing services that are not separately compensated. In such a case, ordinarily no separate allocation would be appropriate with respect to either the embedded trademark or the embedded marketing services. These embedded elements, however, must be taken into account in evaluating the comparability of the controlled transfer to any uncontrolled comparables and in determining the arm's length consideration for the intercompany sale of the trademarked goods. See proposed §1.482-4(f)(4)(ii), *Example 2*.

The Treasury Department and the IRS intend that this rule pertaining to contributions to develop or enhance an intangible will provide a clearer framework for analysis than existing §1.482-4(f)(3), particularly where controlled taxpayers document the relevant transactions in advance and act in accordance with the documentation. In this regard, the proposed regulations are intended to encourage controlled taxpayers to document such transactions contemporaneously and consistently over time.

Examples in proposed §1.482-4(f)(4)(ii) illustrate the application of proposed §1.482-4(f)(4) to a range of transactions involving contributions to develop or enhance an intangible.

#### *D. Contractual terms imputed from economic substance—§1.482-1(d)(3)(ii)(C), Examples 3, 4, and 5*

The proposed regulations recognize that controlled taxpayers have considerable flexibility to specify the contractual terms regarding contributions to develop or enhance an intangible. The Commissioner generally will give effect to these contractual terms for Federal income tax

purposes, provided that they are consistent with the economic substance of the parties' conduct. On the other hand, if the controlled taxpayer fails to specify contractual terms for a transaction, or if the stated terms do not accord with the economic substance of the underlying activities, the Commissioner may impute contractual terms that are consistent with the economic substance of the underlying transactions. See §1.482-1(d)(3).

Proposed *Example 3*, *Example 4*, and *Example 5* in §1.482-1(d)(3)(ii)(C) illustrate scenarios in which the Commissioner may impute contractual terms based on the principles in proposed §1.482-4(f)(3) and (f)(4) and proposed §1.482-9. These new examples illustrate the imputation of contractual terms in cases where controlled taxpayers fail to specify contractual terms or where the contractual terms specified do not accord with economic substance.

#### *E. Conforming Changes to Other Provisions*

In view of the proposed changes described above, conforming changes to §§1.482-0 through -2, 1.6038A-3, 1.6662-6(g), and 31.3121(s)-1 are necessary. Proposed amendments to these provisions are set forth in this document. In addition, the Treasury Department and the IRS are considering the extent to which changes to §1.861-8(e)(4), which provides guidance regarding expenses attributable to dividends received and which refers to the existing services regulations, may be appropriate to improve the coordination of that regulation with the transfer pricing regulations.

#### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because these regulations do not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the

Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The Treasury Department and the IRS specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for January 14, 2004, at 10 a.m., in the auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by December 23, 2003. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### **Drafting Information**

The principal authors of these proposed regulations are J. Peter Luedtke and Helen Hong-George of the Office of Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

\* \* \* \* \*

**Proposed Amendments to the Regulations**

Accordingly, 26 CFR parts 1 and 31 are proposed to be amended as follows:

**PART 1—INCOME TAXES**

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Section 1.482–9 also issued under 26 U.S.C. 482. \* \* \*

Par. 2. Section 1.482–0 is amended by:

- 1. Revising the section heading.
- 2. Removing the entries for §1.482–2(b) and adding a new entry in its place.
- 3. Revising the entries for §1.482–4(f)(3), (f)(4) and (f)(5) and adding new entries for §1.482–4(f)(6).
- 4. Adding new entries for §§1.482–6(c)(3)(i)(B)(I) and (2) and 1.482–9.

The additions and revisions read as follows:

*§1.482–0 Outline of regulations under section 482.*

\* \* \* \* \*

*§1.482–2 Determination of taxable income in specific situations.*

\* \* \* \* \*

- (b) Rendering of services.

\* \* \* \* \*

*§1.482–4 Methods to determine taxable income in connection with a transfer of intangible property.*

\* \* \* \* \*

- (f) \* \* \*
- (3) Ownership of intangible property.
  - (i) Identification of owner.
    - (A) In general.
    - (B) Cost sharing arrangements.
  - (ii) Examples.
  - (4) Contribution to the value of an intangible owned by another.
    - (i) In general.
    - (ii) Examples.
    - (5) Consideration not artificially limited.
    - (6) Lump-sum payments.
      - (i) In general.
      - (ii) Exceptions.

- (iii) Example.

*§1.482–6 Profit split method.*

\* \* \* \* \*

- (c) \* \* \*
- (3) \* \* \*
  - (i) In general. \* \* \*
  - (B) Allocate residual profit.
  - (I) Nonroutine contributions generally.
  - (2) Nonroutine contributions of intangible property.

*§1.482–9 Methods to determine taxable income in connection with a controlled services transaction.*

- (a) In general.
- (b) Comparable uncontrolled services price method.
  - (1) In general.
  - (2) Comparability and reliability considerations.
    - (i) In general.
    - (ii) Comparability.
      - (A) In general.
      - (B) Adjustments for differences between controlled and uncontrolled transactions.
    - (iii) Data and assumptions.
  - (3) Arm’s length range.
  - (4) Examples.
  - (5) Indirect evidence of the price of a comparable uncontrolled services transaction.
    - (i) In general.
    - (ii) Example.
  - (c) Gross services margin method.
    - (1) In general.
    - (2) Determination of arm’s length price.
      - (i) In general.
      - (ii) Related uncontrolled transaction.
      - (iii) Applicable uncontrolled price.
      - (iv) Appropriate gross services profit.
      - (v) Arm’s length range.
    - (3) Comparability and reliability considerations.
      - (i) In general.
      - (ii) Comparability.
        - (A) Functional comparability.
        - (B) Other comparability factors.
        - (C) Adjustments for differences between controlled and uncontrolled transactions.
        - (D) Buy-sell distributor.
      - (iii) Data and assumptions.
        - (A) In general.
        - (B) Consistency in accounting.
      - (4) Examples.
      - (d) Cost of services plus method.
        - (1) In general.

- (2) Determination of arm’s length price.
  - (i) In general.
  - (ii) Appropriate gross services profit.
  - (iii) Comparable transactional costs.
  - (iv) Arm’s length range.
- (3) Comparability and reliability considerations.
  - (i) In general.
  - (ii) Comparability.
    - (A) Functional comparability.
    - (B) Other comparability factors.
    - (C) Adjustments for differences between the controlled and uncontrolled transactions.
  - (iii) Data and assumptions.
    - (A) In general.
    - (B) Consistency in accounting.
    - (4) Examples.
    - (e) Comparable profits method.
      - (1) In general.
      - (2) Determination of arm’s length result.
        - (i) Tested party.
        - (ii) Profit level indicators.
        - (iii) Comparability and reliability considerations—Data and assumptions—Consistency in accounting.
      - (3) Examples.
      - (f) Simplified cost-based method for certain services.
        - (1) Evaluation of arm’s length charge.
          - (i) In general.
          - (ii) Coordination with best method rule.
        - (2) Limitation on allocations by Commissioner.
          - (i) In general.
          - (ii) Applicable number of percentage points.
          - (iii) Method inapplicable to high-margin transactions.
          - (iv) Measurement of limitations on allocations.
          - (v) Scope of limitation on allocations by the Commissioner.
            - (A) Loss transactions and transactions priced in excess of arm’s length.
            - (B) Allocation and apportionment of costs.
        - (3) Conditions on application of simplified cost-based method.
          - (i) Adequate books and records.
          - (ii) Written contract.
            - (A) In general.
            - (B) *De minimis* exception.
          - (4) Transactions not eligible for simplified cost-based method.
            - (i) Services similar to services provided by renderer or recipient to uncontrolled parties.



- (ii) Services rendered to a recipient that receives services from controlled taxpayers in significant amounts.
- (iii) Services involving the use of intangible property.
- (iv) Non-services transactions included in integrated transactions.
- (v) Certain transactions.
- (5) Examples.
- (g) Profit split method.
  - (1) In general.
  - (2) Examples.
- (h) Unspecified methods.
- (i) Contingent-payment contractual terms for services.
  - (1) Economic substance of contingent payment contractual terms recognized.
  - (2) Contingent-payment arrangement.
    - (i) Written contract.
    - (ii) Specified contingency.
    - (iii) Basis for payment.
  - (3) Commissioner's authority to impute contingent-payment terms.
  - (4) Evaluation of arm's length charge.
  - (5) Examples.
- (j) Total services costs.
- (k) Allocation of costs.
  - (1) In general.
  - (2) Appropriate method of allocation and apportionment.
    - (i) Reasonable method standard.
    - (ii) Use of general practices.
  - (3) Examples.
    - (1) Controlled services transaction.
      - (1) In general.
      - (2) Activity.
      - (3) Benefit.
        - (i) In general.
        - (ii) Indirect or remote benefit.
        - (iii) Duplicative activities.
        - (iv) Shareholder activities.
      - (v) Passive association.
    - (4) Examples.
  - (m) Coordination with transfer pricing rules for other transactions.
    - (1) Services transactions that include other types of transactions.
    - (2) Services transactions that effect a transfer of intangible property.
    - (3) Services subject to a qualified cost sharing arrangement.
    - (4) Other types of transactions that include controlled services transactions.
    - (5) Global dealing operations.
    - (6) Examples.
  - (n) Effective date.

Par. 3. Section 1.482-1 is amended by:

1. Revising paragraphs (a)(1), (b)(2)(i), (d)(3)(ii)(C) *Example 3*, (f)(2)(iii)(B), (g)(4)(i), the first two sentences in paragraph (g)(4)(iii) *Example 1*, and paragraph (i) introductory text.

2. Adding paragraph (d)(3)(ii)(C), *Example 4* and *Example 5*.

3. Adding a sentence at the end of paragraph (d)(3)(v).

The additions and revisions read as follows:

*§1.482-1 Allocation of income and deductions among taxpayers.*

(a) *In general*—(1) *Purpose and scope*. The purpose of section 482 is to ensure that taxpayers clearly reflect income attributable to controlled transactions, and to prevent the avoidance of taxes with respect to such transactions. Section 482 places a controlled taxpayer on a tax parity with an uncontrolled taxpayer by determining the true taxable income of the controlled taxpayer. This section sets forth general principles and guidelines to be followed under section 482. Section 1.482-2 provides rules for the determination of the true taxable income of controlled taxpayers in specific situations, including controlled transactions involving loans or advances or the use of tangible property. Sections 1.482-3 through 1.482-6 provide rules for the determination of the true taxable income of controlled taxpayers in cases involving the transfer of property. Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after October 6, 1994, and before January 1, 1996. Section 1.482-7 sets forth the cost sharing provisions applicable to taxable years beginning on or after January 1, 1996. Section 1.482-8 provides examples illustrating the application of the best method rule. Finally, §1.482-9 provides rules for the determination of the true taxable income of controlled taxpayers in cases involving the performance of services.

\* \* \* \* \*

(b) \* \* \*

(2) *Arm's length methods*—(i) *Methods*. Sections 1.482-2 through 1.482-6 and §1.482-9 provide specific methods to be used to evaluate whether transactions between or among members of the controlled group satisfy the arm's length standard and if they do not to determine the arm's length result. Section 1.482-7

provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result.

\* \* \* \* \*

(d) \* \* \*

(3) \* \* \*

(ii) \* \* \*

(C) \* \* \*

*Example 3. Contractual terms imputed from economic substance.* (i) FP, a foreign producer of wristwatches, is the registered holder of the YY trademark in the United States and in other countries worldwide. In Year 1, FP enters the U.S. market by selling YY wristwatches to its newly organized U.S. subsidiary, USSub, for distribution in the U.S. market. USSub pays FP a fixed price per wristwatch, and USSub and FP undertake without separate compensation marketing activities to establish the YY trademark in the U.S. market. Unrelated foreign producers of trademarked wristwatches and U.S. distributors respectively undertake similar marketing activities in independent arrangements involving distribution of trademarked wristwatches in the U.S. market. In Years 1 through 6, USSub markets and sells YY wristwatches in the United States. Further, in Years 1 through 6, USSub undertakes incremental marketing activities in addition to the activities similar to those observed in the independent distribution transactions in the U.S. market. FP does not directly or indirectly compensate USSub for performing these incremental activities during Years 1 through 6. Assume that, aside from these incremental activities, and after any adjustments are made to improve the reliability of the comparison, the price paid per wristwatch by the independent distributors for wristwatches would provide the most reliable measure of the arm's length price paid per YY wristwatch by USSub.

(ii) By Year 7, the wristwatches with the YY trademark generate a premium return in the U.S. market, as compared to wristwatches marketed by the independent distributors. In Year 7, substantially all the premium return from the YY trademark in the U.S. market is attributed to FP, for example through an increase in the price paid per watch by USSub, or by some other means.

(iii) In determining whether an allocation of income is appropriate in Year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, *ex ante*, an uncontrolled taxpayer operating at arm's length would engage in marketing activities to develop or enhance an intangible owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, USSub's undertaking the incremental marketing activities in Years 1 through 6 is a course of conduct that is inconsistent with the parties' attribution to FP in Year 7 of substantially all the premium return from the enhanced YY trademark in the United States market. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub

an appropriate portion of the premium return from the YY trademark wristwatches. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for its incremental marketing activities in Years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term exclusive U.S. distribution agreement to exploit the YY trademark that allows USSub to benefit from the incremental marketing activities it performed. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term distribution agreement, an agreement that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

*Example 4. Contractual terms imputed from economic substance.* (i) FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries worldwide. In Year 1, FP licenses to its newly organized U.S. subsidiary, USSub, exclusive rights to certain manufacturing and marketing intangibles (including the AA trademark) for purposes of manufacturing and marketing athletic gear in the United States under the AA trademark. The contractual terms obligate USSub to pay FP a royalty based on sales, and obligate both FP and USSub to undertake without separate compensation specified types and levels of marketing activities. Unrelated foreign businesses license independent U.S. businesses to manufacture and market athletic gear in the United States, using trademarks owned by the unrelated foreign businesses. The contractual terms of these uncontrolled transactions require the licensees to pay royalties based on sales of the merchandise, and obligate the licensors and licensees to undertake without separate compensation specified types and levels of marketing activities. In Years 1 through 6, USSub manufactures and sells athletic gear under the AA trademark in the United States. Assume that, after adjustments are made to improve the reliability of the comparison for any material differences relating to marketing activities, manufacturing or marketing intangibles, and other comparability factors, the royalties paid by independent licensees would provide the most reliable measure of the arm's length royalty owed by USSub to FP, apart from the additional facts.

(ii) In Years 1 through 6, USSub performs incremental marketing activities with respect to the AA trademark athletic gear, in addition to the activities required under the terms of the license agreement. FP does not directly or indirectly compensate USSub for performing these incremental activities during Years 1 through 6. By Year 7, AA trademark athletic gear generates a premium return in the United States, as compared to similar athletic gear marketed by independent licensees. In Year 7, USSub and FP enter into a separate services agreement under which FP agrees to compensate USSub on a cost basis for the incremental marketing activities that USSub performed during Years 1 through 6, and to compensate USSub on a cost basis for any incremental marketing activities it may perform in Year 7 and thereafter. In addition, the

parties revise the license agreement executed in Year 1, and increase the royalty to a level that attributes to FP substantially all the premium return from sales of the AA trademark athletic gear in the United States.

(iii) In determining whether an allocation of income is appropriate in Year 7, the Commissioner may consider the economic substance of the arrangements between USSub and FP and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, *ex ante*, an uncontrolled taxpayer operating at arm's length would engage in incremental marketing activities to develop or enhance an intangible owned by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of a future benefit. In this case, USSub's undertaking the incremental marketing activities in Years 1 through 6 is a course of conduct that is inconsistent with the parties' adoption in Year 7 of contractual terms whereby FP compensates USSub on a cost basis for the incremental marketing activities that it performed. Therefore, the Commissioner may impute one or more agreements between USSub and FP, consistent with the economic substance of their course of conduct, which would afford USSub an appropriate portion of the premium return from the AA trademark athletic gear. For example, the Commissioner may impute a separate services agreement that affords USSub contingent-payment compensation for the incremental activities it performed during Years 1 through 6, which benefited FP by contributing to the value of the trademark owned by FP. In the alternative, the Commissioner may impute a long-term exclusive U.S. license agreement that allows USSub to benefit from the incremental activities. As another alternative, the Commissioner may require FP to compensate USSub for terminating USSub's imputed long-term U.S. license agreement, a license that USSub made more valuable at its own expense and risk. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in this particular case.

*Example 5. Contractual terms imputed from economic substance.* (i) Company X is a member of a controlled group that has been in operation in the pharmaceutical sector for many years. In Years 1 through 4, Company X undertakes research and development activities. As a result of those activities, a compound is developed that may be more effective than existing medications in the treatment of certain conditions.

(ii) Company Y is acquired in Year 4 by the controlled group that includes Company X. Once Company Y is acquired, patent rights with respect to the compound in several jurisdictions are registered by Company Y, making Company Y the legal owner of such patents.

(iii) In determining whether an allocation is appropriate in Year 4, the Commissioner may consider the economic substance of the arrangements between Company X and Company Y, and the parties' course of conduct throughout their relationship. Based on this analysis, the Commissioner determines that it is unlikely that, *ex ante*, an uncontrolled taxpayer operating at arm's length would engage in research and

development activities to develop a patentable compound to be registered by another party unless it received contemporaneous compensation or otherwise had a reasonable anticipation of receiving a future benefit from those activities. In this case, Company X's undertaking the research and development activities is inconsistent with the registration of the patent by Company Y. Therefore, the Commissioner may impute one or more agreements between Company X and Company Y consistent with the economic substance of their course of conduct, which would afford Company X an appropriate portion of the premium return from the patent rights. For example, the Commissioner may impute a separate services agreement that affords Company X contingent-payment compensation for its research and development activities in Years 1 through 4, which benefited Company Y by creating and further contributing to the value of the patent rights ultimately registered by Company Y. In the alternative, the Commissioner may impute a transfer of patentable intangible rights from Company X to Company Y immediately preceding the registration of patent rights by Company Y. The taxpayer may present additional facts that could indicate which of these or other alternative agreements best reflects the economic substance of the underlying transactions, consistent with the parties' course of conduct in the particular case.

