

determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis therefore is not required.

Drafting Information

The principal author of these temporary regulations is David R. Haglund of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

List of Subjects

26 CFR 1.701-1 through 1.771-1

Income taxes, Partnerships.

26 CFR 1.1361-OA through 1.1388-1

Income taxes, Small business, Subchapter S corporation, Cooperatives.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

PART 1—AMENDED

Paragraph 1. The authority for Part 1 continues to read in part:

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

Par. 2. New § 1.702-1T is added immediately after § 1.702-1 to read as follows:

§ 1.702-1T Temporary regulations on requirement to separately state meal, travel, and entertainment expenses.

Each partner shall take into account separately his or her distributive share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1987, and ending with or within partners' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274(l)(2), each partner shall take into account separately his or her distributive share of rents paid or incurred after December 31, 1986, by partnerships that have taxable years beginning before January 1, 1989, and ending with or within partners' taxable years beginning on or after January 1, 1987.

Par. 3. New § 1.1366-1T is added immediately after § 1.1361-OA to read as follows:

§ 1.1366-1T Temporary regulations on requirement to separately state meal, travel, and entertainment expenses.

Each shareholder shall take into account separately his or her pro rata

share of meal, travel, and entertainment expenses paid or incurred after December 31, 1986, by S corporations that have taxable years beginning before January 1, 1987, and ending with or within shareholders' taxable years beginning on or after January 1, 1987. In addition, with respect to skybox rentals under section 274(l)(2), each shareholder shall take into account separately his or her pro rata share of rents paid or incurred after December 31, 1986, by S corporations that have taxable years beginning before January 1, 1989, and ending with or within shareholders' taxable years beginning on or after January 1, 1987.

There is need for immediate guidance with respect to the provisions contained in this Treasury decision. For this reason it is found impracticable to issue it with notice and public procedure under subsection (b) of section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved:

O. Donaldson Chapoton,

Assistant Secretary of the Treasury.

February 9, 1988.

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26 CFR Parts 1 and 602

[T.D. 8179]

Organizations Under Common Control; Eighty Percent Control Test for a Brother-Sister Controlled Group

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations and withdrawal of temporary regulations.

SUMMARY: This document provides final regulations relating to organizations under common control for purposes of certain rules relating to pension, profit-sharing, and stock bonus plans. The applicable tax law was enacted as part of the Employee Retirement Income Security Act of 1974 (ERISA) and amended by the Revenue Act of 1978 (1978 Act) and the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). This document also contains final amendments to the income tax regulations relating to the definition of a brother-sister group of corporations under common control. These amendments conform the regulations to the decision in *United States v. Vogel Fertilizer* by the Supreme Court which held that a person's stock ownership is not taken into account for purposes of

the 80% control test unless that person owns stock in each corporation of the putative brother-sister controlled group. These regulations provide the public with the guidance needed to comply with the law.

DATES: Generally, the amendments to the regulations under section 52 of the Code (relating to tax credits for employees) apply to taxable years beginning after December 31, 1976. The amendments to § 1.414(b)-1 and § 1.414(c)-1 through (c)-4 (relating to employees of trades or businesses under common control) generally are effective for plan years beginning after September 2, 1974 (subject to special rules for plans in existence on January 1, 1974). Section 1.414(b)-1(c) and 1.414(c)-1 are amended to include references to section 408(k), which was added to the Code by the 1978 Act, and section 416, which was added by TEFRA. The additions of sections 408(k) and 416 are effective for taxable years beginning after December 31, 1978 and December 31, 1983, respectively. The amendments to § 1.1563-1, which defines a controlled group of corporations, are effective for taxable years ending after December 31, 1970. However, § 1.1563-1(d) provides that certain of the amendments will not apply retroactively if the result would be adverse to certain taxpayers.

FOR FURTHER INFORMATION CONTACT:

Charles M. Whedbee of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224. Attention CC:LR:T (202-566-3458, not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains final amendments to the Income Tax Regulations (26 CFR Parts 1, 11, and 13) under section 414 (b) and (c) of the Internal Revenue Code of 1954, relating to the aggregation of employees of members of a group of corporations, trades, or businesses that are under common control. The employees are treated as if employed by a single employer for purposes of applying certain rules relating to pension, profit-sharing, and stock bonus plans, enacted by the Employee Retirement Income Security Act of 1974 (88 Stat. 925). These regulations were published in proposed form in the *Federal Register* on November 5, 1975 (40 FR 51467), following the adoption of temporary regulations by Treasury decision, published on October 29, 1975 (40 FR 51435). The final regulations reflect

amendments to section 414 (b) and (c) made by section 152(d) of the 1978 Act (92 Stat. 2799) and section 240(c)(1) of TEFRA (96 Stat. 520), which made the provisions of section 414 (b) and (c) applicable with respect to simplified employee pension plans under section 408(k) and to the special rules for top-heavy plans under section 416, respectively.

The final amendments to the regulations under section 1563, relating to the definition of a brother-sister group of corporations under common control, conform those regulations to a decision of the Supreme Court, *United States v. Vogel Fertilizer Co.*, 455 U.S. 16 (1982). The amendments were proposed in a notice of rulemaking published in the *Federal Register* on November 16, 1983 (48 FR 52081). Section 414(c) delegates authority to the Secretary to prescribe regulations for the determination of common control, limited to rules based upon principles similar to those which apply in the case of section 414(b). Common control in section 414(b) is defined by reference to section 1563(a), determined without regard to subsections (a)(4) (relating to certain insurance companies) and (e)(3)(C) (relating to attribution from an employee's trust described in section 401(a)). In addition, section 52 provides that, for purposes of certain jobs credits, employees of members of the same group of controlled corporations or other business organizations are treated as employed by a single employer. Regulations prescribed under section 52 are also based on principles similar to the rules under section 1563. Because the proposed and temporary regulations under section 414 (b) and (c) and the regulations under section 52 paralleled the regulations under section 1563, the November 16, 1983 notice of rulemaking proposed conforming amendments to those regulations. Those amendments are also adopted by this Treasury decision.

Comments

Comments were received in response to both notices of proposed rulemaking, but no public hearing was requested and none was held. Generally, the comments raised issues that had already been considered before publication of the two notices of proposed rulemaking.

Several comments contended that the regulations initially proposed under section 414 (b) and (c) were partly inconsistent with the legislative history of ERISA. They objected that the proposed regulations aggregating employees of commonly controlled entities for various tests relating to coverage, vesting, and benefit

limitations of employee plans could be interpreted to require complete uniformity among the separate plans established by individual organizations within the group. The proposed regulations therefore, did not give effect to certain permissible variances described in the report of the House Ways and Means Committee. The comments suggested that the final regulations contain a provision to the effect that section 414 (b) and (c) was "not intended to mean that all pension plans of a controlled group of corporations or partnerships must be exactly alike, or that a controlled group could not have pension plans for some corporations but not for others" (H.R. Rep. No. 779, 93d Cong., 2d Sess. 49 (1974)). This suggestion is not adopted. These regulations are intended to be definitional only, and do not determine the actual treatment of the employees of a group defined as being a single employer. Thus, once a group of organizations is defined as a single employer, whether or not plans maintained by members of that group are qualified is tested under sections 401, 408(k), 410, 411, 415, and 416.

Other comments suggested that foreign organizations be ignored for purposes of section 414 (b) and (c) and that only employees or organizations that are under common control and engaged in similar businesses be aggregated. These suggestions are also rejected as beyond the scope of definitional regulations.