\* \* \* \* \*

(v) \* \* \* See §1.482-9(m).

\* \* \* \* \*

(f) \* \* \*

(2) \* \* \*

(iii) \* \* \*

(B) *Circumstances warranting consideration of multiple year data.* The extent to which it is appropriate to consider multiple year data depends on the method being applied and the issue being addressed. Circumstances that may warrant consideration of data from multiple years include the extent to which complete and accurate data is available for the taxable year under review, the effect of business cycles in the controlled taxpayer's industry, or the effects of life cycles of the product or intangible being examined. Data from one or more years before or after the taxable year under review must ordinarily be considered for purposes of applying the provisions of paragraph (d)(3)(iii) of this section (Risk), paragraph (d)(4)(i) of this section (Market share strategy), §1.482-4(f)(2) (Periodic adjustments), §1.482-5 (Comparable profits method), §1.482-9(e) (Comparable profits method for services), §1.482-9(f) (Simplified cost-based method for services), and §1.482-9(i) (Contingent-payment contractual terms for services). On the other hand, multiple year data ordinarily

will not be considered for purposes of applying the comparable uncontrolled price method of §1.482-3(b) or the comparable uncontrolled services price method of §1.482-9(b) (except to the extent that risk or market share strategy issues are present).

\*\*\*\*\*

(g) \*\*\*

(4) *Setoffs*—(i) *In general*. If an allocation is made under section 482 with respect to a transaction between controlled taxpayers, the Commissioner will take into account the effect of any other non-arm's length transaction between the same controlled taxpayers in the same taxable year which will result in a setoff against the original section 482 allocation. Such setoff, however, will be taken into account only if the requirements of paragraph (g)(4)(ii) of this section are satisfied. If the effect of the setoff is to change the characterization or source of the income or deductions, or otherwise distort taxable income, in such a manner as to affect the U.S. tax liability of any member, adjustments will be made to reflect the correct amount of each category of income or deductions. For purposes of this setoff provision, the term arm's length refers to the amount defined in paragraph (b) of this section (Arm's length standard), without regard to the rules in §1.482-2(a) that treat certain interest rates as arm's length rates of interest.

\*\*\*\*\*

(iii) *Examples*. \*\*\*

*Example 1*. P, a U.S. corporation, renders construction services to S, its foreign subsidiary in Country Y, in connection with the construction of S's factory. An arm's length charge for such services determined under §1.482-9 would be \$100,000. \*\*\*

\*\*\*\*\*

(i) *Definitions*. The definitions set forth in paragraphs (i)(1) through (i)(10) of this section apply to this §§1.482-1 through 1.482-9.

\*\*\*\*\*

Par. 4. Section 1.482-2(b) is revised to read as follows:

*§1.482-2 Determination of taxable income in specific situations.*

\*\*\*\*\*

(b) *Rendering of services*. For rules governing allocations under section 482

to reflect an arm's length charge for controlled transactions involving the rendering of services, see §1.482-9.

\*\*\*\*\*

Par. 5. Section 1.482-4 is amended by:

1. Redesignating paragraphs (f)(4) and (f)(5) as paragraphs (f)(5) and (f)(6), respectively.

2. Revising paragraph (f)(3) and adding new paragraph (f)(4).

The revision and addition reads as follows.

*§1.482-4 Methods to determine taxable income in connection with a transfer of intangible property.*

\*\*\*\*\*

(f) \*\*\*

(3) *Ownership of intangible property*—(i) *Identification of owner*—(A) *In general*. The legal owner of an intangible pursuant to the intellectual property law of the relevant jurisdiction, or the holder of rights constituting an intangible pursuant to contractual terms (such as the terms of a license) or other legal provision, will be considered the sole owner of the respective intangible for purposes of this section unless such ownership is inconsistent with the economic substance of the underlying transactions. See §1.482-1(d)(3)(ii)(B) (Identifying contractual terms). If no owner of the respective intangible is identified under the intellectual property law of the relevant jurisdiction, or pursuant to contractual terms (including terms imputed pursuant to §1.482-1(d)(3)(ii)(B)) or other legal provision, then the controlled taxpayer who has control of the intangible, based on all the facts and circumstances, will be considered the sole owner of the intangible for purposes of this section.

(B) *Cost sharing arrangements*. The rule in paragraph (f)(3)(i)(A) of this section shall apply to interests in covered intangibles, as defined in §1.482-7(b)(4)(iv), only as provided in §1.482-7 (Sharing of costs).

(ii) *Examples*. The principles of this paragraph (f)(3) are illustrated by the following examples:

*Example 1*. FP, a foreign corporation, is the registered holder of the AA trademark in the United States. FP licenses to a U.S. subsidiary, USSub, the exclusive rights to manufacture and market products in the United States under the AA trademark. FP is the

owner of the trademark pursuant to intellectual property law. USSub is the owner of the license pursuant to the contractual terms of the license, but is not the owner of the trademark. See paragraphs (b)(3) and (4) of this section (defining an intangible as, among other things, a trademark or a license).

*Example 2*. The facts are the same as in *Example 1*. As a result of its sales and marketing activities, USSub develops a list of several hundred credit-worthy customers that regularly purchase AA trademarked products. Neither the terms of the contract between FP and USSub nor the relevant intellectual property law specify which party owns the customer list. Because USSub has knowledge of the contents of the list, and has practical control over its use and dissemination, USSub is considered the sole owner of the customer list for purposes of this paragraph (f)(3).

(4) *Contribution to the value of an intangible owned by another*—(i) *In general*. The arm's length consideration for a contribution by one controlled taxpayer that develops or enhances the value, or may be reasonably anticipated to develop or enhance the value, of an intangible owned by another controlled taxpayer shall be determined in accordance with the applicable rules under section 482. If the consideration for such a contribution is embedded within the contractual terms for a controlled transaction that involves such intangible, then ordinarily no separate allocation will be made with respect to such contribution. In such cases, pursuant to §1.482-1(d)(3), the contribution must be accounted for in evaluating the comparability of the controlled transaction to uncontrolled comparables, and accordingly in determining the arm's length consideration in the controlled transaction.

(ii) *Examples*. The principles of this paragraph (f)(4) are illustrated by the following examples:

*Example 1*. A, a member of a controlled group, allows B, another member of the controlled group, to use tangible property, such as laboratory equipment, in connection with B's development of an intangible that B owns. By furnishing tangible property, A makes a contribution to the development of an intangible owned by another controlled taxpayer, B. Pursuant to paragraph (f)(4)(i) of this section, the arm's length charge for A's furnishing of tangible property will be determined under the rules for use of tangible property in §1.482-2(c).

*Example 2*. (i) *Facts*. FP, a foreign producer of wristwatches, is the registered holder of the YY trademark in the United States and in other countries worldwide. FP enters into a five-year, renewable distribution agreement with its newly organized U.S. subsidiary, USSub. The contractual terms of the agreement grant USSub the right to sell trademark YY wristwatches in the United States, obligate USSub to pay a fixed price per wristwatch throughout the entire term of the contract, and obligate both FP

and USSub to undertake without separate compensation specified types and levels of marketing activities.

(ii) The consideration for FP's and USSub's marketing activities, as well as the consideration for the license to sell YY trademarked merchandise, are embedded in the transfer price paid for the wristwatches. Accordingly, pursuant to paragraph (f)(4)(i) of this section, ordinarily no separate allocation would be appropriate with respect to these embedded contributions.

(iii) Whether an allocation is warranted with respect to the transfer price for the wristwatches is determined under §1.482-1 and §§1.482-3 through 1.482-6. The comparability analysis would include consideration of all relevant factors, including the nature of the intangible embedded in the wristwatches and the nature of the marketing activities required under the contract. This analysis would also take into account that the compensation for the activities performed by USSub and FP, as well as the consideration for USSub's use of the YY trademark, is embedded in the transfer price for the wristwatches, rather than provided for in separate agreements. See §§1.482-3(f) and 1.482-9(m)(4). If it is not possible to identify uncontrolled transactions that incorporate a similar range of interrelated elements and there are nonroutine contributions by each of FP and USSub, then the most reliable measure of the arm's length price for the wristwatches may be the residual profit split method. The analysis would take into account routine and nonroutine contributions by USSub and FP in order to determine an appropriate allocation of the combined operating profits from the sale of the wristwatches and related activities.

*Example 3. (i) Facts.* FP, a foreign producer of athletic gear, is the registered holder of the AA trademark in the United States and in other countries. In Year 1, FP licenses to a newly organized U.S. subsidiary, USSub, the exclusive rights to use certain manufacturing and marketing intangibles to manufacture and market athletic gear in the United States under the AA trademark. The license agreement obligates USSub to pay a royalty based on sales of trademarked merchandise. The license agreement also obligates FP and USSub to perform without separate compensation specified types and levels of marketing activities. In Year 1, USSub manufactures and sells athletic gear under the AA trademark in the United States.

(ii) The consideration for FP's and USSub's respective marketing activities is embedded in the contractual terms of the license for the AA trademark. Accordingly, pursuant to paragraph (f)(4)(i) of this section, ordinarily no separate allocation would be appropriate with respect to the embedded contributions in Year 1. See §1.482-9(m)(4).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement would be analyzed under §1.482-1 and this section through §1.482-6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangibles subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. Pursuant to paragraph (f)(4)(i) of this section, the analysis would also take into account the fact that the compensation for the marketing services is embedded in the royalty for the AA trademark, rather than provided for in a

separate services agreement. If it is not possible to identify uncontrolled transactions that incorporate a similar range of interrelated elements and there are nonroutine contributions by each of FP and USSub, then the most reliable measure of the arm's length royalty for the AA trademark may be the residual profit split method. The analysis would take into account routine and nonroutine contributions by USSub and FP in order to determine an appropriate allocation of the combined operating profits from the sale of the AA trademarked merchandise and related activities.

*Example 4. (i) Facts.* The Year 1 facts are the same as in *Example 3*, with the following exceptions. In Year 2, USSub undertakes certain incremental marketing activities, in addition to those required by the contractual terms of the license for the AA trademark. The parties do not execute a separate agreement with respect to the incremental marketing activities performed by USSub. The license agreement executed in Year 1 is of sufficient duration that it is reasonable to anticipate that USSub will obtain the benefit of its incremental activities, in the form of increased sales or revenues of trademarked products in the U.S. market.

(ii) To the extent that it was reasonable to anticipate that USSub's incremental marketing activities would increase the value only of USSub's intangible (that is, USSub's license to use the AA trademark for a specified term), and not the value of the AA trademark owned by FP, USSub's incremental activities do not constitute a contribution for which an allocation is warranted under paragraph (f)(4)(i) of this section.

*Example 5. (i) Facts.* The Year 1 facts are the same as in *Example 3*. In Year 2, FP and USSub enter into a separate services agreement that obligates USSub to perform certain incremental marketing activities to promote AA trademark athletic gear in the United States, beyond the activities specified in license agreement. In Year 2, USSub begins to perform these incremental activities, pursuant to the separate services agreement with FP.

(ii) Whether an allocation is warranted with respect to USSub's incremental marketing activities covered by the separate services agreement would be evaluated under §§1.482-1 and 1.482-9, including a comparison of the compensation provided for the services with the results obtained under a method pursuant to §1.482-9, selected and applied in accordance with the best method rule of §1.482-1(c).

(iii) Whether an allocation is warranted with respect to the royalty under the license agreement is determined under §1.482-1 and this section through §1.482-6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of the license, the nature of the intangibles subject to the license, and the nature of the marketing activities required to be undertaken pursuant to the license. The comparability analysis would take into account that the compensation for the incremental activities by USSub is provided for in the separate services agreement, rather than embedded in the royalty for the AA trademark. If it is not possible to identify uncontrolled transactions that incorporate a similar range of interrelated elements and there are nonroutine contributions by each of FP and USSub, then the most reliable measure of the arm's length royalty for the AA trademark

may be the residual profit split method. The analysis would take into account routine and nonroutine contributions by USSub and FP in order to determine an appropriate allocation of the combined operating profits from the sale of the AA trademarked merchandise and related activities.

*Example 6. (i) Facts.* The Year 1 facts are the same as in *Example 3*. In Year 2, FP and USSub enter into a separate services agreement that obligates FP to perform incremental marketing activities by advertising AA trademarked athletic gear in selected international sporting events, such as the Olympics and the soccer World Cup. FP's corporate advertising department develops and coordinates these special promotions. The separate services agreement obligates USSub to pay an amount to FP for the benefit to USSub that may reasonably be anticipated as the result of FP's incremental activities. The separate services agreement is not a qualified cost sharing arrangement under §1.482-7. FP begins to perform the incremental activities in Year 2 pursuant to the separate services agreement.

(ii) Whether an allocation is warranted with respect to the incremental marketing activities performed by FP under the separate services agreement would be evaluated under §1.482-9. Under the circumstances, it is reasonable to anticipate that FP's activities would increase the value of USSub's license as well as the value of FP's trademark. Accordingly, the incremental activities by FP may constitute in part a controlled services transaction for which USSub must compensate FP. The analysis of whether an allocation is warranted would include a comparison of the compensation provided for the services with the results obtained under a method pursuant to §1.482-9, selected and applied in accordance with the best method rule of §1.482-1(c).

(iii) Whether an allocation is appropriate with respect to the royalty under the license agreement would be evaluated under §1.482-1 and this section through §1.482-6. The comparability analysis would include consideration of all relevant factors, such as the term and geographical exclusivity of USSub's license, the nature of the intangibles subject to the license, and the marketing activities required to be undertaken by both FP and USSub pursuant to the license. This comparability analysis would take into account that the compensation for the incremental activities performed by FP was provided for in the separate services agreement, rather than embedded in the royalty for the AA trademark. If it is not possible to identify uncontrolled transactions that incorporate a similar range of interrelated elements and there are nonroutine contributions by each of FP and USSub, then the most reliable measure of the arm's length royalty for the AA trademark may be the residual profit split method. The analysis would take into account routine and nonroutine contributions by USSub and FP in order to determine an appropriate allocation of the combined operating profits from the sale of the AA trademarked merchandise and related activities.

\* \* \* \* \*

Par. 6. Section 1.482-6 is amended by:  
1. Revising the third sentence in paragraph (c)(2)(ii)(B)(I), the first sentence in paragraph (c)(2)(ii)(D), the last sentence

in paragraph (c)(3)(i)(A) and the first sentence in paragraph (c)(3)(ii)(D).

2. Revising paragraph (c)(3)(i)(B).

The revisions read as follows:

§1.482-6 Profit split method.

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(ii) \* \* \*

(B) \* \* \* (1) \* \* \* Although all of the factors described in §1.482-1(d)(3) must be considered, comparability under this method is particularly dependent on the considerations described under the comparable profits method in §1.482-5(c)(2) or §1.482-9(e)(2)(iii), because this method is based on a comparison of the operating profit of the controlled and uncontrolled taxpayers. \* \* \*

\* \* \* \* \*

(D) *Other factors affecting reliability.* Like the methods described in §§1.482-3, 1.482-4, 1.482-5 and 1.482-9, the comparable profit split relies exclusively on external market benchmarks. \* \* \*

\* \* \* \* \*

(3) \* \* \* (i) \* \* \*

(A) \* \* \* Market returns for the routine contributions should be determined by reference to the returns achieved by uncontrolled taxpayers engaged in similar activities, consistent with the methods described in §§1.482-3, 1.482-4, 1.482-5 and 1.482-9.

(B) *Allocate residual profit—(1) Nonroutine contributions generally.* The allocation of income to the controlled taxpayer's routine contributions will not reflect profits attributable to each controlled taxpayer's contributions to the relevant business activity that are not routine (nonroutine contributions). A nonroutine contribution is a contribution that cannot be fully accounted for by reference to market returns, or that is so interrelated with other transactions that it cannot be reliably evaluated on a separate basis. Thus, in cases where such nonroutine contributions are present there normally will be an unallocated residual profit after the allocation of income described in paragraph (c)(3)(i)(A) of this section. Under this second step, the residual profit generally should be divided among the controlled taxpayers based upon the relative value of

their nonroutine contributions to the relevant business activity. The relative value of the nonroutine contributions of each taxpayer should be measured in a manner that most reliably reflects each nonroutine contribution made to the controlled transaction and each controlled taxpayer's role in the nonroutine contributions. If the nonroutine contribution by one of the controlled taxpayers is also used in other business activities (such as transactions with other controlled taxpayers), an appropriate allocation of the value of the nonroutine contribution must be made among all the business activities in which it is used.

(2) *Nonroutine contributions of intangible property.* In many cases, nonroutine contributions of a taxpayer to the relevant business activity may be contributions of intangible property. For purposes of paragraph (c)(3)(i)(B)(1) of this section, the relative value of nonroutine intangible property contributed by taxpayers may be measured by external market benchmarks that reflect the fair market value of such intangible property. Alternatively, the relative value of nonroutine intangible property contributions may be estimated by the capitalized cost of developing the intangible property and all related improvements and updates, less an appropriate amount of amortization based on the useful life of each intangible. Finally, if the intangible development expenditures of the parties are relatively constant over time and the useful life of the intangible property contributed by all parties is approximately the same, the amount of actual expenditures in recent years may be used to estimate the relative value of nonroutine intangible property contributions.

\* \* \* \* \*

(D) *Other factors affecting reliability.* Like the methods described in §§1.482-3, 1.482-4, 1.482-5 and 1.482-9, the first step of the residual profit split relies exclusively on external market benchmarks. \* \* \*

\* \* \* \* \*

Par. 7. A new §1.482-9 is added to read as follows:

§1.482-9 Methods to determine taxable income in connection with a controlled services transaction.

(a) *In general.* The arm's length amount charged in a controlled services transaction must be determined under one of the methods provided for in this section. Each method must be applied in accordance with the provisions of §1.482-1, including the best method rule of §1.482-1(c), the comparability analysis of §1.482-1(d), and the arm's length range of §1.482-1(e), except as those provisions are modified in this section. The methods are—

(1) The comparable uncontrolled services price method, described in paragraph (b) of this section;

(2) The gross services margin method, described in paragraph (c) of this section;

(3) The cost of services plus method, described in paragraph (d) of this section;

(4) The comparable profits method, described in §1.482-5 and in paragraph (e) of this section;

(5) The simplified cost-based method for certain services, described in paragraph (f) of this section;

(6) The profit split method, described in §1.482-6 and in paragraph (g) of this section; and

(7) Unspecified methods, described in paragraph (h) of this section.

(b) *Comparable uncontrolled services price method—(1) In general.* The comparable uncontrolled services price method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the amount charged in a comparable uncontrolled services transaction. The comparable uncontrolled services price method is ordinarily used where the controlled services either are identical to or have a high degree of similarity to the services in the uncontrolled transaction.

(2) *Comparability and reliability considerations—(i) In general.* Whether results derived from application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482-1(c). The application of these factors under the comparable uncontrolled services price method is discussed in paragraphs (b)(2)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *In general.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the provisions of §1.482-1(d). Although all of the factors described in §1.482-1(d)(3) must be considered, similarity of the services rendered, and of the intangibles (if any) used in performing the services, generally will have the greatest effects on comparability under this method. In addition, because even minor differences in contractual terms or economic conditions could materially affect the amount charged in an uncontrolled transaction, comparability under this method depends on close similarity with respect to these factors, or adjustments to account for any differences. The results derived from applying the comparable uncontrolled services price method generally will be the most direct and reliable measure of an arm's length price for the controlled transaction if an uncontrolled transaction has no differences from the controlled transaction that would affect the price, or if there are only minor differences that have a definite and reasonably ascertainable effect on price and for which appropriate adjustments are made. If such adjustments cannot be made, or if there are more than minor differences between the controlled and uncontrolled transactions, the comparable uncontrolled services price method may be used, but the reliability of the results as a measure of the arm's length price will be reduced. Further, if there are material differences for which reliable adjustments cannot be made, this method ordinarily will not provide a reliable measure of an arm's length result.

(B) *Adjustments for differences between controlled and uncontrolled transactions.* If there are differences between the controlled and uncontrolled transactions that would affect price, adjustments should be made to the price of the uncontrolled transaction according to the comparability provisions of §1.482-1(d)(2). Specific examples of factors that may be particularly relevant to application of this method include—

- (1) Quality of the services rendered;
- (2) Contractual terms (e.g., scope and terms of warranties or guarantees regarding the services, volume, credit and payment terms, allocation of risks, including any contingent-payment terms and

whether costs were incurred without a provision for current reimbursement);

(3) Intangibles (if any) used in rendering the services;

(4) Geographic market in which the services are rendered or received;

(5) Risks borne (e.g., costs incurred to render the services, without provision for current reimbursement);

(6) Duration or quantitative measure of services rendered;

(7) Collateral transactions or ongoing business relationships between the renderer and the recipient, including arrangement for the provision of tangible property in connection with the services; and

(8) Alternatives realistically available to the renderer and the recipient.

(iii) *Data and assumptions.* The reliability of the results derived from the comparable uncontrolled services price method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply the method. See §1.482-1(c) (Best method rule).

(3) *Arm's length range.* See §1.482-1(e)(2) for the determination of an arm's length range.

(4) *Examples.* The principles of this paragraph (b) are illustrated by the following examples:

*Example 1. Internal comparable uncontrolled services price.* Company A, a United States corporation, performs shipping, stevedoring, and related services for controlled and uncontrolled parties on a short-term or as-needed basis. Company A charges uncontrolled parties in Country X a uniform fee of \$60 per container to place loaded cargo containers in Country X on oceangoing vessels for marine transportation. Company A also performs identical services in Country X for its wholly owned subsidiary, Company B, and there are no substantial differences between the controlled and uncontrolled transactions. In evaluating the appropriate measure of the arm's length price for the container-loading services performed for Company B, because Company A renders substantially identical services in Country X to both controlled and uncontrolled parties, it is determined that the comparable uncontrolled services price constitutes the best method for determining the arm's length price for the controlled services transaction. Based on the reliable data provided by Company A concerning the price charged for services in comparable uncontrolled transactions, a loading charge of \$60 per cargo container will be considered the most reliable measure of the arm's length price for the services rendered to Company B. See paragraph (b)(2)(ii)(A) of this section.

*Example 2. External comparable uncontrolled services price.* (i) The facts are the same as in *Example 1*, except that Company A performs services

for Company B, but not for uncontrolled parties. Based on information obtained from unrelated parties (which is determined to be reliable under the comparability standards set forth in paragraph (b)(2) of this section), it is determined that uncontrolled parties in Country X perform services comparable to those rendered by Company A to Company B, and that such parties charge \$60 per cargo container.

(ii) In evaluating the appropriate measure of an arm's length price for the loading services that Company A renders to Company B, the \$60 per cargo container charge is considered evidence of a comparable uncontrolled services price. See paragraph (b)(2)(ii)(A) of this section.

*Example 3. External comparable uncontrolled services price.* The facts are the same as in *Example 2*, except that uncontrolled parties in Country X render similar loading and stevedoring services, but only under contracts that have a minimum term of one year. If the difference in the duration of the services has a material effect on prices, adjustments to account for these differences must be made to the results of the uncontrolled transactions according to the provisions of §1.482-1(d)(2), and such adjusted results may be used as a measure of the arm's length result.

*Example 4. Use of valuable intangibles.* (i) Company A, a United States corporation in the biotechnology sector, renders research and development services exclusively to its affiliates. Company B is Company A's wholly owned subsidiary in Country X. Company A renders research and development services to Company B.

(ii) In performing its research and development services function, Company A uses proprietary software that it developed internally. Company A uses the software to evaluate certain genetically engineered compounds developed by Company B. Company A owns the copyright on this software and does not license it to uncontrolled parties.

(iii) No uncontrolled parties can be identified that perform services identical or with a high degree of similarity to those performed by Company A. Because there are material differences for which reliable adjustments cannot be made, the comparable uncontrolled services price method is unlikely to provide a reliable measure of the arm's length price. See paragraph (b)(2)(ii)(A) of this section.

*Example 5. Internal comparable.* (i) Company A, a United States corporation, and its subsidiaries render computer consulting services relating to systems integration and networking to business clients in various countries. Company A and its subsidiaries render only consulting services, and do not manufacture computer hardware or software nor distribute such products. The controlled group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) Company A and its subsidiaries sometimes undertake engagements directly for clients, and sometimes work as subcontractors to unrelated parties on more extensive supply-chain consulting engagements for clients. In undertaking the latter engagements with third party consultants, Company A typically prices its services based on consulting hours worked multiplied by a rate determined for

each category of employee. The company also charges, at no markup, for out-of-pocket expenses

such as travel, lodging, and data acquisition charges.

The Company has established the following schedule of hourly rates:

Category	Rate
Project managers	\$400 per hour
Technical staff	\$300 per hour

(iii) Thus, for example, a project involving 100 hours of the time of project managers and 400 hours of technical staff time would result in the following project fees (without regard to any out-of-pocket expenses):  $(100 \text{ hrs.} \times \$400/\text{hr.}) + [400 \text{ hrs.} \times \$300/\text{hr.}] = \$40,000 + \$120,000 = \$160,000$ .

(iv) Company B, a Country X subsidiary of Company A, contracts to perform consulting services for a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. In determining an arm's length charge, the price that Company A charges for consulting services as a subcontractor in comparable uncontrolled transactions will be considered evidence of a comparable uncontrolled services price. Thus, in this case, a payment of \$144,000, (or  $[75 \text{ hrs.} \times \$400/\text{hr.}] + [380 \text{ hrs.} \times \$300/\text{hr.}] = \$30,000 + \$114,000$ ) may be used as a measure of the arm's length price for the work performed by Company A project managers and technical staff. In addition, if the comparable uncontrolled services price method is used, then, consistent with the practices employed by the comparables with respect to similar types of expenses, Company B must reimburse Company A for appropriate out-of-pocket expenses. See paragraph (b)(2)(ii)(A) of this section.

*Example 6. Adjustments for differences.* (i) The facts are the same as in *Example 5*, except that the engagement is undertaken with the client on a fixed fee basis. That is, prior to undertaking the engagement Company B and Company A estimate the resources required to undertake the engagement, and, based on hourly fee rates, charge the client a single fee for completion of the project. Company A's portion of the engagement results in fees of \$144,000.

(ii) The engagement, once undertaken, requires 20% more hours by each of Companies A and B than originally estimated. Nevertheless, the unrelated client pays the fixed fee that was agreed upon at the start of the engagement. Company B pays Company A \$144,000, in accordance with the fixed fee arrangement.

(iii) Company A often enters into similar fixed fee engagements with clients. In addition, Company A's records for similar engagements show that when it experiences cost overruns, it does not collect additional fees from the client for the difference between projected and actual hours. Accordingly, in evaluating whether the fees paid by Company B to Company A are arm's length, it is determined that no adjustments to the intercompany service charge are warranted. See §1.482-1(d)(3)(ii) and paragraph (b)(2)(ii)(A) of this section.

*Example 7. Adjustments for differences.* The facts are the same as in *Example 6*, except that Company A does not typically enter into fixed fee engagements with clients, and in addition Company A typically receives payments equal to its full fee (i.e., the

appropriate hourly fee rate multiplied by the number of hours to complete the engagement) for all consulting work that it performs, regardless of whether actual hours exceed pre-engagement estimates. When Company A's realistic alternatives to entering into the engagement with Company B are taken into account, it is determined that the intercompany charge paid by Company B to Company A should be adjusted to the amount of its full fee. See §1.482-1(d)(3)(ii) and paragraph (b)(2)(ii)(B)(8) of this section.

(5) *Indirect evidence of the price of a comparable uncontrolled services transaction—(i) In general.* The price of a comparable uncontrolled services transaction may be derived based on indirect measures of the price charged in comparable uncontrolled services transactions, but only if the following requirements are met—

(A) The data are widely and routinely used in the ordinary course of business in the particular industry or market segment for purposes of determining prices actually charged in comparable uncontrolled services transactions;

(B) The data are used to set prices in the controlled services transaction in the same way they are used to set prices in uncontrolled services transactions of the controlled taxpayer, or in the same way they are used by uncontrolled taxpayers to set prices in uncontrolled services transactions; and

(C) The amount charged in the controlled services transaction may be reliably adjusted to reflect differences in quality of the services, contractual terms, market conditions, risks borne (including contingent-payment terms), duration or quantitative measure of services rendered, and other factors that may affect the price to which uncontrolled taxpayers would agree.

(ii) *Example.* The following example illustrates this paragraph (b)(5):

*Example. Indirect evidence of comparable uncontrolled services price.* (i) Company A is a United States insurance company. Company A's wholly owned Country X subsidiary, Company B, performs specialized risk analysis for Company A as well as for uncontrolled parties. In determining the price actually charged to uncontrolled entities for performing such risk analysis, Company B uses a proprietary, multi-factor computer program, which

relies on the gross value of the policies in the customer's portfolio, the relative composition of those policies, their location, and the estimated number of personnel hours necessary to complete the project. Uncontrolled companies that perform comparable risk analysis in the same industry or market-segment use similar proprietary computer programs to price transactions with uncontrolled customers (the competitors' programs may incorporate different inputs, or may assign different weights or values to individual inputs, in arriving at the price).

(ii) During the taxable year subject to audit, Company B performed risk analysis for uncontrolled parties as well as for Company A. Because prices charged to uncontrolled customers reflected the composition of each customer's portfolio together with other factors, the prices charged in Company B's uncontrolled transactions do not provide a reliable basis for determining the comparable uncontrolled services price for the similar services rendered to Company A. However, in evaluating an arm's length price for the studies performed by Company B for Company A, Company B's proprietary computer program may be considered as indirect evidence of the comparable uncontrolled services price that would be charged to perform the services for Company A. The reliability of the results obtained by application of this internal computer program as a measure of an arm's length price for the services will be increased to the extent that Company A used the internal computer program to generate actual transaction prices for risk-analysis studies performed for uncontrolled parties during the same taxable year under audit; Company A used data that are widely and routinely used in the ordinary course of business in the insurance industry to determine the price charged; and Company A reliably adjusted the price charged in the controlled services transaction to reflect differences that may affect the price to which uncontrolled taxpayers would agree.

(c) *Gross services margin method—(1) In general.* The gross services margin method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross profit margin realized in comparable uncontrolled transactions. This method ordinarily is used in cases where a controlled taxpayer performs services or functions in connection with a related uncontrolled transaction between a member of the controlled group and an uncontrolled taxpayer. This method may be used where a controlled taxpayer renders services (agent services) to another member of the controlled group in connection with

a transaction between that other member and an uncontrolled taxpayer. This method also may be used in cases where a controlled taxpayer contracts to provide services to an uncontrolled taxpayer (intermediary function) and another member of the controlled group actually performs a portion of the services provided.

(2) *Determination of arm's length price*—(i) *In general*. The gross services margin method evaluates whether the price charged or amount retained by a controlled taxpayer in the controlled services transaction in connection with the related uncontrolled transaction is arm's length by determining the appropriate gross profit of the controlled taxpayer.

(ii) *Related uncontrolled transaction*. The related uncontrolled transaction is a transaction between a member of the controlled group and an uncontrolled taxpayer as to which the controlled taxpayer performs agent services or an intermediary function.

(iii) *Applicable uncontrolled price*. The applicable uncontrolled price is the price paid or received by the uncontrolled taxpayer in the related uncontrolled transaction.

(iv) *Appropriate gross services profit*. The appropriate gross services profit is computed by multiplying the applicable uncontrolled price by the gross services profit margin in comparable uncontrolled transactions. The determination of the appropriate gross services profit will take into account any functions performed by other members of the controlled group, as well as any other relevant factors described in §1.482-1(d)(3). The comparable gross services profit margin may be determined by reference to the commission in an uncontrolled transaction, where that commission is stated as a percentage of the price charged in the uncontrolled transaction.

(v) *Arm's length range*. See §1.482-1(e)(2) for determination of the arm's length range.

(3) *Comparability and reliability considerations*—(i) *In general*. Whether results derived from application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482-1(c). The application of these factors under the gross services margin method is discussed in

paragraphs (c)(3)(ii) and (iii) of this section.

(ii) *Comparability*—(A) *Functional comparability*. The degree of comparability between an uncontrolled transaction and a controlled transaction is determined by applying the comparability provisions of §1.482-1(d). A gross services profit provides compensation for services or functions that bear a relationship to the related uncontrolled transaction, including an operating profit in return for the investment of capital and the assumption of risks by the controlled taxpayer performing the services or functions under review. Therefore, although all of the factors described in §1.482-1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangibles (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. If possible, the appropriate gross services profit margin should be derived from comparable uncontrolled transactions by the controlled taxpayer under review, because similar characteristics are more likely found among different transactions by the same controlled taxpayer than among transactions by other parties. In the absence of comparable uncontrolled transactions involving the same controlled taxpayer, an appropriate gross services profit margin may be derived from transactions of uncontrolled taxpayers involving comparable services or functions with respect to similarly related transactions.

(B) *Other comparability factors*. Comparability under this method is not dependent on close similarity of the related uncontrolled transaction to the related transactions involved in the uncontrolled comparables. However, substantial differences in the nature of the related uncontrolled transaction and the related transactions involved in the uncontrolled comparables, such as differences in the type of property transferred or service provided in the related uncontrolled transaction, may indicate significant differences in the services or functions performed by the controlled and uncontrolled taxpayers with respect to their respective related transactions. Thus, it ordinarily would be expected that the services or

functions performed in the controlled and uncontrolled transactions would be with respect to related transactions involving the transfer of property within the same product categories or the provision of services of the same general type (e.g., information-technology systems design). Furthermore, significant differences in the intangibles (if any) used by the controlled taxpayer in the controlled services transaction as distinct from the uncontrolled comparables may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between controlled and uncontrolled transactions*. If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit margin, adjustments should be made to the gross services profit margin, according to the comparability provisions of §1.482-1(d)(2). For this purpose, consideration of the total services costs associated with functions performed and risks assumed may be necessary, because differences in functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related costs. Specific examples of factors that may be particularly relevant to this method include—

(1) Contractual terms (e.g., scope and terms of warranties or guarantees regarding the services or function, volume, credit and payment terms, and allocation of risks, including any contingent-payment terms);

(2) Intangibles (if any) used in performing the services or function;

(3) Geographic market in which the services or function are performed or in which the related uncontrolled transaction takes place; and



(4) Risks borne, including, if applicable, inventory-type risk.

(D) *Buy-sell distributor.* If a controlled taxpayer that performs an agent service or intermediary function is comparable to a distributor that takes title to goods and resells them, the gross profit margin earned by such distributor on uncontrolled sales, stated as a percentage of the price for the goods, may be used as the comparable gross services profit margin.

(iii) *Data and assumptions—(A) In general.* The reliability of the results derived from the gross services margin method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482-1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit margin affects the reliability of the results under this method.

(4) *Examples.* The principles of this paragraph (c) are illustrated by the following examples:

*Example 1. Agent services.* Company A and Company B are members of a controlled group. Company A is a foreign manufacturer of industrial equipment. Company B is a U.S. company that acts as a commission agent for Company A by arranging for Company A to make direct sales of the equipment it manufactures to unrelated purchasers in the U.S. market. Company B does not take title to the equipment, but instead receives from Company A commissions that are determined as a specified percentage of the sales price for the equipment that is charged by Company A to the unrelated purchaser. Company B also arranges for direct sales of similar equipment by unrelated foreign manufacturers to unrelated purchasers in the U.S. market. Company B charges these unrelated foreign manufacturers a commission fee of 5% of the sales price charged by the unrelated foreign manufacturers to the unrelated U.S. purchasers for the equipment. Information regarding the comparable agent services provided by Company B to unrelated foreign manufacturers is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjustments for such differences have been made. If the comparable gross services profit margin is 5% of the price charged in the related transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is equal to 5% of the applicable uncontrolled price charged by Company A in sales of equipment in the related uncontrolled transactions.