Only one comment was received in response to the second notice of rulemaking. The comment noted that the decision in *Vogel Fertilizer* and the proposed amendments to the regulations result in the retroactive disaggregation of what were brother-sister controlled groups under the regulations before their amendment by this Treasury decision. Such disaggregation may decrease the tax liability of the individual organizations that no longer have to share a graduated rate schedule (or a single surtax exemption for taxable years beginning before January 1, 1979) or other deductions and credits. The comment suggested that the effects of this disaggregation be mitigated by allowing taxpayers to file amended returns, including claims for refunds, even for closed taxable years. This suggestion is not adopted because the period of limitation on filing a claim for credit or refund as specified in section 6511 cannot be extended by regulation.

Description of Changes

Two changes have been made to the regulations as proposed. The first is to add references to sections 408(k) and

416 as provisions to which these regulations apply. These references were added to sections 414 (b) and (c) by section 152(d) of the 1978 Act and section 240(c)(1) of TEFRA, respectively.

A new paragraph (f) has been added to § 1.414(c)-3. That section generally provides that for purposes of determining control of an organization, certain defined interests will not be counted as either an "interest" or as "stock". However, in some situations the application of this general rule will result in the exclusion of an organization from a controlled group. The new paragraph provides that if an interest is owned by a person directly or constructively and that ownership results in the inclusion of an organization in a group of trades or businesses under common control, then that interest will not be treated as not outstanding under paragraph (b) or (c) of § 1.414(c)-3 if the result would be that the organization would not be a member of a group of trades or businesses under common control. This rule, which is necessary to prevent the exclusion rules from being used to avoid common control status, is analogous to the rule of section 1563(f)(3)(C), which applies for purposes of determining whether a corporation is a component member of a controlled group of corporations. New paragraph (f) of § 1.414(c)-3 is effective April 1, 1988.

Removal of Temporary Regulations

The final regulations under section 414 (b) and (c) supersede the temporary regulations (§§ 11.414(c)-1 through 11.414(c)-5) under ERISA, published in the *Federal Register* on October 29, 1975 (40 FR 51435). This document, therefore, removes those temporary regulations.

Temporary regulations under the Tax Reform Act of 1969 (26 CFR §§ 13.16 and 13.16-1) were superseded by final regulations published on April 25, 1972 (37 FR 8068). As proposed in the notice of rulemaking published on November 16, 1983 (48 FR 52081), those temporary regulations are removed.

Executive Order 12291 and Regulatory Flexibility Act

The Commissioner of the Internal Revenue has determined that this final rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. The Regulatory Flexibility Act does not apply to the portion of this document that adopts the amendments to the regulations proposed in 1975. The Internal Revenue Service has also concluded that the portion of the final regulations contained herein, which

adopt the amendments proposed in 1983, are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

Paperwork Reduction Act

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1980. These requirements have been approved by OMB.

Drafting Information

The principal author of these final regulations is Michel A. Dazé of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

List of Subjects

26 CFR 1.0-1 through 1.58-8

Income taxes, Tax liability, Tax rates, Credits.

26 CFR 1.401-0 through 1.425-1

Income taxes, Employee benefit plans, Pensions, Stock options, Individual Retirement Accounts, Employee stock ownership plans.

26 CFR 1.1501-1 through 1.1564-1

Income taxes, Controlled group of corporations, Consolidated returns.

26 CFR Part 11

Income taxes, Pensions, Employee Retirement Income Security Act of 1974.

26 CFR Part 13

Income taxes, Tax Reform Act of 1969.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of amendments to the regulations

Accordingly, 26 CFR Part 1, Part 11, Part 13, and Part 602 are amended as follows:

PART 1—[AMENDED]

Paragraph 1. The authority citation for Part 1 is amended to add the following citations:

Authority: 26 U.S.C. 7805. * * * § 1.52-1 also issued under 26 U.S.C. 52 (b); § 1.414(c)-1

through 1.414(c)-5 also issued under 26 U.S.C. 414(c).

Par. 2. Section 1.52-1 is amended as follows:

1. Paragraphs (c)(1)(i), (c)(1)(ii), and (d)(1)(i) are amended by removing "§ 1.414(c)-4(b)(1)" and adding instead "§ 1.414(c)-4(b)(1)".