*Example 2. Agent services.* The facts are the same as in *Example 1*, except that Company B does not act

as a commission agent for unrelated parties and it is not possible to obtain reliable information concerning commission rates charged by uncontrolled commission agents that engage in comparable transactions with respect to related sales of property. It is possible, however, to obtain reliable information regarding the gross profit margins earned by unrelated parties that briefly take title to and then resell similar property in uncontrolled transactions, in which they purchase the property from foreign manufacturers and resell the property to purchasers in the U.S. market. Analysis of the facts and circumstances indicates that, aside from certain minor differences for which adjustments can be made, the uncontrolled parties that resell property perform similar functions and assume similar risks as Company B performs and assumes when it acts as a commission agent for Company A's sales of property. Under these circumstances, the gross profit margin earned by the unrelated distributors on the purchase and resale of property may be used, subject to any adjustments for any material differences between the controlled and uncontrolled transactions, as a comparable gross services profit margin. The appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is therefore equal to this comparable gross services margin, multiplied by the applicable uncontrolled price charged by Company A in its sales of equipment in the related uncontrolled transactions.

*Example 3. Agent services.* (i) Company A and Company B are members of a controlled group. Company A is a U.S. corporation that renders computer consulting services, including systems integration and networking, to business clients.

(ii) In undertaking engagements with clients, Company A in some cases pays a commission of 3% of its total fees to unrelated parties that assist Company A in obtaining consulting engagements. Typically, such fees are paid to non-computer consulting firms that provide strategic management services for their clients. When Company A obtains a consulting engagement with a client of a non-computer consulting firm, Company A does not subcontract with the other consulting firm, nor does the other consulting firm play any role in Company A's consulting engagement.

(iii) Company B, a Country X subsidiary of Company A, assists Company A in obtaining an engagement to perform computer consulting services for a Company B banking industry client in Country X. Although Company B has an established relationship with its Country X client and was instrumental in arranging for Company A's engagement with the client, Company A's particular expertise was the primary consideration in the motivating the client to engage Company A. Based on the relative contributions of Companies A and B in obtaining and undertaking the engagement, Company B's role was primarily to facilitate the consulting engagement between Company A and the Country X client. Information regarding the commissions paid by Company A to unrelated parties for providing similar services to facilitate Company A's consulting engagements is sufficiently complete to conclude that it is likely that all material differences between these uncontrolled transactions and the controlled transaction between Company B and Company A have been identified and that appropriate adjustments have been made for

any such differences. If the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in the similarly related transactions involved in the uncontrolled comparables, then the appropriate gross services profit that Company B may earn and the arm's length price that it may charge Company A for its agent services is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company A in its related uncontrolled consulting engagement with Company B's client.

*Example 4. Intermediary function.* (i) The facts are the same as in *Example 3*, except that Company B contracts directly with its Country X client to provide computer consulting services and Company A performs the consulting services on behalf of Company B. Company A does not enter into a consulting engagement with Company B's Country X client. Instead, Company B charges its Country X client an uncontrolled price for the consulting services, and Company B pays a portion of the uncontrolled price to Company A for performing the consulting services on behalf of Company B.

(ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the consulting contract indicates that Company B functioned primarily as an intermediary-contracting party, and the gross services margin method is the most reliable method for determining the amount that Company B may retain as compensation for its intermediary function with respect to Company A's consulting services. In this case, therefore, because Company B entered into the related uncontrolled transaction to provide services, Company B receives the applicable uncontrolled price that is paid by the Country X client for the consulting services. Company A technically performs services for Company B when it performs, on behalf of Company B, the consulting services Company B contracted to provide to the Country X client. The arm's length amount that Company A may charge Company B for performing the consulting services on Company B's behalf is equal to the applicable uncontrolled price received by Company B in the related uncontrolled transaction, less Company B's appropriate gross services profit, which is the amount that Company B may retain as compensation for performing the intermediary function.

(iii) Reliable data concerning the commissions that Company A paid to uncontrolled parties for assisting it in obtaining engagements to provide consulting services similar to those it has provided on behalf of Company B provide useful information in applying the gross services margin method. However, consideration should be given to whether the third party commission data may need to be adjusted to account for any additional risk that Company B may have assumed as a result of its function as an intermediary-contracting party, compared with the risk it would have assumed if it had provided agent services to assist Company A in entering into an engagement to provide its consulting service directly. In this case, the information regarding the commissions paid by Company A to unrelated parties for providing agent services to facilitate its performance of consulting services for unrelated parties is sufficiently

complete to conclude that all material differences between these uncontrolled transactions and the controlled performance of an intermediary function, including possible differences in the amount of risk assumed in connection with performing that function, have been identified and that appropriate adjustments have been made. If the comparable gross services margin earned by unrelated parties in providing such agent services is 3% of total fees charged in Company B's related uncontrolled transactions, then the appropriate gross services profit that Company B may retain as compensation for performing an intermediary function (and the amount, therefore, that is deducted from the applicable uncontrolled price to arrive at the arm's length price that Company A may charge Company B for performing consulting services on Company B's behalf) is equal to this comparable gross services margin (3%), multiplied by the applicable uncontrolled price charged by Company B in its contract to provide services to the uncontrolled party.

*Example 5. External comparable.* (i) The facts are the same as in *Example 4*, except that neither Company A nor Company B engage in transactions with third parties that facilitate similar consulting engagements.

(ii) Analysis of the relative contributions of Companies A and B in obtaining and undertaking the contract indicates that Company B's role was primarily to facilitate the consulting arrangement between Company A and the Country X client. Although no reliable internal data are available regarding comparable transactions with uncontrolled entities, reliable data exist regarding commission rates for similar facilitating services between uncontrolled parties. These data indicate that a 3% commission (3% of total engagement fee) is charged in such transactions. Information regarding the uncontrolled comparables is sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. If the appropriate gross services profit margin is 3% of total fees, then an arm's length result of the controlled services transaction is for Company B to retain an amount equal to 3% of total fees paid to it.

(d) *Cost of services plus method—(1) In general.* The cost of services plus method evaluates whether the amount charged in a controlled services transaction is arm's length by reference to the gross services profit markup realized in comparable uncontrolled transactions. The cost of services plus method is ordinarily used in cases where the controlled service renderer provides the same or similar services to both controlled and uncontrolled parties. This method is ordinarily not used in cases where the controlled services transaction involves a contingent-payment arrangement, as described in paragraph (i)(2) of this section.

(2) *Determination of arm's length price—(i) In general.* The cost of services plus method measures an arm's length

price by adding the appropriate gross services profit to the controlled taxpayer's comparable transactional costs.

(ii) *Appropriate gross services profit.* The appropriate gross services profit is computed by multiplying the controlled taxpayer's comparable transactional costs by the gross services profit markup, expressed as a percentage of the comparable transactional costs earned in comparable uncontrolled transactions.

(iii) *Comparable transactional costs.* Comparable transactional costs consist of the costs of providing the services under review that are taken into account as the basis for determining the gross services profit markup in comparable uncontrolled transactions. Depending on the facts and circumstances, such costs typically include all compensation attributable to employees directly involved in the performance of such services, materials and supplies consumed or made available in rendering such services, and other costs of rendering the services. Comparable transactional costs must be determined on a basis that will facilitate comparison with the comparable uncontrolled transactions. For that reason, comparable transactional costs may not necessarily equal total services costs, as defined in paragraph (j) of this section, and in appropriate cases may be a subset of total services costs. Generally accepted accounting principles or Federal income tax accounting rules (where Federal income tax data for comparable transactions or business activities is available) may provide useful guidance, but will not conclusively establish the appropriate comparable transactional costs for purposes of this method.

(iv) *Arm's length range.* See §1.482-1(e)(2) for determination of an arm's length range.

(3) *Comparability and reliability considerations—(i) In general.* Whether results derived from the application of this method are the most reliable measure of the arm's length result must be determined using the factors described under the best method rule in §1.482-1(c).

(ii) *Comparability—(A) Functional comparability.* The degree of comparability between controlled and uncontrolled transactions is determined by applying the comparability provisions of §1.482-1(d). A service renderer's gross services profit provides compensation for performing

services related to the controlled services transaction under review, including an operating profit for the service renderer's investment of capital and assumptions of risks. Therefore, although all of the factors described in §1.482-1(d)(3) must be considered, comparability under this method is particularly dependent on similarity of services or functions performed, risks borne, intangibles (if any) used in providing the services or functions, and contractual terms, or adjustments to account for the effects of any such differences. For purposes of evaluating functional comparability, it may be necessary to consider the results under this method expressed as a markup on total services costs of the controlled taxpayer and comparable uncontrolled parties, because differences in functions performed may be reflected in differences in service costs other than those included in comparable transactional costs. If possible, the appropriate gross services profit markup should be derived from comparable uncontrolled transactions of the same taxpayer participating in the controlled services transaction, because similar characteristics are more likely to be found among services provided by the same service provider than among services provided by other service providers. In the absence of such services transactions, an appropriate gross services profit markup may be derived from comparable uncontrolled services transactions of other service providers.

(B) *Other comparability factors.* Comparability under this method is less dependent on close similarity between the services provided than under the comparable uncontrolled services price method. Substantial differences in the services may, however, indicate significant functional differences between the controlled and uncontrolled taxpayers. Thus, it ordinarily would be expected that the controlled and uncontrolled transactions would involve services of the same general type (e.g., information-technology systems design). Furthermore, if a significant amount of the controlled taxpayer's comparable transactional costs consists of service costs incurred in a tax accounting period other than the tax accounting period under review, the reliability of the analysis would be reduced. In addition, significant differences in the value of the services rendered, due for example to the use of valuable

intangibles, may also affect the reliability of the comparison. Finally, the reliability of profit measures based on gross services profit may be adversely affected by factors that have less effect on prices. For example, gross services profit may be affected by a variety of other factors, including cost structures or efficiency-related factors (for example, differences in the level of experience of the employees performing the service in the controlled and uncontrolled transactions). Accordingly, if material differences in these factors are identified based on objective evidence, the reliability of the analysis may be affected.

(C) *Adjustments for differences between the controlled and uncontrolled transactions.* If there are material differences between the controlled and uncontrolled transactions that would affect the gross services profit markup, adjustments should be made to the gross services profit markup earned in the comparable uncontrolled transaction according to the provisions of §1.482-1(d)(2). For this purpose, consideration of the comparable transactional costs associated with the functions performed and risks assumed may be necessary, because differences in the functions performed are often reflected in these costs. If there are differences in functions performed, however, the effect on gross services profit of such differences is not necessarily equal to the differences in the amount of related comparable transactional costs. Specific examples of the factors that may be particularly relevant to this method include—

- (1) The complexity of the services;
- (2) The duration or quantitative measure of services;
- (3) Contractual terms (e.g., scope and terms of warranties or guarantees provided, volume, credit and payment terms, allocation of risks, including any contingent-payment terms);
- (4) Economic circumstances; and
- (5) Risks borne.

(iii) *Data and assumptions—(A) In general.* The reliability of the results derived from the cost of services plus method is affected by the completeness and accuracy of the data used and the reliability of the assumptions made to apply this method. See §1.482-1(c) (Best method rule).

(B) *Consistency in accounting.* The degree of consistency in accounting practices between the controlled transaction and the uncontrolled comparables that materially affect the gross services profit markup affects the reliability of the results under this method. Thus, for example, if differences in cost accounting practices would materially affect the gross services profit markup, the ability to make reliable adjustments for such differences would affect the reliability of the results obtained under this method. Further, reliability under this method depends on the extent to which the controlled and uncontrolled transactions reflect consistent reporting of comparable transactional costs. For purposes of this paragraph (d)(3)(iii)(B), the term comparable transactional costs includes the cost of acquiring tangible property that is transferred (or used) with the services, to the extent that the arm's length price of the tangible property is not separately evaluated as a controlled transaction under another provision.

(4) *Examples.* The principles of this paragraph (d) are illustrated by the following examples:

*Example 1. Internal comparable.* (i) Company A designs and assembles information-technology networks and systems. When Company A renders services for uncontrolled parties, it receives compensation based on time and materials spent on the project. This fee includes the cost of hardware and software purchased from uncontrolled vendors and incorporated in the final network or system. Reliable accounting records maintained by Company A indicate that Company A earned a gross services profit markup of 10% on its time and materials in providing design services during the year under examination on information technology projects for uncontrolled entities.

(ii) Company A designed an information-technology network for its Country X subsidiary, Company B. The services rendered to Company B are similar in scope and complexity to services that Company A rendered to uncontrolled parties during the year under examination. Using Company A's accounting records (which are determined to be reliable under paragraph (d)(3) of this section), it is possible to identify the comparable transactional costs involved in the controlled services transaction with reference to the costs incurred by Company A in rendering similar design services to uncontrolled parties. Company A's records indicate that it does not incur any additional types of costs in rendering similar services to uncontrolled customers. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on the gross services profit markup data derived from Company A's uncontrolled transactions involving similar design services, an arm's length result for the controlled services transaction is

equal to the price that will allow Company A to earn a 10% gross services profit markup on its comparable transactional costs.

*Example 2. Inability to adjust for differences in comparable transactional costs.* The facts are the same as in *Example 1*, except that Company A's staff that rendered the services to Company B consisted primarily of engineers in training status or on temporary rotation from other Company A subsidiaries. In addition, the Company B network incorporated innovative features, including specially designed software suited to Company B's requirements. The use of less-experienced personnel and staff on temporary rotation, and the special features of the Company B network significantly increased the time and costs associated with the project, as compared to time and costs associated with similar projects completed for uncontrolled customers. These factors constitute material differences between the controlled and the uncontrolled transactions that affect the determination of Company A's comparable transactional costs associated with the controlled services transaction, as well as the gross services profit markup. Moreover, it is not possible to perform reliable adjustments for these differences, on the basis of the available accounting data. Under these circumstances, the reliability of the cost of services plus method as a measure of an arm's length price is substantially reduced.

*Example 3. Operating loss by reference to total services costs.* The facts and analysis are the same as in *Example 1*, except that available information indicates that there may be material differences between the controlled and uncontrolled services transactions, and that these differences may not be reflected in the comparable transactional costs. Accordingly, the taxpayer performs additional analysis pursuant to paragraph (d)(3)(ii) of this section, and restates the results in *Example 1* (in which the arm's length charge was determined by reference to 10% gross services profit markup on comparable transactional costs) in the form of a markup on total services costs. This analysis by reference to total services costs shows that Company A generated an operating loss on the controlled services transaction, which indicates that material differences likely exist between the total services costs in the controlled and uncontrolled transactions, other than the costs that are identified as comparable transactional costs. Upon further scrutiny, the presence of such material differences between the controlled and uncontrolled transactions may indicate that the cost of services plus method does not provide the most reliable measure of an arm's length result under the facts and circumstances.

*Example 4. Internal comparable.* (i) Company A, a U.S. corporation, and its subsidiaries perform computer consulting services relating to systems integration and networking for business clients in various countries. Company A and its subsidiaries render only consulting services and do not manufacture or distribute computer hardware or software to clients. The controlled group is organized according to industry specialization, with key industry specialists working for Company A. These personnel typically form the core consulting group that teams with consultants from the local-country subsidiaries to serve clients in the subsidiaries' respective countries.

(ii) On some occasions, Company A and its subsidiaries undertake engagements directly for clients. On other occasions, they work as subcontractors for

uncontrolled parties on more extensive supply-chain consulting engagements for clients. In undertaking the latter engagements with third-party consultants,

Company A typically prices its services at four times the compensation costs of its consultants, defined as

the consultants' base salary plus estimated fringe benefits, as defined in the table below:

Category	Rate
Project managers	\$100 per hour
Technical staff	\$75 per hour

(iii) In uncontrolled transactions, Company A also charges the customer, at no markup, for out-of-pocket expenses such as travel, lodging, and data acquisition charges. Thus, for example, a project involving 100 hours of time from project managers, and 400 hours of technical staff time would result in total compensation costs to Company A of  $(100 \text{ hrs.} \times \$100/\text{hr.}) + (400 \text{ hrs.} \times \$75/\text{hr.}) = \$10,000 + \$30,000 = \$40,000$ . Applying the markup of 300%, the total fee charged would thus be  $(4 \times \$40,000)$ , or \$160,000, plus out-of-pocket expenses.

(iv) Company B, a Country X subsidiary of Company A, contracts to render consulting services to a Country X client in the banking industry. In undertaking this engagement, Company B uses its own consultants and also uses the services of Company A project managers and technical staff that specialize in the banking industry for 75 hours and 380 hours, respectively. The data available are sufficiently complete to conclude that it is likely that all material differences between the controlled and uncontrolled transactions have been identified and adjusted for. Based on reliable data concerning the compensation costs to Company A, an arm's length result for the controlled services transaction is equal to \$144,000. This is calculated as follows:  $[4 \times (75 \text{ hrs.} \times \$100/\text{hr.})] + [4 \times (380 \text{ hrs.} \times \$75/\text{hr.})] = \$30,000 + \$114,000 = \$144,000$ , reflecting a 4x markup on the total compensation costs for Company A project managers and technical staff. In addition, consistent with Company A's pricing of uncontrolled transactions, Company B must reimburse Company A for appropriate out-of-pocket expenses incurred in performing the services.

(e) *Comparable profits method*—(1) *In general*. The comparable profits method evaluates whether the amount charged in a controlled transaction is arm's length, based on objective measures of profitability (profit level indicators) derived from uncontrolled taxpayers that engage in similar business activities under similar circumstances. The rules in §1.482-5 for application of the comparable profits method apply to controlled services transactions, except as modified in this paragraph (e).

(2) *Determination of arm's length result*—(i) *Tested party*. This paragraph (e) applies where the relevant business activity of the tested party as determined under §1.482-5(b)(2) is the rendering of services in a controlled services transaction. Where the tested party determined under §1.482-5(b)(2) is instead the recipient of

the controlled services, the rules under this paragraph (e) are not applicable to determine the arm's length result.

(ii) *Profit level indicators*. In addition to the profit level indicators provided in §1.482-5(b)(4), a profit level indicator that may provide a reliable basis for comparing operating profits of the tested party involved in a controlled services transaction and uncontrolled comparables is the ratio of operating profit to total services costs (as defined in paragraph (j) of this section).