2. Paragraph (d)(1)(i) is also amended by removing "singly or in combination."

3. A new flush paragraph to read as set forth below is added at the end of paragraph (d)(1)(ii).

4. Paragraph (g) is amended by removing "§ 1.414(c)-3" from the first sentence and adding instead "§ 1.414(c)-3".

5. A new paragraph (h) is added at the end thereof to read as set forth below.

§ 1.52-1 Trades or businesses that are under common control.

(d) *Brother-sister group of trade or businesses under common control—(1) In general.* * * *

The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.

(h) *Transitional rule—(1) In general.* Paragraph (d) of this section, as amended by T.D. 8179, applies to all taxable years to which section 52(b) applies.

(2) *Election.* In the case of taxable years ending before March 2, 1988.

(i) If, pursuant to paragraph (b) of this section, an organization indicated in a timely filed return that it chose to be a member of a brother-sister group under common control, and it is not a member of such group because of the amendments to paragraph (d) of this section made by T.D. 8179 such organization may make the choice described in paragraph (b) of this section by filing an amended return on or before September 2, 1988 if such organization would otherwise still be a member of more than one group of trades or businesses under common control, and

(ii) If an organization

(A) Is a member of a brother-sister group of trades or businesses under common control under § 1.52-1(d)(1) as in effect before amendment by T.D. 8179 ("old group"), for such taxable year and

(B) Is not such a member for such taxable year because of the amendments made by such Treasury decision.

such organization (whether or not a corporation) nevertheless will be treated as a member of such old group if all the organizations (whether or not corporations) that are members of the old group meet all the requirements of § 1.1563-1(d)(3) with respect to such taxable year.

Par. 3. The following new sections are added immediately after § 1.413-2.

§ 1.414(b)-1 Controlled group of corporations.

(a) *Definition of controlled group of corporations.* For purposes of this section, the term "controlled group of corporations" has the same meaning as is assigned to the term in section 1563(a) and the regulations thereunder, except that (1) the term "controlled group of corporations" shall not include an "insurance group" described in section 1563(a)(4), and (2) section 1563(e)(3)(C) (relating to stock owned by certain employees' trusts) shall not apply. For purposes of this section, the term "members of a controlled group" means two or more corporations connected through stock ownership described in section 1563(a) (1), (2), or (3), whether or not such corporations are "component members of a controlled group" within the meaning of section 1563(b). Two or more corporations are members of a controlled group at any time such corporations meet the requirements of section 1563(a) (as modified by this paragraph). For purposes of this section, if a corporation is a member of more than one controlled group of corporations, such corporation shall be treated as a member of each controlled group.

(b) *Single plan adopted by two or more members.* If two or more members of a controlled group of corporations adopt a single plan for a plan year, then the minimum funding standard provided in section 412, the tax imposed by section 4971, and the applicable limitations provided by section 404(a) shall be determined as if such members were a single employer. In such a case, the amount of such items and the allocable portion attributable to each member shall be determined in the manner provided in regulations under sections 412, 4971, and 404(a).

(c) *Cross reference.* For rules relating to the application of sections 401, 408(k) 410, 411, 415, and 416 with respect to two or more trades or businesses which are under common control, see section 414(c) and the regulations thereunder.

§ 1.414(c)-1 Commonly controlled trades or businesses.

For purposes of applying the provisions of sections 401 (relating to qualified pension, profit-sharing, and stock bonus plans), 408(k) (relating to simplified employee pensions), 410 (relating to minimum participation standards), 411 (relating to minimum vesting standards), 415 (relating to limitations on benefits and contributions under qualified plans), and 416 (relating to top-heavy plans), all employees of two or more trades or businesses under common control within the meaning of § 1.414(c)-2 for any period shall be treated as employed by a single employer. See sections 401, 408(k), 410, 411, 415, and 416 and the regulations thereunder for rules relating to employees of trades or businesses which are under common control. See § 1.414(c)-5 for effective date.

§ 1.414(c)-2 Two or more trades or businesses under common control.

(a) *In general.* For purposes of this section, the term "two or more trades or businesses under common control" means any group of trades or businesses which is either a "parent-subsidiary group of trades or businesses under common control" as defined in paragraph (b) of this section, a "brother-sister group of trades or businesses under common control" as defined in paragraph (c) of this section, or a "combined group of trades or businesses under common control" as defined in paragraph (d) of this section. For purposes of this section and §§ 1.414(c)-3 and 1.414(c)-4, the term "organization" means a sole proprietorship, a partnership (as defined in section 7701(a)(2)), a trust, an estate, or a corporation.

(b) Parent-subsidiary group of trades or businesses under common control—

(1) *In general.* The term "parent-subsidiary group of trades or businesses under common control" means one or more chains of organizations conducting trades or businesses connected through ownership of a controlling interest with a common parent organization if—

(i) A controlling interest in each of the organizations, except the common parent organization, is owned (directly and with the application of § 1.414(c)-4(b)(1), relating to options) by one or more of the other organizations; and

(ii) The common parent organization owns (directly and with the application of § 1.414(c)-4(b)(1), relating to options) a controlling interest in at least one of the other organizations, excluding, in computing such controlling interest, any direct ownership interest by such other organizations.

(2) *Controlling interest defined—(i) Controlling interest.* For purposes of paragraphs (b) and (c) of this section, the phrase "controlling interest" means:

(A) In the case of an organization which is a corporation, ownership of stock possessing at least 80 percent of total combined voting power of all classes of stock entitled to vote of such corporation or at least 80 percent of the total value of shares of all classes of stock of such corporation;

(B) In the case of an organization which is a trust or estate, ownership of an actuarial interest of at least 80 percent of such trust or estate;

(C) In the case of an organization which is a partnership, ownership of at least 80 percent of the profits interest or capital interest of such partnership; and

(D) In the case of an organization which is a sole proprietorship, ownership of such sole proprietorship.

(ii) *Actuarial interest.* For purposes of this section, the actuarial interest of each beneficiary of trust or estate shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary. The factors and methods prescribed in § 20.2031-7 or § 20.2031-10 (Estate Tax Regulations), whichever is appropriate, for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's actuarial interest.

(c) Brother-sister group of trades or businesses under common control—(1)

In general. The term "brother-sister group of trades or businesses under common control" means two or more organizations conducting trades or businesses if (i) the same five or fewer persons who are individuals, estates, or trusts own (directly and with the application of § 1.414(c)-4) a controlling interest in each organization, and (ii) taking into account the ownership of each such person only to the extent such ownership is identical with respect to each such organization, such persons are in effective control of each organization. The five or fewer persons whose ownership is considered for purposes of the controlling interest requirement for each organization must be the same persons whose ownership is considered for purposes of the effective control requirement.

(2) *Effective control defined.* For purposes of this paragraph, persons are in "effective control" of an organization if—

(i) In the case of an organization which is a corporation, such persons own stock possessing more than 50 percent of the total combined voting power of all classes of stock entitled to

vote or more than 50 percent of the total value of shares of all classes of stock of such corporation;

(ii) In the case of an organization which is a trust or estate, such persons own an aggregate actuarial interest of more than 50 percent of such trust or estate;

(iii) In the case of an organization which is a partnership, such persons own an aggregate of more than 50 percent of the profits interest or capital interest of such partnership; and

(iv) In the case of an organization which is a sole proprietorship, one of such persons owns such sole proprietorship.

(d) *Combined group of trades or businesses under common control.* The term "combined group of trades or businesses under common control" means any group of three or more organizations, if (1) each such organization is a member of either a parent-subsidiary group of trades or businesses under common control or a brother-sister group of trades or businesses under common control, and (2) at least one such organization is the common parent organization of a parent-subsidiary group of trades or businesses under common control and is also a member of a brother-sister group of trades or businesses under common control.