(iii) *Comparability and reliability considerations—Data and assumptions—Consistency in accounting*. Consistency in accounting practices between the relevant business activity of the tested party and the uncontrolled service providers is particularly important in determining the reliability of the results under this method, but less than in applying the cost of services plus method. Adjustments may be appropriate if materially different treatment is applied to particular cost items related to the relevant business activity of the tested party and the uncontrolled service providers. For example, adjustments may be appropriate where the tested party and the uncontrolled comparables use inconsistent approaches to classify similar expenses as "cost of goods sold" and "selling, general, and administrative expenses." Although distinguishing between these two categories may be difficult, the distinction is less important to the extent that the ratio of operating profit to total services costs is used as the appropriate profit level indicator. Determining whether adjustments are necessary under these or similar circumstances requires thorough analysis of the functions performed and consideration of the cost accounting practices of the tested party and the uncontrolled comparables. Other adjustments as provided in §1.482-5(c)(2)(iv) may also be necessary to increase the reliability of the results under this method.

(3) *Examples*. The principles of this paragraph (e) are illustrated by the following examples:

*Example 1. Ratio of operating profit to total services costs as the appropriate profit level indicator.* (i) A Country T parent firm, Company A, and its Country Y subsidiary, Company B, both engage in manufacturing as their principal business activity. Company A also performs certain advertising services for itself and its affiliates. In year 1, Company A renders advertising services to Company B.

(ii) Based on the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company A is selected as the tested party. No data are available for comparable independent manufacturing firms that render advertising services to third parties. Financial data are available, however, for ten independent firms that render similar advertising services as their principal business activity in Country X. The ten firms are determined to be comparable under §1.482-5(c). Neither Company A nor the comparable companies use valuable intangibles in rendering the services.

(iii) Based on the available financial data of the comparable companies, it cannot be determined whether these comparable companies report costs for financial accounting purposes in the same manner as the tested party. The publicly available financial data of the comparable companies segregate total services costs into cost of goods sold and sales, general and administrative costs, with no further segmentation of costs provided. Due to the limited information available regarding the cost accounting practices used by the comparable companies, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator. This ratio includes total services costs to minimize the effect of any inconsistency in accounting practices between Company A and the comparable companies.

*Example 2. Application of the operating profit to total services costs profit level indicator.* (i) Company A is a foreign subsidiary of Company B, a U.S. corporation. Company B is under examination for its 2005 taxable year. Company B renders management consulting services to Company A. Company B's consulting function includes analyzing Company A's operations, benchmarking Company A's financial performance against companies in the same industry, and to the extent necessary, developing a strategy to improve Company A's operational performance. The accounting records of Company B allow reliable identification of the total services costs of the consulting staff associated with the management consulting services rendered to Company A. Company A reimburses Company B for its costs associated with rendering the consulting services, with no markup.

(ii) Based on all the facts and circumstances, it is determined that the comparable profits method will provide the most reliable measure of an arm's length result. Company B is selected as the tested party, and its rendering of management consulting services is identified as the relevant business activity. Data are available from ten domestic companies that operate in the industry segment involving management consulting and that perform activities comparable to the relevant business activity of Company B. These comparables include entities that primarily perform management consulting services for uncontrolled parties.

The comparables incur similar risks as Company A incurs in performing the consulting services, and do not make use of valuable intangibles or special processes.

(iii) Based on the available financial data of the comparables, it cannot be determined whether the comparables report their costs for financial accounting purposes in the same manner as Company B reports its costs in the relevant business activity. The available financial data for the comparables only report an aggregate figure for costs of goods sold and

operating expenses, and do not segment the underlying services costs. Due to this limitation, the ratio of operating profits to total services costs is determined to be the most appropriate profit level indicator.

(iv) For the taxable years 2003 through 2005, Company B shows the following results for the services performed for Company A:

	2003	2004	2005	Average
Revenues	1,200,000	1,100,000	1,300,000	1,200,000
Cost of Goods Sold	100,000	100,000	N/A	66,667
Operating Expenses	1,100,000	1,000,000	1,300,000	1,133,333
Operating Profit	0	0	0	0

(v) After adjustments have been made to account for identified material differences between the relevant business activity of Company B and the comparables, the average ratio for the taxable years

2003 through 2005 of operating profit to total services costs is calculated for each of the uncontrolled service providers. Applying each ratio to Company B's average total services costs from the relevant

business activity for the taxable years 2003 through 2005 would lead to the following comparable operating profit (COP) for the services rendered provided by Company B:

Uncontrolled Service Provider	OP/Total Service Costs	Company B COP
Company 1	15.75%	\$189,000
Company 2	15.00%	\$180,000
Company 3	14.00%	\$168,000
Company 4	13.30%	\$159,600
Company 5	12.00%	\$144,000
Company 6	11.30%	\$135,600
Company 7	11.25%	\$135,000
Company 8	11.18%	\$134,160
Company 9	11.11%	\$133,320
Company 10	10.75%	\$129,000

(vi) The available data are not sufficiently complete to conclude that it is likely that all material differences between the relevant business activity of Company B and the comparables have been identified. Therefore, an arm's length range can be established only pursuant to §1.482-1(e)(2)(iii)(B). The arm's length range is established by reference to the interquartile range of the results as calculated under

§1.482-1(e)(2)(iii)(C), which consists of the results ranging from \$168,000 to \$134,160. Company B's reported average operating profit of zero (\$0) falls outside this range. Therefore, an allocation may be appropriate.

(vii) Because Company B reported income of zero, to determine the amount, if any, of the allocation, Company B's reported operating profit for

2005 is compared to the comparable operating profits derived from the comparables' results for 2005. The ratio of operating profit to total services costs in 2005 is calculated for each of the comparables and applied to Company B's 2005 total services costs to derive the following results:

<i>Uncontrolled Service Provider</i>	<i>OP/Total Service Costs (For 2005)</i>	<i>Company B COP</i>
Company 1	15.00%	\$195,000
Company 2	14.75%	\$191,750
Company 3	14.00%	\$182,000
Company 4	13.50%	\$175,500
Company 5	12.30%	\$159,900
Company 6	11.05%	\$143,650
Company 7	11.03%	\$143,390
Company 8	11.00%	\$143,000
Company 9	10.50%	\$136,500
Company 10	10.25%	\$133,250

(viii) Based on these results, the median of the comparable operating profits for 2005 is \$151,775. Therefore, Company B's income for 2005 is increased by \$151,775, the difference between Company B's reported operating profit for 2005 of zero and the median of the comparable operating profits for 2005.

(f) *Simplified cost-based method for certain services*—(1) *Evaluation of arm's length charge*—(i) *In general*. The simplified cost-based method evaluates whether the amount charged in a controlled services transaction that meets the conditions of paragraph (f)(3) of this section and is not described in paragraph (f)(2)(iii) or (f)(4) of this section is arm's length by reference to the markup on total services costs by uncontrolled taxpayers that engage in similar business activities under similar circumstances. This measure of an arm's length price corresponds to the profit level indicator consisting of the ratio of operating profit to total services costs, described in paragraph (e)(2)(ii) of this section.

(ii) *Coordination with best method rule*. If a controlled services transaction that meets the conditions of paragraph (f)(3) of this section and is not described in paragraphs (f)(2)(iii) or (f)(4) of this section is priced under or consistent with the simplified cost-based method, then the simplified cost-based method will be considered the best method for purposes of §1.482-1(c).

(2) *Limitation on allocations by the Commissioner*—(i) *In general*. Except

as provided in paragraphs (f)(2)(iv) and (v) of this section, the Commissioner may make an allocation with respect to a controlled services transaction that meets the conditions of paragraph (f)(3) of this section, that is not described in paragraphs (f)(2)(iii) or (f)(4) of this section, and that is priced under or consistent with the simplified cost-based method, only if the arm's length markup on total services costs exceeds the markup charged by the taxpayer on total services costs in the controlled transaction by at least the applicable number of percentage points described in paragraph (f)(2)(ii) of this section. For purposes of this paragraph (f), the arm's length markup on total services costs means the excess of the arm's length price of the controlled services transaction determined in accordance with the applicable rules under the section 482 regulations, without regard to this paragraph (f), over total services costs (as defined in paragraph (j) of this section), expressed as a percentage of total services costs.

(ii) *Applicable number of percentage points*. The applicable number of percentage points is six if the amount charged by the taxpayer is equal to total services costs, and the applicable number of percentage points declines ratably to zero by one percentage point for every increase of two percentage points in the markup on total services costs charged in the controlled transaction.

(iii) *Method inapplicable to high-margin transactions*. The simplified cost-based method may not be used if the arm's length markup on total services costs exceeds 10%.

(iv) *Measurement of limitation on allocations*. The rules of paragraphs (f)(2)(i) and (ii) of this section are expressed in this paragraph in equations and a table. The minimum arm's length markup necessary for an allocation by the Commissioner (Z) is the sum of the markup charged by the taxpayer (X) and the applicable number of percentage points determined under paragraph (f)(2)(ii) of this section (Y). This minimum arm's length markup necessary for allocation by the Commissioner (Z) also equals the lesser of—

(A) The sum of six percentage points and half of the markup charged by the taxpayer (X); and

(B) Ten percentage points, where the markup charged by the taxpayer is not less than zero. Thus:

$$Z = X + Y = \min((6\% + 0.5 \times X), 10\%) \text{ where } X \geq 0.$$

(C) The following table illustrates the results of these calculations in representative cases:

Markup charged by taxpayer (X)	0%	1%	2%	3%	4%	5%	6%	7%	8%	9%
Applicable number of percentage points (Y)	6	5.5	5	4.5	4	3.5	3	2.5	2	n/a
Arm's length markup necessary for allocation by the Commissioner (Z)	6%	6.5%	7%	7.5%	8%	8.5%	9%	9.5%	10%	10%

(v) *Scope of limitation on allocations by the Commissioner*—(A) *Loss transactions and transactions priced in excess of arm's length.* Nothing in this paragraph (f) shall limit the authority of the Commissioner to make an allocation where—

(1) The amount charged by the taxpayer is less than the total services costs with respect to the services; or

(2) The markup on total services costs charged by the taxpayer in the controlled transaction exceeds the arm's length markup on total services costs.

(B) *Allocation and apportionment of costs.* Nothing in this paragraph (f) limits the authority of the Commissioner to determine the total services costs in the controlled services transaction where the taxpayer's method of allocating and apportioning total services costs to the controlled service is not consistent with the method used to allocate and apportion total services costs in determining the arm's length markup, or otherwise does not constitute a reasonable method of allocation and apportionment, based on all the facts and circumstances.

(3) *Conditions on application of simplified cost-based method.* The arm's length amount charged in a controlled services transaction may be evaluated under the simplified cost-based method only if the following conditions are met.

(i) *Adequate books and records.* Permanent books of account and records must be maintained throughout the time when costs with respect to the controlled services are incurred by the renderer. Such books and records must be adequate to permit verification by the Commissioner of the total services costs incurred by the renderer, including verification of the methods used to allocate and apportion such costs to the services in question.

(ii) *Written contract*—(A) *In general.* A written contract must be in place throughout the time when costs with respect to the controlled services are incurred by the renderer and must provide the following—

(1) That the controlled recipient of such services becomes unconditionally obligated at the time the renderer incurs costs to pay the renderer an amount equal to total costs plus, to the extent provided in such contract, any markup on total services costs; and

(2) A general description of the classes of controlled services transactions subject to the contract.

(B) *De minimis exception.* A written contract need not be in place if the conduct of the controlled taxpayers is consistent with the terms described in paragraph (f)(3)(ii)(A) of this section and, for the taxable year at issue, the controlled taxpayer rendering the services establishes to the satisfaction of the Commissioner that—

(1) The aggregate gross income of the members controlled group consisting of taxpayers that are United States persons (as defined in §7701(a)(30)) is less than \$200 million; or

(2) The aggregate costs of such controlled group members evaluated under the simplified cost-based method are less than \$10 million.

(4) *Transactions not eligible for simplified cost-based method*—(i) *Services similar to services provided by renderer or recipient to uncontrolled parties.* The arm's length charge in a controlled services transaction may not be determined under the simplified cost-based method where the renderer, the recipient, or another controlled taxpayer in the same controlled group renders, or has rendered, similar services to one or more uncontrolled taxpayers (unless such services are rendered on a *de minimis* basis).

(ii) *Services rendered to a recipient that receives services from controlled taxpayers in significant amounts.* The arm's length charge in a controlled services transaction may not be determined under the simplified cost-based method where the services are rendered to a recipient that receives services from controlled taxpayers in significant amounts. A recipient may be presumed to receive

services in significant amounts unless the controlled taxpayer rendering the services establishes, to the satisfaction of the Commissioner, that the aggregate amount paid or accrued by the recipient of the controlled services to the renderer or renderers with respect to such services during a taxable year of the recipient is less than an amount equal to 50% of the total costs of the recipient in that taxable year. For purposes of this paragraph (f)(4)(ii), the total costs of the recipient exclude any amounts paid or accrued for materials that are properly reflected in the recipient's cost of goods sold.

(iii) *Services involving the use of intangible property.* The arm's length charge in a controlled services transaction may not be determined under the simplified cost-based method where the renderer's valuable or unique intangible property, or the renderer's particular resources or capabilities (such as the knowledge of and ability to take advantage of particularly advantageous situations or circumstances), contribute significantly to the value of the services and the renderer's costs associated with the services do not include costs with respect to such use of its intangible property or resources that are significant.

(iv) *Non-services transactions included in integrated transactions.* The arm's length charge in a controlled services transaction may not be determined under the simplified cost-based method to the extent a transaction other than a services transaction (such as a transfer of tangible property) accounts for a more than *de minimis* amount of value in a transaction structured as a controlled services transaction. In such cases, the arm's length charge for only the services element of the integrated transaction may be determined under the simplified cost-based method.

(v) *Certain transactions.* The arm's length charge may not be determined under the simplified cost-based method in any of the following categories of transactions:

- (A) Manufacturing;
- (B) Production;

- (C) Extraction;
- (D) Construction;
- (E) Reselling, distribution, acting as a sales or purchasing agent, or acting under a commission or other similar arrangement;
- (F) Research, development, or experimentation;
- (G) Engineering or scientific;
- (H) Financial transactions, including guarantees; and
- (I) Insurance or reinsurance.

(5) *Examples.* The following examples illustrate the operation of this paragraph (f), including the limitations of paragraph (f)(2) of this section on allocations by the Commissioner. For purposes of illustrating the operation and scope of such limitations, the examples assume a determination of an arm's length markup on total services costs and, where appropriate, the interquartile range and median with respect to the arm's length markup on total costs. In each example, assume that S is a wholly owned subsidiary of P; that the conditions described in paragraph (f)(3) of this section are satisfied; and that the relevant controlled services are not described in paragraph (f)(4) of this section.

*Example 1.* Company P renders accounting services to Company S. Company P uses the simplified cost-based method for the accounting services, and determines the amount charged as Company P's total cost of rendering the services, with no markup. Based on an application of the section 482 regulations without regard to this paragraph (f), the Commissioner determines that the interquartile range of arm's length markups on total services costs is between 3% and 6%, and the median is 4%. Because the arm's length markup on total services costs (4%) exceeds the markup on total services costs applied by the taxpayer (0%) by fewer than the applicable number of percentage points (6), the Commissioner may not make an allocation.

*Example 2.* Company P performs logistics-coordination services for its subsidiaries, including Company S. Company P uses the simplified cost-based method for the logistics services, and determines the amount charged as Company P's total cost of rendering the services, plus a markup of 5%. Based on an application of the section 482 regulations without regard to this paragraph (f), the Commissioner determines that the interquartile range of arm's length markups on total services costs is between 6% and 13%, and the median is 9%. Because the arm's length markup on total services costs (9%) exceeds the markup on total services costs applied by the taxpayer (5%) by more than the applicable number of percentage points (3.5), the limitations imposed by this rule on the Commissioner's authority to make an allocation do not apply. With respect to the determination and application of the arm's length range, see §1.482-1(e).

*Example 3.* Company P renders administrative services to its subsidiaries, including Company S.

Company P uses the simplified cost-based method for the administrative services, as it has for the preceding two years, and determines for all three years the amount charged as Company P's total cost of rendering the services, plus a markup of 5%. Based on an application of the section 482 regulations without regard to this paragraph (f), the Commissioner identifies uncontrolled comparables in the same industry segment that perform similar functions and bear similar risks as Company P. These transactions meet the comparability criteria under the comparable profits method of paragraph (e) of this section and §1.482-5. An analysis of the information available on the comparable parties shows that the ratio of operating profit to total services costs is the most appropriate profit level indicator, and that this ratio is relatively stable where at least three years are included in the average. The information available is not sufficiently complete to conclude that it is likely that all material differences between Company P and the uncontrolled comparables have been identified. Consequently, the Commissioner determines an arm's length range based on the results of all the uncontrolled comparables that achieve a similar level of comparability and reliability, and the Commissioner adjusts that range by applying a valid statistical method to the results of all the uncontrolled comparables. The Commissioner determines an interquartile range of arm's length markups on total services costs, which is between 6% and 13%, with a median of 9%. Because the arm's length markup on total services costs (9%) exceeds the average three-year markup on total services costs applied by the taxpayer (5%) by more than the applicable number of percentage points (3.5), the limitations imposed by this rule on the Commissioner's authority to make an allocation do not apply. With respect to the determination and application of the arm's length range, see §1.482-1(e).

*Example 4.* Company P renders administrative services to Company S. Company P uses the simplified cost-based method for the administrative services, and determines the amount charged as Company P's total cost of rendering the services, plus a markup of 6%. Based on an application of the section 482 regulations without regard to this paragraph (f), the Commissioner determines that the interquartile range of arm's length markups on total services costs is between 3% and 5%, and the median is 4.5%. Because the arm's length markup on total services costs (4.5%) is less than the markup applied by the taxpayer (6%), the limitations imposed by this rule on the Commissioner's authority to make an allocation do not apply.