(e) *Examples.* The definitions of parent-subsidiary group of trades or businesses under common control, brother-sister group of trades or businesses under common control, and combined group of trades or businesses under common control may be illustrated by the following examples.

Example (1). (a) The ABC partnership owns stock possessing 80 percent of the total combined voting power of all classes of stock entitled to voting of S corporation. ABC partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC partnership and S Corporation.

(b) Assume the same facts as in (a) and assume further that S owns 80 percent of the profits interest in the DEF Partnership. The ABC Partnership is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of the ABC Partnership, S Corporation, and the DEF Partnership. The result would be the same if the ABC Partnership, rather than S, owned 80 percent of the profits interest in the DEF Partnership.

Example (2). L Corporation owns 80 percent of the only class of stock of T Corporation, and T, in turn, owns 40 percent of the capital interest in the GHI Partnership. L also owns 80 percent of the only class of stock of N Corporation and N, in turn, owns 40 percent of the capital interest in the GHI Partnership. L is the common parent of a parent-subsidiary group of trades or

businesses under common control consisting of L Corporation, T Corporation, N Corporation, and the GHI Partnership.

Example (3). ABC Partnership owns 75 percent of the only class of stock of X and Y Corporations; X owns all the remaining stock of Y, and Y owns all the remaining stock of X. Since interorganization ownership is excluded (that is, treated as not outstanding)

for purposes of determining whether ABC owns a controlling interest of at least one of the other organizations, ABC is treated as the owner of stock possessing 100 percent of the voting power and value of all classes of stock of X and of Y for purposes of paragraph (b)(1)(ii) of this section. Therefore, ABC is the common parent of a parent-subsidiary group of trades or businesses under common

control consisting of the ABC Partnership, X Corporation, and Y Corporation.

Example (4). Unrelated individuals A, B, C, D, E, and F own an interest in sole proprietorship A, a capital interest in the GHI Partnership, and stock of corporations M, W, X, Y, and Z (each of which has only one class of stock outstanding) in the following proportions:

ORGANIZATIONS

Individuals	A	GHI	M	W	X	Y	Z
A	100%	50%	100%	60%	40%	20%	60%
B	—	40%	—	15%	40%	50%	30%
C	—	—	—	—	10%	10%	10%
D	—	—	—	25%	—	20%	—
E	—	10%	—	—	10%	—	—
	100%	100%	100%	100%	100%	100%	100%

Under these facts the following four brother-sister groups of trades or businesses under common control exist: GHI, X and Z; X, Y and Z; W and Y; A and M. In the case of GHI, X, and Z, for example, A and B together have effective control of each organization because their combined identical ownership of GHI, X and Z is greater than 50%. (A's identical ownership of GHI, X and Z is 40% because A owns at least a 40% interest in each organization. B's identical ownership of GHI, X and Z is 30% because B owns at least a 30% interest in each organization.) A and B (the persons whose ownership is considered for purposes of the effective control requirement) together own a controlling interest in each organization because they own at least 80% of the capital interest of partnership GHI and at least 80% of the total combined voting power of corporations X and Z. Therefore, GHI, X and Z comprise a brother-sister group of trades or businesses under common control. Y is not a member of this group because neither the effective control requirement nor the 80% controlling interest requirement are met. (The effective control requirement is not met because A's and B's combined identical ownership in GHI, X, Y and Z (20% for A and 30% for B) does not exceed 50%. The 80% controlling interest test is not met because A and B together only own 70% of the total combined voting power of the stock of Y.) A and M are not members of this group because B owns no interest in either organization and A's ownership of GHI, X and Z, considered alone, is less than 80%.

Example (5). The outstanding stock of corporations U and V, which have only one class of stock outstanding, is owned by the following unrelated individuals:

CORPORATIONS

Individuals	U (percent)	V (percent)
A	12	12
B	12	12
C	12	12
D	12	12
E	13	13
F	13	13
G	13	13
H	13	13
	100	100

Any group of five of the shareholders will own more than 50 percent of the stock in each corporation, in identical holdings. However, U and V are not members of a brother-sister group of trades or businesses under common control because at least 80 percent of the stock of each corporation is not owned by the same five or fewer persons.

Example (6). A, an individual, owns a controlling interest in ABC Partnership and DEF Partnership. ABC, in turn, owns a controlling interest in X Corporation. Since ABC, DEF, and X are each members of either a parent-subsidiary group or a brother-sister group of trades or businesses under common control, and ABC is the common parent of a parent-subsidiary group of trades or businesses under common control consisting of ABC and X, and also a member of a brother-sister group of trades or businesses under common control consisting of ABC and DEF, ABC Partnership, DEF Partnership, and X Corporation are members of the same combined group of trades or businesses under common control.

§ 1.414(c)-3 Exclusion of certain interests or stock in determining control.

(a) *In general.* For purposes of § 1.414(c)-2(b) (2) (i) and (c)(2), the term "interest" and the term "stock" do not

include an interest which is treated as not outstanding under paragraph (b) of this section in the case of a parent-subsidiary group of trades or businesses under common control or under paragraph (c) of this section in the case of a brother-sister group of trades or businesses under common control. In addition, the term "stock" does not include treasury stock or nonvoting stock which is limited and preferred as to dividends. For definitions of certain terms used in this section, see paragraph (d) of this section.

(b) *Parent-subsidiary group of trades or businesses under common control—*

(1) *In general.* If an organization (hereinafter in this section referred to as "parent organization") owns (within the meaning of paragraph (b)(2) of this section)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of such corporation.

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of § 1.414(c)-2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether the parent organization or such other organization (hereinafter in this section referred to as "subsidiary organization") is a member of a parent-subsidiary group of trades or businesses under common control, an interest in such subsidiary organization excluded under

paragraph (b) (3), (4), (5), or (6) of this section shall be treated as not outstanding.

(2) *Ownership.* For purposes of paragraph (b)(1) of this section, a parent organization shall be considered to own an interest in or stock of another organization which it owns directly or indirectly with the application of paragraph (b)(1) of § 1.414(c)-4 and—

(i) In the case of a parent organization which is a partnership, a trust, or an estate, with the application of paragraphs (b) (2), (3), and (4) of § 1.414(c)-4, and

(ii) In the case of a parent organization which is a corporation, with the application of paragraph (b)(4) of § 1.414(c)-4.

(3) *Plan of deferred compensation.* An interest which is an interest in or stock of the subsidiary organization held by a trust which is part of a plan of deferred compensation (within the meaning of section 406(a)(3) and the regulations thereunder) for the benefit of the employees of the parent organization or the subsidiary organization shall be excluded.

(4) *Principal owners, officers, etc.* An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of § 1.414(c)-4) by an individual who is a principal owner, officer, partner, or fiduciary of the parent organization shall be excluded.

(5) *Employees.* An interest which is an interest in or stock of the subsidiary organization owned (directly and with the application of § 1.414(c)-4) by an employee of the subsidiary organization shall be excluded if such interest or such stock is subject to conditions which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or such stock, the direct or record owner's right) to dispose of such interest or such stock and which run in favor of the parent or subsidiary organization.

(6) *Controlled exempt organization.* An interest which is an interest in or stock of the subsidiary organization shall be excluded if owned (directly and with the application of § 1.414(c)-4) by an organization (other than the parent organization):

(i) To which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by the parent organization or subsidiary organization, by an individual, estate, or trust that is a principal owner of the parent organization, by an officer,

partner, or fiduciary of the parent organization, or by any combination thereof.