*Example 5.* Company P provides administrative services to Company S. P uses the simplified cost-based method for the administrative services, and determines the amount charged as Company P's total cost of providing the services, minus a "markdown" of 1%. Because the markup on total services costs applied by the taxpayer in the controlled transaction (-1%) is less than zero, the limitations imposed by this rule on the Commissioner's authority to make an allocation do not apply.

*Example 6.* Company P performs custodial and maintenance services for certain office properties owned by Company S. Company P uses the simplified cost-based method for the administrative services, and determines the amount charged as Company P's total cost of providing the services

plus a markup of 8%. The Commissioner identifies uncontrolled comparables that perform a similar range of custodial and maintenance services for uncontrolled parties and charge those parties an annual fee based on the total square footage of the property. These transactions meet the comparability criteria under the comparable uncontrolled services price method of paragraph (b) of this section. Based on reliable accounting information, the Commissioner determines that it is possible to restate the price for the maintenance and custodial services charged to uncontrolled parties as representing a markup on total services costs of 4%. Because the markup on total services costs charged by the taxpayer on the controlled transactions exceeds the markup on total services costs determined by an application of the section 482 regulations without regard to this paragraph (f), the limitations imposed by this rule on the Commissioner's authority to make an allocation do not apply.

*Example 7.* Company P performs logistics-coordination services for its subsidiaries, including Company S. Company P uses the simplified cost-based method for the logistics services, and determines the amount charged as P's total cost of providing the services, plus a markup of 4%. Based on an application of the section 482 regulations without regard to this paragraph (f), the Commissioner determines that the interquartile range of arm's length markups on total services costs is between 3% and 11%, and the median is 8.5%. Given that the arm's length markup on total services costs (8.5%) exceeds the markup applied by the taxpayer (4%) by more than the applicable number of percentage points (4), the limitations imposed by this rule on the Commissioner's authority to make an allocation do not apply. With respect to the application of the arm's length range, see §1.482-1(e).

*Example 8.* Company P provides administrative services to Company S. Company P uses the simplified cost-based method for the administrative services, and determines the amount charged as Company P's total cost of providing the services, plus a markup of 4%. The taxpayer allocates and apportions to the administrative services total services costs of 300x, and reports a total price of 312x. Based on an application of the section 482 regulations without regard to this paragraph (f), the Commissioner determines that the interquartile range of arm's length markups on total services costs is between 3% and 6%, and the median is 4%. Because the arm's length markup on total services costs (4%) is equivalent to the markup on total services costs applied by the taxpayer (4%), the simplified cost-based method would generally prevent an allocation by the Commissioner based on the amount of markup charged. On examination, the Commissioner determines that the taxpayer should have allocated and apportioned total services costs of 325x to the administrative services, rather than 300x. Because the taxpayer's method of allocation and apportionment was not reasonable under the facts and circumstances, the Commissioner may make an allocation to reflect application of the markup on total services costs claimed by the taxpayer to the correct base of costs.



*Example 9.* Company P provides administrative services to Company S. Company P uses the simplified cost-based method for the administrative services, and determines the amount charged as Company P's total cost of providing the services, with a 4% markup. The taxpayer allocates and apportions to the administrative services total services costs of 300x. Based on an application of the section 482 regulations without regard to this paragraph (f), the Commissioner determines that the interquartile range of arm's length markups on total services costs is between 3% and 6%, and the median is 4%. Because the arm's length markup on total services costs (4%) is equivalent to the markup on total services costs applied by the taxpayer (4%), the simplified cost-based method would generally prevent an allocation by the Commissioner based on the amount of markup charged. On examination, the Commissioner determines that the taxpayer should have allocated and apportioned total services costs of 280x to the administrative services, rather than 300x. Because the taxpayer's method of allocation and apportionment was not reasonable under the facts and circumstances, the Commissioner may make an allocation to reflect application of the markup on total services costs claimed by the taxpayer to the correct base of costs.

*Example 10.* Company P performs supply-chain management services for its subsidiaries, including Company S. Company P uses the simplified cost-based method for these supply-chain services, and determines the amount charged as the total costs of providing the services plus a markup of 8%. Based on an application of the section 482 regulations without regard to this paragraph (f), the Commissioner determines that the interquartile range of arm's length markups is between 7% and 25%, and the median is 18%. Because the arm's length markup on total services costs is more than 10%, the simplified cost-based method is not applicable.

(g) *Profit split method*—(1) *In general.* The profit split method evaluates whether the allocation of the combined operating profit or loss attributable to one or more controlled transactions is arm's length by reference to the relative value of each controlled taxpayer's contribution to that combined operating profit or loss. The relative value of each controlled taxpayer's contribution is determined in a manner that reflects the functions performed, risks assumed and resources employed by such controlled taxpayer in the relevant business activity. The profit split method is ordinarily used in controlled services transactions involving high-value services or transactions that are highly integrated and that cannot be reliably evaluated on a separate basis. For application of the profit split method (both the comparable profit split and the residual profit split), see §1.482-6.

(2) *Examples.* The principles of this paragraph (g) are illustrated by the following examples:

*Example 1. Residual profit split.* (i) Company A, a corporation resident in Country X, auctions spare parts by means of an interactive database. Company A maintains a database that lists all spare parts available for auction. Company A developed the software used to run the database. Company A's database is managed by Company A employees in a data center located in Country X, where storage and manipulation of data also takes place. Company A has a wholly owned subsidiary, Company B, located in Country Y. Company B performs marketing and advertising activities to promote Company A's interactive database. Company B solicits unrelated companies to auction spare parts on Company A's database, and solicits customers interested in purchasing spare parts online. Company B owns and maintains a computer server in Country Y, where it receives information on spare parts available for auction. Company B has also designed a specialized communications network that connects its data center to Company A's data center in Country X. The communications network allows Company B to enter data from uncontrolled companies on Company A's database located in Country X. Company B's communications network also allows uncontrolled companies to access Company A's interactive database and purchase spare parts. Company B bore the risks and cost of developing this specialized communications network. Company B enters into contracts with uncontrolled companies and provides the companies access to Company A's database through the Company B network.

(ii) Analysis of the facts and circumstances indicates that both Company A and Company B possess valuable intangibles that they use to conduct the spare parts auction business. Company A bore the economic risks of developing and maintaining software and the interactive database. Company B bore the economic risks of developing the necessary technology to transmit information from its server to Company A's data-center, and to allow uncontrolled companies to access Company A's database. Company B helped to enhance the value of Company A's trademark and to establish a network of customers in Country Y. In addition, because the transactions between Company A and Company B are highly integrated, it is difficult to reliably evaluate them separately. Given the facts and circumstances, the Commissioner determines that a residual profit split method will provide the most reliable measure of an arm's length result.

(iii) Under the residual profit split method, profits are first allocated based on the routine contributions of each taxpayer. Routine contributions include general sales, marketing or administrative functions performed by Company B for Company A for which it is possible to identify market returns. Any residual profits will be allocated based on the nonroutine contributions of each taxpayer. Since both Company A and Company B provided nonroutine contributions, the residual profits are allocated based on these contributions.

*Example 2. Residual profit split.* (i) Company A, a U.S. corporation, is a large multinational corporation engaged in oil and mineral exploration, development and extraction/mining. In performing these functions, Company A uses teams of specialists who are drawn from its employees and employees of two of its wholly owned subsidiaries, Company B and

Company C. Company B is a U.S. corporation engaged in the business of providing general construction contracting services. Company C is a mining/extraction subsidiary of Company A and is located in Country C.

(ii) Through its long-term relationship with the Country C government, Company C obtains drilling rights on a tract of land for which it already owns mining rights. Because Company C lacks the expertise and personnel to perform oil exploration, Company C enters into an agreement with Companies A and B to provide certain services to facilitate exploration for oil on the tract. Specifically, Company A provides management services and Company B provides all necessary labor and equipment for the exploration. All three controlled companies provide their own administrative support for their respective functions.

(iii) Analysis of the facts and circumstances indicates that Companies A, B, and C all make nonroutine contributions. In addition, because the transactions between Companies A, B and C are highly integrated, it is difficult to reliably evaluate them on a separate basis. Given the facts and circumstances, the Commissioner determines that a residual profit split method will provide the most reliable measure of the arm's length results of the services performed by all three related taxpayers.

(iv) Under the residual profit split method, profits are first allocated based on the routine contributions of the three controlled taxpayers. Routine contributions include any general, sales, marketing or administrative functions performed by either Companies A, B or C for which it is possible to identify market returns. Any residual profits will be allocated based on the nonroutine contributions made by each taxpayer. Since Company C provided nonroutine contributions in the form of drilling rights, residual profits are allocated to Company C based on this contribution.

(h) *Unspecified methods.* Methods not specified in paragraphs (b) through (g) of this section may be used to evaluate whether the amount charged in a controlled services transaction is arm's length. Any method used under this paragraph (h) must be applied in accordance with the provisions of §1.482-1. Consistent with the specified methods, an unspecified method should take into account the general principle that uncontrolled taxpayers evaluate the terms of a transaction by considering the realistic alternatives to that transaction, and only enter into a particular transaction if none of the alternatives is preferable to it. For example, the comparable uncontrolled services price method compares a controlled services transaction to similar uncontrolled transactions to provide a direct estimate of the price to which the parties would have agreed had they resorted directly to a market alternative to the controlled services transaction. Therefore, in establishing whether a controlled services transaction achieved an arm's length result, an unspecified method

should provide information on the prices or profits that the controlled taxpayer could have realized by choosing a realistic alternative to the controlled services transaction (e.g., outsourcing a particular service function, rather than performing the function itself). As with any method, an unspecified method will not be applied unless it provides the most reliable measure of an arm's length result under the principles of the best method rule. See §1.482-1(c). Therefore, in accordance with §1.482-1(d) (Comparability), to the extent that an unspecified method relies on internal data rather than uncontrolled comparables, its reliability will be reduced. Similarly, the reliability of a method will be affected by the reliability of the data and assumptions used to apply the method, including any projections used.

(i) *Contingent-payment contractual terms for services*—(1) *Economic substance of contingent payment contractual terms recognized*. In the case of a contingent-payment arrangement, the arm's length result for the controlled services transaction ordinarily would not require payment by the recipient to the renderer in the tax accounting period in which the service is rendered if the specified contingency does not occur in that period, provided that it is reasonable to conclude that no such payment would be made by uncontrolled taxpayers engaged in similar transactions under similar circumstances. If the specified contingency occurs in a tax accounting period subsequent to the period in which the service is rendered, the arm's length result for the controlled services transaction ordinarily would require payment by the recipient to the renderer on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer in performing the activities in the absence of a provision that unconditionally obligates the recipient to pay for the activities performed in the tax accounting period in which the service is rendered, provided that it is reasonable to conclude that such payment would be made by uncontrolled taxpayers that engaged in similar transactions under similar circumstances.

(2) *Contingent-payment arrangement*. For purposes of this paragraph (i), an arrangement shall be treated as a contingent-payment arrangement if—

(i) *Written contract*. The arrangement is set forth in a written contract entered into prior to the start of the activity or group of activities constituting the controlled services transaction;

(ii) *Specified contingency*. The contract states that payment is contingent (in whole or in part) upon the happening of a future benefit (within the meaning of paragraph (1)(3) of this section) for the recipient directly related to the controlled services transaction; and

(iii) *Basis for payment*. The contract provides for payment on a basis that reflects the recipient's benefit from the services rendered and the risks borne by the renderer. Whether the specified contingency bears a direct relationship to the controlled services transaction, and whether the basis for payment reflects the recipient's benefit and the renderer's risk, are evaluated based on all the facts and circumstances. Pursuant to §1.482-1(d)(3)(ii)(B), one factor that is especially important is whether the contingency and the basis for payment are consistent with the economic substance of the controlled transaction and the conduct of the controlled parties.

(3) *Commissioner's authority to impute contingent-payment terms*. Consistent with the authority in §1.482-1(d)(3)(ii)(B), the Commissioner may impute contingent-payment contractual terms in a controlled services transaction if the economic substance of the transaction is consistent with the existence of such terms.

(4) *Evaluation of arm's length charge*. Whether the amount charged in a contingent-payment arrangement is arm's length will be evaluated in accordance with this section and other applicable rules under section 482. Payment under a contingent-payment contract must be reasonable and consistent with the economic substance of the controlled services transaction, based on all facts and circumstances, and must reflect the recipient's benefit from the services rendered and the risks borne by the renderer. In evaluating whether the amount charged in a contingent-payment arrangement for the manufacture, construction, or development of tangible or intangible property owned by the recipient is arm's length, the charge determined under the rules of §§1.482-3 and 1.482-4 for the transfer of

similar property may be considered. See §1.482-1(f)(2)(ii).

(5) *Examples*. The principles of this paragraph (i) are illustrated by the following examples:

*Example 1.* (i) Company X is a member of a controlled group that has operated in the pharmaceutical sector for many years. In Year 1, Company X enters into a written services agreement with Company Y, another member of the controlled group, whereby Company X will perform certain research and development activities for Company Y. The parties enter into the agreement before Company X undertakes any of the research and development activities covered by the agreement. At the time the agreement is entered into, the possibility that any new products will be developed is highly uncertain and the possible market or markets for any products that may be developed are not known and cannot be estimated with any reliability. Under the agreement, Company Y will own any patent or other rights that result from the activities of Company X under the agreement and Company Y will make payments to Company X only if such activities result in commercial sales of one or more derivative products. In that event, Company Y will pay Company X, for a specified period, x% of Company Y's gross sales of each of such products. Payments are required with respect to each jurisdiction in which Company Y has sales of such a derivative product, beginning with the first year in which the sale of a product occurs in the jurisdiction and continuing for six additional years with respect to sales of that product in that jurisdiction.

(ii) As a result of research and development activities performed by Company X for Company Y in Years 1 through 4, a compound is developed that may be more effective than existing medications in the treatment of certain conditions. Company Y registers the patent rights with respect to the compound in several jurisdictions in Year 4. In Year 6, Company Y begins commercial sales of the product in Jurisdiction A and, in that year, Company Y makes the payment to Company X that is required under the agreement. Sales of the product continue in Jurisdiction A in Years 7 through 9 and Company Y makes the payments to Company X in Years 7 through 9 that are required under the agreement.

(iii) The years under examination are Years 6 through 9. In evaluating whether the contingent payment terms will be recognized, the Commissioner considers whether the conditions of §1.482-9(i)(2) are met and whether the specified contingency and basis of payment are consistent with the economic substance of the controlled services transaction and with the conduct of the controlled parties. The Commissioner determines that the contingent-payment arrangement is reflected in the written agreement between Company X and Company Y; that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction; and that the basis for the payment provided for in the event such sales occur reflects the recipient's benefit and the renderer's risk. Consistent with §1.482-1(d)(3)(ii)(B) and (iii)(B), the Commissioner determines that the parties' conduct over the term of the agreement has been consistent with their contractual allocation of risk; that Company X has the

financial capacity to bear the risk that its research and development services may be unsuccessful and that it may not receive compensation for such services; and that Company X exercises managerial and operational control over the research and development, such that it is reasonable for Company X to assume the risk of those activities. The Commissioner also determines that the arrangement is consistent with terms that uncontrolled parties operating under similar conditions could reasonably be expected to adopt with respect to comparable research and development activities. Based on all these facts, the Commissioner determines that the terms of the contingent-payment arrangement are consistent with economic substance.

(iv) In determining whether the amount charged under the contingent-payment arrangement in each of Years 6 through 9 is arm's length, the Commissioner evaluates under §1.482-9 and other applicable rules under §482 the compensation paid in each year for the research and development services. This analysis takes into account that under the contingent-payment terms Company X bears the risk that it might not receive payment for its services in the event that those services do not result in marketable products and the risk that the magnitude of its payment depends on the magnitude of product sales, if any. The Commissioner also considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risk and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, in evaluating the reasonableness of the compensation of x% of gross sales that is paid to Company X during the first four years of commercial sales of derivative products, the Commissioner may consider the royalties (or other consideration) charged for intangibles that are comparable to those incorporated in the derivative products and that resulted from Company X's research and development activities under the contingent-payment arrangement.

*Example 2.* (i) The facts are the same as in paragraphs (i) and (ii) of *Example 1*, except that, in the event that Company X's activities result in commercial sales of one or more derivative products by Company Y, Company Y will pay Company X a fee equal to the research and development costs borne by Company X plus an amount equal to x% of such costs, with the payment to be made in the first year in which any such sales occur. The x% markup on costs is within the range, ascertainable in Year 1, of markups on costs of independent contract researchers that are compensated under terms that unconditionally obligate the recipient to pay for the activities performed in the tax accounting period in which the service is rendered. In Year 6, Company Y makes the single payment to Company X that is required under the arrangement.

(ii) The years under examination are Years 6 through 9. In evaluating whether the contingent payment terms will be recognized, the Commissioner considers whether the requirements of §1.482-9(i)(2) were met at the time the written agreement was entered into and whether the specified contingency and basis for payment are consistent with the economic substance of the controlled services transaction and

with the conduct of the controlled parties. The Commissioner determines that the contingent-payment terms are reflected in the written agreement between Company X and Company Y and that commercial sales of products developed under the arrangement represent future benefits for Company Y directly related to the controlled services transaction. However, in this case, the Commissioner determines that the basis for payment provided for in the event such sales occur (costs of the services plus x%, representing the markup for contract research in the absence of any nonpayment risk) does not reflect the recipient's benefit and the renderer's risks in the controlled services transaction. The Commissioner also determines that the arrangement is not consistent with terms that uncontrolled parties operating under similar conditions could reasonably be expected to adopt with respect to comparable research and development activities. Based on all these facts, the Commissioner determines that the terms of the contingent-payment arrangement are not consistent with economic substance.

(iii) Accordingly, the Commissioner determines to exercise its authority to impute contingent-payment contractual terms that accord with economic substance, pursuant to paragraph (i)(3) of this section and §1.482-1(d)(3)(ii)(B). In this regard, the Commissioner takes into account that at the time the arrangement was entered into, the possibility that any new products would be developed was highly uncertain and the possible market or markets for any products that may be developed were not known and could not be estimated with any reliability. In such circumstances, it is reasonable to conclude that one possible basis of payment that uncontrolled parties could adopt in similar transactions under similar circumstances, in order to reflect the recipient's benefit and the renderer's risks, would be a charge equal to a percentage of commercial sales of one or more derivative products that result from the research and development activities. The Commissioner in this case may impute terms that require Company Y to pay Company X a percentage of sales of the products developed under the agreement in each of Years 6 through 9.

(iv) In determining an appropriate arm's length charge under such imputed contractual terms, the Commissioner conducts an analysis under §1.482-9 and other applicable rules under section 482, and considers the alternatives reasonably available to the parties in connection with the controlled services transaction. One such alternative, in view of Company X's willingness and ability to bear the risks and expenses of research and development activities, would be for Company X to undertake such activities on its own behalf and to license the rights to products successfully developed as a result of such activities. Accordingly, for purposes of its determination, the Commissioner may consider the royalties (or other consideration) charged for intangibles that are comparable to those incorporated in the derivative products that resulted from Company X's research and development activities under the contingent-payment arrangement.

(j) *Total services costs.* For purposes of this section, total services costs means all costs of rendering those services for

which total services costs are being determined. Total services costs include all costs, based on analysis of the facts and circumstances, that can be directly identified with the act of rendering the services, and all other costs reasonably allocable to the services, under the principles of paragraph (k)(2) of this section. In general, costs for this purpose should comprise full consideration for all resources expended, used, or made available to achieve the specific objective for which the service is rendered. Reference to generally accepted accounting principles or Federal income tax accounting rules (where Federal income tax data for comparable transactions or business activities are available) may provide a useful starting point but will not be conclusive. Total services costs do not include interest expense, foreign income taxes (as defined in §1.901-2(a)), or domestic income taxes.

(k) *Allocation of costs—(1) In general.* In any case where the renderer's activity that results in a benefit (within the meaning of paragraph (l)(3) of this section) for one recipient in a controlled services transaction also generates a benefit for one or more other members of a controlled group (including the benefit, if any, to the renderer), and the amount charged under this section in the controlled services transaction is determined under a method that makes reference to costs, costs must be allocated among the portions of the activity for the benefit of the first mentioned recipient and such other members of the controlled group under this paragraph (k). The principles of this paragraph (k) must also be used whenever it is appropriate to allocate and apportion any class of costs (e.g., overhead costs) in order to determine the total services costs of rendering the services. In no event will an allocation of costs based on a generalized or non-specific benefit be appropriate.

(2) *Appropriate method of allocation and apportionment—(i) Reasonable method standard.* Any reasonable method may be used to allocate and apportion costs under this section. In establishing the appropriate method of allocation and apportionment, consideration should be given to all bases and factors, including, for example, total services costs, total costs for a relevant activity, assets, sales, compensation, space utilized, and time spent. The costs incurred by supporting

departments may be apportioned to other departments on the basis of reasonable overall estimates, or such costs may be reflected in the other departments' costs by applying reasonable departmental overhead rates. Allocations and apportionments of costs must be made on the basis of the full cost, as opposed to the incremental cost.

(ii) *Use of general practices.* The practices used by the taxpayer to apportion costs in connection with preparation of statements and analyses for the use of management, creditors, minority shareholders, joint venturers, clients, customers, potential investors, or other parties or agencies in interest will be considered as potential indicators of reliable allocation methods, but need not be accorded conclusive weight by the Commissioner. In determining the extent to which allocations are to be made to or from foreign members of a controlled group, practices employed by the domestic members in apportioning costs among themselves will also be considered if the

relationships with the foreign members are comparable to the relationships among the domestic members of the controlled group. For example, if for purposes of reporting to public stockholders or to a governmental agency, a corporation apportions the costs attributable to its executive officers among the domestic members of a controlled group on a reasonable and consistent basis, and such officers exercise comparable control over foreign members of the controlled group, such domestic apportionment practice will be considered in determining the allocations to be made to the foreign members.

(3) *Examples.* The principles of this paragraph (k) are illustrated by the following examples:

*Example 1.* Company A pays an annual license fee of 500x to an uncontrolled taxpayer for unlimited use of a database within the corporate group. Under the terms of the license with the uncontrolled taxpayer, Company A is permitted to use the database for its own use and in rendering research services to its subsidiary, Company B. Company B obtains benefits from the database that are similar to those that

it would obtain if it had independently licensed the database from the uncontrolled taxpayer. Evaluation of the arm's length charge (under a method in which costs are relevant) to Company B for the controlled services that incorporate use of the database must take into account the full amount of the license fee of 500x paid by Company A, as reasonably allocated and apportioned to the relevant benefits, although the incremental use of the database for the benefit of Company B did not result in an increase in the license fee paid by Company A.

*Example 2.* (i) Company A is a consumer products company located in the United States. Companies B and C are wholly owned subsidiaries of Company A and are located in Countries B and C, respectively. Company A and its subsidiaries manufacture products for sale in their respective markets. Company A hires a consultant who has expertise regarding a manufacturing process used by Company A and its subsidiary, Company B. Company C, the Country C subsidiary, uses a different manufacturing process, and accordingly will not receive any benefit from the outside consultant hired by Company A. In allocating and apportioning the cost of hiring the outside consultant (100), Company A determines that sales constitute the most appropriate allocation key.

(ii) Company A and its subsidiaries have the following sales:

Company	A	B	C	Total
Company Sales	400	100	200	700

(iii) Because Company C does not obtain any benefit from the consultant, none of the costs are allocated to it. Rather, the costs of 100 are allocated and

apportioned ratably to Company A and Company B as the entities that obtain a benefit from the campaign,

based on the total sales of those entities (500). An appropriate allocation of the costs of the consultant is as follows:

Company	A	B	Total
Allocation	$\frac{400}{500}$	$\frac{100}{500}$	
Amount	80	20	100

(1) *Controlled services transaction—(1) In general.* A controlled services transaction includes any activity (as defined in paragraph (1)(2) of this section) by one member of a group of controlled taxpayers (the renderer) that results in a benefit (as defined in paragraph (1)(3) of this section) to one or more other members of the controlled group (the recipient(s)).

(2) *Activity.* An activity includes the performance of functions, assumptions of risks, or use by a renderer of tangible or intangible property or other resources, capabilities, or knowledge, such as knowledge of and ability to take advantage of particularly advantageous situations or circumstances. An activity also includes making

available to the recipient any property or other resources of the renderer.

(3) *Benefit—(i) In general.* An activity is considered to provide a benefit to the recipient if the activity directly results in a reasonably identifiable increment of economic or commercial value that enhances the recipient's commercial position, or that may reasonably be anticipated to do so. An activity is generally considered to confer a benefit if, taking into account the facts and circumstances, an uncontrolled taxpayer in circumstances comparable to those of the recipient would be willing to pay an uncontrolled party to perform the same or similar activity on either a fixed or contingent-payment basis, or if the recipient otherwise would have performed for itself the

same activity or a similar activity. A benefit may result to the owner of an intangible if the renderer engages in an activity that is reasonably anticipated to result in an increase in the value of that intangible.

(ii) *Indirect or remote benefit.* An activity is not considered to provide a benefit to the recipient if, at the time the activity is performed, the present or reasonably anticipated benefit from that activity is so indirect or remote that the recipient would not be willing to pay, on either a fixed or contingent-payment basis, an uncontrolled party to perform a similar activity, and would not be willing to perform such activity for itself for this purpose. The determination whether the benefit from an activity is indirect or remote is based on the

nature of the activity and the situation of the recipient, taking into consideration all facts and circumstances.

(iii) *Duplicative activities.* If an activity performed by a controlled taxpayer duplicates an activity that is performed, or that reasonably may be anticipated to be performed, by another controlled taxpayer on or for its own account, the activity is not considered to provide a benefit to the recipient, unless the duplicative activity itself provides an additional benefit to the recipient.

(iv) *Shareholder activities.* An activity is not considered to provide a benefit if the primary effect of that activity is to protect the renderer's capital investment in the recipient or in other members of the controlled group, or if the activity relates primarily to compliance by the renderer with reporting, legal, or regulatory requirements applicable specifically to the renderer, where the renderer controls every other member in such group. Activities in the nature of day-to-day management generally do not relate to protection of the renderer's capital investment. Based on analysis of the facts and circumstances, activities in connection with a corporate reorganization may be considered to provide a benefit to one or more controlled taxpayers.

(v) *Passive association.* A controlled taxpayer generally will not be considered to obtain a benefit where that benefit results from the controlled taxpayer's status as a member of a controlled group. A controlled taxpayer's status as a member of a controlled group may, however, be taken into account for purposes of evaluating comparability between controlled and uncontrolled transactions.

(4) *Examples.* The principles of this paragraph (1) are illustrated by the following examples. In each example, assume that Company X is a U.S. corporation and Company Y is a wholly owned subsidiary of Company X in Country B.

*Example 1. In general.* In developing a worldwide advertising and promotional campaign for a consumer product, Company X pays for and obtains designation as an official sponsor of the Olympics. This designation allows Company X and all its subsidiaries, including Company Y, to identify themselves as sponsors and to use the Olympic logo in advertising and promotional campaigns. The Olympic sponsorship campaign generates benefits to Company X, Company Y, and other subsidiaries of Company X.

*Example 2. Indirect or remote benefit.* Based on recommendations contained in a study performed by its internal staff, Company X implements certain changes in its management structure and the compensation of managers of divisions located in the United States. No changes were recommended or considered for Company Y in Country B. The internal study and the resultant changes in its management may increase the competitiveness and overall efficiency of Company X. Any benefits to Company Y as a result of the study are, however, indirect or remote. Consequently, Company Y is not considered to obtain a benefit from the study.

*Example 3. Indirect or remote benefit.* Based on recommendations contained in a study performed by its internal staff, Company X decides to make changes to the management structure and management compensation of its subsidiaries, in order to increase their profitability. As a result of the recommendations in the study, Company X implements substantial changes in the management structure and management compensation scheme of Company Y. The study and the changes implemented as a result of the recommendations are anticipated to increase the profitability of Company X and its subsidiaries. The increased management efficiency of Company Y that results from these changes is considered to be a specific and identifiable benefit, rather than remote or speculative. Consequently, Company Y is considered to obtain a benefit from the study.

*Example 4. Duplicative activities.* At its corporate headquarters in the United States, Company X performs certain treasury functions for Company X and for its subsidiaries, including Company Y. These treasury functions include raising capital, arranging medium and long-term financing for general corporate needs, including cash management. Under these circumstances, the treasury functions performed by Company X do not duplicate the functions performed by Company Y's staff. Accordingly, Company Y is considered to obtain a benefit from the functions performed by Company X.

*Example 5. Duplicative activities.* The facts are the same as in *Example 4*, except that Company Y's functions include ensuring that the financing requirements of its own operations are met. Analysis of the facts and circumstances indicates that Company Y independently administers all financing and cash-management functions necessary to support its operations, and does not utilize financing obtained by Company X. Under the circumstances, the treasury functions performed by Company X are duplicative of similar functions performed by Company Y's staff, and the duplicative functions do not enhance Company Y's position. Accordingly, Company Y is not considered to obtain a benefit from the duplicative activities performed by Company X.

*Example 6. Duplicative activities.* Company X's in-house legal staff has specialized expertise in several areas, including intellectual property law. Company Y is involved in negotiations with an unrelated party to enter into a complex joint venture that includes multiple licenses and cross-licenses of patents and copyrights. Company Y retains outside counsel that specializes in intellectual property law to review the transaction documents. Outside counsel advises that the terms for the proposed transaction are advantageous to Company Y and that the contracts are valid and fully enforceable. Before Company Y executes

the contracts, the legal staff of Company X also reviews the transaction documents and concurs in the opinion provided by outside counsel. The activities performed by Company X substantially duplicate the legal services obtained by Company Y, but they also reduce the commercial risk associated with the transaction. Accordingly, Company Y is considered to obtain a benefit from Company X's duplicative review of the contracts.

*Example 7. Shareholder activities.* Company X is a publicly held corporation. U.S. laws and regulations applicable to publicly held corporations such as Company X require the preparation and filing of periodic reports that show, among other things, profit and loss statements, balance sheets, and other material financial information concerning the company's operations. Company X analyzes and compiles data regarding operation of its subsidiaries, including Company Y. The periodic reports prepared and filed by Company X include information on the financial results of Company Y and other subsidiaries. Because Company X's preparation and filing of the reports relate primarily to its role as an investor of capital and a shareholder in Company Y, these activities constitute shareholder activities and therefore Company Y is not considered to obtain a benefit from the preparation and filing of the reports.

*Example 8. Shareholder activities.* The facts are the same as in *Example 7*, except that Company Y is subject to reporting requirements in Country B similar to those applicable to Company X in the United States. Much of the data that Company X analyzes and compiles regarding Company Y's operations for purposes of complying with the U.S. reporting requirements is made available to Company Y for its use in preparing reports that must be filed in Country B. Company Y incorporates these data, after minor adjustments for differences in local accounting practices, into the reports that it files in Country B. Under these circumstances, because Company X's analysis and compilation of Company Y's financial data do not relate primarily to its role as an investor of capital or shareholder in Company Y, Company Y is considered to obtain a benefit from the analysis and compilation of Company Y's financial data.

*Example 9. Shareholder activities.* Members of Company X's internal audit staff visit Company Y on a semiannual basis in order to review the subsidiary's adherence to internal operating procedures issued by Company X and its compliance with U.S. anti-bribery laws, which apply to Company Y on account of its ownership by a U.S. Because the reviews by Company X's audit staff relate primarily to Company X's investment in Company Y by ensuring that Company X and its subsidiaries are in compliance with Company X's internal operating procedures and Country A laws, the visits are shareholder activities and therefore Company Y is not considered to obtain a benefit from the visits.

*Example 10. Shareholder activities.* Country B recently enacted legislation that changed the foreign currency exchange controls applicable to foreign shareholders of Country B corporations. Company X concludes that it may benefit from changing the capital structure of Company Y, thus taking advantage of the new foreign currency exchange control laws in Country B. Company X engages an investment banking firm and a law firm to review the Country B legislation and to propose possible changes to the

capital structure of Company Y. Because Company X retains and pays the firms in order to facilitate Company Y's ability to pay dividends and other amounts, these expenses relate primarily to Company X's role as an investor of capital and therefore Company Y is not considered to obtain a benefit from the activities.

*Example 11. Shareholder activities.* The facts are the same as in *Example 10*, except that Company Y bears the full cost of retaining the firms to evaluate the new foreign currency control laws in Country B and to make appropriate changes to its stock ownership by Company X. Company X is considered to obtain a benefit from the rendering by Company Y of these activities, which would be shareholder activities if conducted by Company X (see *Example 10*).

*Example 12. Shareholder activities.* The facts are the same as in *Example 10*, except that the new laws relate solely to corporate governance in Country B, and Company X retains the law firm and investment banking firm in order to evaluate whether restructuring would increase Company Y's profitability, reduce the number of legal entities in Country B, and increase Company Y's ability to introduce new products more quickly in Country B. Because Company X retained the law firm and the investment banking firm solely to enhance Company Y's profitability and the efficiency of its operations, the activities do not relate primarily to Company X's role as a shareholder or investor of capital and therefore Company Y is considered to obtain.

*Example 13. Shareholder activities.* Company X establishes detailed personnel policies for its subsidiaries, including Company Y. Company X also reviews and approves the performance appraisals of Company Y's executives, monitors levels of compensation paid to all Company Y personnel, and is involved in hiring and firing decisions regarding the senior executives of Company Y. Because this personnel-related activity by Company X involves day-to-day management of Company Y, it does not relate primarily to Company X's role as an investor of capital or a shareholder of Company Y, and therefore Company Y is considered to obtain a benefit from the activity.

*Example 14. Shareholder activities.* Each year, Company X conducts a two-day retreat for its senior executives. The purpose of the retreat is to refine the long-term business strategy of Company X and its subsidiaries, including Company Y, and to produce a confidential strategy statement. The strategy statement identifies several potential growth initiatives for Company X and its subsidiaries and lists general means of increasing the profitability of the company as a whole. The strategy statement is made available without charge to Company Y and the other subsidiaries of Company X. Company Y independently evaluates whether to implement some, all, or none of the initiatives contained in the strategy statement. Because the preparation of the strategy statement does not relate primarily to Company X's role as an investor of capital or a shareholder of Company Y, the expense of preparing the document is not a shareholder expense. In determining whether Company Y obtained a benefit from the making available of access to the strategy statement, the test is whether, based on the facts and circumstances, Company Y would be willing to pay for a similar analysis and similar recommendations, or otherwise would have undertaken a similar analysis on its own if it were an

uncontrolled taxpayer operating under similar conditions as Company Y.

*Example 15. Passive association/benefit.* Company X is the parent corporation of a large controlled group that has been in operation in the information-technology sector for ten years. Company Y is a small corporation that was recently acquired by the Company X controlled group from local Country B owners. Several months after the acquisition of Company Y, Company Y obtained a contract to redesign and assemble the information-technology networks and systems of a large financial institution in Country B. The project was significantly larger and more complex than any other project undertaken to date by Company Y. Company Y did not use Company X's marketing intangibles to solicit the contract, and Company X had no involvement in the solicitation, negotiation, or anticipated execution of the contract. For purposes of this section, Company Y is not considered to obtain a benefit from Company X or any other member of the controlled group because the ability of Company Y to obtain the contract, or to obtain the contract on more favorable terms than would have been possible prior to its acquisition by the Company X controlled group, was due to Company Y's status as a member of the Company X controlled group and not to any specific activity by Company X or any other member of the controlled group.

*Example 16. Passive association/benefit.* The facts are the same as in *Example 15*, except that Company X executes a performance guarantee with respect to the contract, agreeing to assist in the project if Company Y fails to meet certain mileposts. This performance guarantee allowed Company Y to obtain the contract on more favorable terms than otherwise would have been possible. Company Y is considered to obtain a benefit from Company X's execution of the performance guarantee.

*Example 17. Passive association/benefit.* The facts are the same as in *Example 15*, except that Company X began the process of negotiating the contract with the financial institution in Country B before acquiring Company Y. Once Company Y was acquired by Company X, the contract with the financial institution was entered into by Company Y. Company Y is considered to obtain a benefit from Company X's negotiation of the contract.

(m) *Coordination with transfer pricing rules for other transactions*—(1) *Services transactions that include other types of transactions.* A transaction structured as a controlled services transaction may include other elements for which a separate category or categories of methods are provided, such as a loan or advance, a rental, or a transfer of tangible or intangible property. See §§1.482-1(b)(2) and 1.482-2(a), (c), and (d). Whether such an integrated transaction is evaluated as a controlled services transaction under this section or whether one or more elements should be evaluated separately under other sections of the section 482 regulations depends on which approach will provide the most reliable measure of an arm's length

result. Ordinarily, an integrated transaction of this type may be evaluated under this section and its separate elements need not be evaluated separately, provided that each component of the transaction may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length result in the controlled transaction. See §1.482-1(d)(3).

(2) *Services transactions that effect a transfer of intangible property.* A transaction structured as a controlled services transaction may in some cases result in a transfer, in whole or in part, of intangible property, or may have an effect similar to the transfer of intangible property, or may include an element that constitutes the transfer of intangible property. If such element relating to intangible property is material to the evaluation, the arm's length result for the element of the transaction that involves intangible property generally must be corroborated or determined by an analysis under §1.482-4.

(3) *Services subject to a qualified cost sharing arrangement.* Services provided by a controlled participant under a qualified cost sharing arrangement are subject to §1.482-7.

(4) *Other types of transactions that include controlled services transactions.* A transaction structured other than as a controlled services transaction may include one or more elements for which separate pricing methods are provided in this section. Whether such an integrated transaction is evaluated under another section of the section 482 regulations or whether one or more elements should be evaluated separately under this section depends on which approach will provide the most reliable measure of an arm's length result. Ordinarily, a single method may be applied to such an integrated transaction, and the separate services component of the transaction need not be separately analyzed under this section, provided that the controlled services may be adequately accounted for in evaluating the comparability of the controlled transaction to the uncontrolled comparables and, accordingly, in determining the arm's length results in the controlled transaction. See §1.482-1(d)(3).

(5) *Global dealing operations.* [Reserved].

(6) *Examples.* The following examples illustrate paragraphs (m)(1) through (4) of this section:

*Example 1.* (i) U.S. parent corporation Company X enters into an agreement to maintain equipment of Company Y, a foreign subsidiary. The maintenance of the equipment requires the use of spare parts. The cost of the spare parts necessary to maintain the equipment amounts to approximately 25 percent of the total costs of maintaining the equipment. Company Y pays a fee that includes a charge for labor and parts.

(ii) Whether this integrated transaction is evaluated as a controlled services transaction or is evaluated as a controlled services transaction and the transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. If it is not possible to find comparable uncontrolled services transactions that involve similar services and tangible property transfers as the controlled transaction between Company X and Company Y, it will be necessary to determine the arm's length charge for the controlled services, and then to evaluate separately the arm's length charge for the tangible property transfers under §1.482-1 and §§1.482-3 through 1.482-6. Alternatively, it may be possible to apply the comparable profits method of §1.482-5, to evaluate the arm's length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of measure of an arm's length result if uncontrolled parties are identified that perform similar, combined functions of maintaining and providing spare parts for similar equipment.

*Example 2.* (i) U.S. parent corporation Company X sells industrial equipment to its foreign subsidiary, Company Y. In connection with this sale, Company X renders to Company Y services that consist of demonstrating the use of the equipment and assisting in the effective start-up of the equipment. Company X structures the integrated transaction as a sale of tangible property and determines the transfer price under the comparable uncontrolled price method of §1.482-3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or is evaluated as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. In this case, the controlled services may be similar to services rendered in the transactions used to determine the comparable uncontrolled price, or they may appropriately be considered a difference between the controlled transaction and comparable transactions with a definite and reasonably ascertainable effect on price for which appropriate adjustments can be made. See §1.482-1(d)(3)(ii)(A)(6). In either case, application of the comparable uncontrolled price method to evaluate the integrated transaction may provide a reliable measure of an arm's length result, and application of a separate transfer pricing method for the controlled services element of the transaction is not necessary.

*Example 3.* (i) The facts are the same as in *Example 2* except that, after assisting Company Y in start-up, Company X also renders ongoing services, including instruction and supervision regarding Company Y's ongoing use of the equipment. Company X

structures the entire transaction, including the incremental ongoing services, as a sale of tangible property, and determines the transfer price under the comparable uncontrolled price method of §1.482-3(b).

(ii) Whether this integrated transaction is evaluated as a transfer of tangible property or is evaluated as a controlled services transaction and a transfer of tangible property depends on which approach will provide the most reliable measure of an arm's length result. It may not be possible to identify comparable uncontrolled transactions in which a seller of merchandise renders services similar to the ongoing services rendered by Company X to Company Y. In such a case, the incremental services in connection with ongoing use of the equipment could not be taken into account as a comparability factor because they are not similar to the services rendered in connection with sales of similar tangible property. Accordingly, it may be necessary to evaluate separately the transfer price for such services under this section in order to produce the most reliable measure of an arm's length result. Alternatively, it may be possible to apply the comparable profits method of §1.482-5 to evaluate the arm's length profit of Company X or Company Y from the integrated controlled transaction. The comparable profits method may provide the most reliable measure of an arm's length result if uncontrolled parties are identified that perform the combined functions of selling equipment and rendering ongoing after-sale services associated with such equipment. In that case, it would not be necessary to separately evaluate the transfer price for the controlled services under this section.

*Example 4.* (i) Company X, a U.S. corporation, and Company Y, a foreign corporation, are members of a controlled group. Both companies develop and manufacture adhesives. Company X also renders research and development services. As part of rendering these services, Company X provides technical manuals and documentation relating to Company X's manufacturing activities. In the process of performing research and development activities for Company Y, Company X developed know-how regarding a more cost-effective process to manufacture adhesives. Company X memorialized this know-how in technical manuals and other related technical documentation, and provided these documents to Company Y, without any restrictions on Company Y's use of the know-how or related materials.

(ii) The controlled services transaction between Company X and Company Y includes an element that constitutes the transfer of intangible property (*i.e.*, know-how). Because the element relating to the intangible property is material to the arm's length evaluation, the arm's length result for that element must be corroborated or determined by an analysis under §1.482-4.

(n) *Effective date.* This section is generally applicable for taxable years beginning on or after the date of publication of this section as final regulations in the **Federal Register**.

Par. 8. In §1.6038A-3(a)(3), *Example 4*, the text is revised to read as follows:

*§1.6038A-3 Record maintenance.*

(a) \* \* \*

(3) \* \* \*

*Example 4.* S, a U.S. reporting corporation, provides computer consulting services for its foreign parent, X. Based on the application of section 482 and the regulations thereunder, it is determined that the cost of services plus method, as described in §1.482-9(d), will provide the most reliable measure of an arm's length result, based on the facts and circumstances of the controlled transaction between S and X. S is required to maintain records to permit verification upon audit of the comparable transactional costs (as described in §1.482-9(d)(2)(iii)) used to calculate the arm's length price. Based on the facts and circumstances, if it is determined that X's records are relevant to determine the correct U.S. tax treatment of the controlled transaction between S and X, the record maintenance requirements under section 6038A(a) and this section will be applicable to the records of X.

\* \* \* \* \*

Par. 9. Section 1.6662-6 is amended by:

1. Redesignating paragraphs (d)(2)(ii)(A) through (d)(2)(ii)(G) as paragraphs (d)(2)(ii)(A)(1) through (d)(2)(ii)(A)(7) and paragraph (d)(2)(ii) introductory text as paragraph (d)(2)(ii)(A), respectively.

2. Adding a new paragraph (d)(2)(ii)(B).

3. Revising paragraphs (d)(2)(iii)(B)(4) and (d)(2)(iii)(B)(6)

4. Adding a third sentence to paragraph (g).

The revisions and additions read as follows:

*§1.6662-6 Transactions between persons described in section 482 and net section 482 transfer price adjustments.*

\* \* \* \* \*

(d) \* \* \*

(2) \* \* \*

(ii) \* \* \*

(B) *Simplified cost-based method.* A taxpayer's selection of the simplified cost-based method for certain services, described in §1.482-9(f), and its application of that method to a controlled services transaction will be considered reasonable for purposes of the specified method requirement only if the taxpayer reasonably concluded that the controlled services transaction meets the conditions of §1.482-9(f)(3) and is not described in paragraphs §1.482-9(f)(2)(iii) or (f)(4). Whether the taxpayer's conclusion was reasonable must be determined from all the facts and circumstances. The factors relevant to this determination include

those described in paragraph (d)(2)(ii)(A) of this section, to the extent applicable.

(iii) \* \* \*

(B) \* \* \*

(4) A description of the method selected and an explanation of why that method was selected, including an evaluation of whether the regulatory conditions and requirements for application of that method, if any, were met;

\* \* \* \* \*

(6) A description of the controlled transactions (including the terms of sale) and any internal data used to analyze those transactions. For example, if a profit split method is applied, the documentation must include a schedule providing the total income, costs, and assets (with adjustments for different accounting practices and currencies) for each controlled taxpayer participating in the relevant business activity and detailing the allocations of such items to that activity. Similarly, if a cost-based method (such as the cost plus method, the simplified cost-based method for certain services, or a comparable profits method with a cost-based profit level indicator) is applied, the documentation must include a description of the manner in which relevant costs are determined and are allocated and apportioned to the relevant controlled transaction.

\* \* \* \* \*

(g) \* \* \* Paragraphs (d)(2)(ii)(B), (iii)(B)(4) and (iii)(B)(6) of this section are applicable for taxable years beginning after the date the final regulations are published in the **Federal Register**.

#### PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT THE SOURCE

Par. 10. The authority citation for part 31 continues to read as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 11. Section 31.3121(s)-1 is amended by:

1. Revising the fourth sentence and adding a fifth sentence in paragraph (c)(2)(iii).

2. Adding a second sentence to paragraph (d).

The revision and additions read as follows:

*§31.3121(s)-1 Concurrent employment by related corporations with common paymaster.*

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(iii) *Group-wide allocation rules.*

\* \* \* To the extent practicable, the Commissioner may use the principles of §1.482-2(b) of this chapter in making the allocations with respect to wages paid after December 31, 1978, and on or before the date the final regulations are published in the **Federal Register**. To the extent practicable, the Commissioner may use the principles of §1.482-9 of this chapter in making the allocations with respect to wages paid after the date of the final regulations are published in the **Federal Register**.

(d) *Effective date.* \* \* \* The fifth sentence of paragraph (c)(2)(iii) of this section is applicable with respect to wages paid on or after the date of publication of that sentence as final regulations in the **Federal Register**.

Dale F. Hart,  
*Acting Deputy Commissioner for  
Services and Enforcement.*

(Filed by the Office of the Federal Register on September 5, 2003, 2:46 p.m., and published in the issue of the Federal Register for September 10, 2003, 68 F.R. 53447)

### Notice of Proposed Rulemaking by Cross-Reference to Temporary Regulations and Notice of Public Hearing

#### Special Depreciation Allowance REG-157164-02

AGENCY: Internal Revenue Service  
(IRS), Treasury

ACTION: Notice of proposed rulemaking  
by cross-reference to temporary regula-  
tions and notice of public hearing.

SUMMARY: In this issue of the Bulletin,  
the IRS is issuing temporary regulations  
(T.D. 9091) relating to the depreciation of  
property subject to section 168 of the In-  
ternal Revenue Code (MACRS property)

and the depreciation of computer software subject to section 167. Specifically, the temporary regulations provide guidance regarding the additional first year depreciation allowance provided by sections 168(k) and 1400L(b) for certain MACRS property and computer software. The text of those temporary regulations also serves as the text of these proposed regulations. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by December 7, 2003. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for December 18, 2003, at 10:00 a.m. must be received by November 29, 2003.

ADDRESSES: Send submissions to  
CC:PA:LPD:PR (REG-157164-02),  
room 5226, Internal Revenue Service,  
P.O. Box 7604, Ben Franklin Station,  
Washington, DC 20044. Alternatively,  
submissions may be hand-delivered Mon-  
day through Friday between the hours of  
8 a.m. and 4 p.m. to CC:PA:LPD:PR  
(REG-157164-02), Courier's Desk, In-  
ternal Revenue Service, 1111 Constitution  
Ave., NW, Washington, DC, or sent elec-  
tronically, via the IRS Internet site at:  
[www.irs.gov/regs](http://www.irs.gov/regs).

FOR FURTHER INFORMATION  
CONTACT: Concerning the proposed reg-  
ulations, Douglas Kim, (202) 622-3110;  
concerning submissions of comments, the  
hearing, and/or to be placed on the build-  
ing access list to attend the hearing, Sonya  
Cruse, (202) 622-4693 (not toll-free num-  
bers).

SUPPLEMENTARY INFORMATION:

#### Background

Temporary regulations in this issue of  
the Bulletin amend 26 CFR part 1 relat-  
ing to sections 168 and 1400L of the Inter-  
nal Revenue Code (Code). The temporary  
regulations contain rules relating to the ad-  
ditional first year depreciation deduction  
provided by sections 168(k) and 1400L(b).

The text of those temporary regulations  
also serves as the text of these proposed  
regulations. The preamble to the tempo-  
rary regulations explains the temporary



regulations and these proposed regulations.

### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rules and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for December 18, 2003, beginning at 10:00 a.m. in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must

submit an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by November 29, 2003. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

### Drafting Information

The principal author of these regulations is Douglas H. Kim, Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and Treasury Department participated in their development.

\* \* \* \* \*

### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 reads as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2. Section 1.167(a)–14 is amended as follows:

*§ 1.167(a)–14 Treatment of certain intangible property excluded from section 197.*

*[The text of this amendment is the same as the text of § 1.167(a)–14T published elsewhere in this issue of the Bulletin].*

Par. 3. Section 1.168(d)–1 is amended as follows:

*§ 1.168(d)–1 Applicable conventions—Half-year and mid-quarter conventions.*

*[The text of this amendment is the same as the text of § 1.168(d)–1T published elsewhere in this issue of the Bulletin].*

Par. 4. Section 1.168(k)–0 is added to read as follows:

*§ 1.168(k)–0 Table of contents.*

*[The text of this proposed section is the same as the text of § 1.168(k)–0T published elsewhere in this issue of the Bulletin].*

Par. 5. Section 1.168(k)–1 is added to read as follows:

*§ 1.168(k)–1 Additional first year depreciation deduction.*

*[The text of this proposed section is the same as the text of § 1.168(k)–1T published elsewhere in this issue of the Bulletin].*

Par. 6. Section 1.169–3 is amended as follows:

*§ 1.169–3 Amortizable basis.*

*[The text of this amendment is the same as the text of § 1.169–3T published elsewhere in this issue of the Bulletin].*

Par. 7. Section 1.1400L(b)–1 is added to read as follows:

*§ 1.1400L(b)–1 Additional first year depreciation deduction for qualified New York Liberty Zone property.*

*[The text of this proposed section is the same as the text of § 1.1400L(b)–1T published elsewhere in this issue of the Bulletin].*

Robert E. Wenzel,  
Deputy Commissioner for  
Services and Enforcement.

(Filed by the Office of the Federal Register on September 5, 2003, 8:45 a.m., and published in the issue of the Federal Register for September 8, 2003, 68 F.R. 53008)

## Deletions From Cumulative List of Organizations Contributions to Which are Deductible Under Section 170 of the Code

### Announcement 2003–67

The names of organizations that no longer qualify as organizations described in section 170(c)(2) of the Internal Revenue Code of 1986 are listed below.

Generally, the Service will not disallow deductions for contributions made to a listed organization on or before the date of announcement in the Internal Revenue Bulletin that an organization no longer qualifies. However, the Service is not precluded from disallowing a deduction for any contributions made after an organization ceases to qualify under section 170(c)(2) if the organization has not timely filed a suit for declaratory judgment under

section 7428 and if the contributor (1) had knowledge of the revocation of the ruling or determination letter, (2) was aware that such revocation was imminent, or (3) was in part responsible for or was aware of the activities or omissions of the organization that brought about this revocation.

If on the other hand a suit for declaratory judgment has been timely filed, contributions from individuals and organizations described in section 170(c)(2) that

are otherwise allowable will continue to be deductible. Protection under section 7428(c) would begin on March 18, 2002, and would end on the date the court first determines that the organization is not described in section 170(c)(2) as more particularly set forth in section 7428(c)(1). For individual contributors, the maximum deduction protected is \$1,000, with a husband and wife treated as one contributor.

This benefit is not extended to any individual, in whole or in part, for the acts or omissions of the organization that were the basis for revocation.

Julie Renee Phelan Foundation, formerly  
Assured Nonprofit Services, Inc.  
Sumner, WA  
Philanthropic Charities, Inc.  
Castro Valley, CA

# Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A

and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance

of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

# Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.  
E.O.—Executive Order.

ER—Employer.  
ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contributions Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
F.R.—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign corporation.  
G.C.M.—Chief Counsel's Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.  
PHC—Personal Holding Company.  
PO—Possession of the U.S.

PR—Partner.  
PRS—Partnership.  
PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statement of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2003-1 through 2003-26 is in Internal Revenue Bulletin 2003-27, dated July 7, 2003.

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<sup>1</sup> A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2003-1 through 2003-26 is in Internal Revenue Bulletin 2003-27, dated July 7, 2003.

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Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**95-11**

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Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**95-39**

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Rev. Rul. 2003-99, 2003-34 I.R.B. 388

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Rev. Proc. 2003-74, 2003-43 I.R.B. 923

**2000-12**

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**2000-15**

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**2000-20**

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Rev. Proc. 2003-72, 2003-38 I.R.B. 578

**2002-9**

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**2002-60**

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**2002-61**

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**2003-28**

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**54-139**

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Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**54-396**

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**55-105**

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**55-372**

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Rev. Rul. 2003-99, 2003-34 I.R.B. 388

**56-128**

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**56-160**

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**56-212**

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**56-344**

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**56-448**

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**56-586**

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**56-680**

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**57-116**

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**57-296**

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**59-120**

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**59-412**

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