(c) *Brother-sister group of trades or businesses under common control—(1) In general.* If five or fewer persons (hereinafter in this section referred to as "common owners") who are individuals, estates, or trusts own (directly and with the application of § 1.414(c)-4)—

(i) In the case of a corporation, 50 percent or more of the total combined voting power of all classes of stock entitled to vote or 50 percent or more of the total value of shares of all classes of stock of such corporation,

(ii) In the case of a trust or an estate, an actuarial interest (within the meaning of § 1.414(c)-2(b)(2)(ii)) of 50 percent or more of such trust or estate, and

(iii) In the case of a partnership, 50 percent or more of the profits or capital interest of such partnership, then for purposes of determining whether such organization is a member of a brother-sister group of trades or businesses under common control, an interest in such organization excluded under paragraph (c) (2), (3), or (4) of this section shall be treated as not outstanding.

(2) *Exempt employees' trust.* An interest which is an interest in or stock of such organization held by an employees' trust described in section 401(a) which is exempt from tax under section 501(a) shall be excluded if such trust is for the benefit of the employees of such organization.

(3) *Employees.* An interest which is an interest in or stock of such organization owned (directly and with the application of § 1.414(c)-4) by an employee of such organization shall be excluded if such interest or stock is subject to conditions which run in favor of a common owner of such organization or in favor of such organization and which substantially restrict or limit the employee's right (or if the employee constructively owns such interest or stock, the direct or record owner's right) to dispose of such interest or stock.

(4) *Controlled exempt organization.* An interest which is an interest in or stock of such organization shall be excluded if owned (directly and with the application of § 1.414(c)-4) by an organization:

(i) To which section 501(c)(3) (relating to certain educational and charitable organizations which are exempt from tax) applies, and

(ii) Which is controlled directly or indirectly (within the meaning of paragraph (d)(7) of this section) by such organization, by an individual, estate, or trust that is a principal owner of such organization, by an officer, partner, or

fiduciary of such organization, or by any combination thereof.

(d) *Definitions—(1) Employee.* For purposes of this section, the term "employee" has the same meaning such term is given in section 3306(i) of the Code (relating to definitions for purposes of the Federal Unemployment Tax Act).

(2) *Principal owner.* For purposes of this section, the term "principal owner" means a person who owns (directly and with the application of § 1.414(c)-4)—

(i) In the case of a corporation, 5 percent or more of the total combined voting power of all classes of stock entitled to vote in such corporation or 5 percent or more of the total value of shares of all classes of stock of such corporation;

(ii) In the case of a trust or estate, an actuarial interest of 5 percent or more of such trust or estate; or

(iii) In the case of a partnership, 5 percent or more of the profits or capital interest of such partnership.

(3) *Officer.* For purposes of this section, the term "officer" includes the president, vice-presidents, general manager, treasurer, secretary, and comptroller of a corporation, and any other person who performs duties corresponding to those normally performed by persons occupying such positions.

(4) *Partner.* For purposes of this section, the term "partner" means any person defined in section 7701(a)(2) (relating to definitions of partner).

(5) *Fiduciary.* For purposes of this section and § 1.414(c)-4, the term "fiduciary" has the same meaning as such term is given in section 7701(a)(6) and the regulations thereunder.

(6) *Substantial conditions.* (i) *In general.* For purposes of this section, an interest in or stock of an organization is subject to conditions which substantially restrict or limit the right to dispose of such interest or stock and which run in favor of another person if the condition extends directly or indirectly to such person preferential rights with respect to the acquisition of the direct owner's (or the record owner's) interest or stock. For a condition to be in favor of another person it is not necessary that such person be extended a discriminatory concession with respect to price. A right of first refusal with respect to an interest or stock in favor of another person is a condition which substantially restricts or limits the direct or record owner's right of disposition which runs in favor of such person. Further, any legally enforceable condition which prohibits the direct or record owner from disposing of his or her interest or stock without the consent

of another person will be considered to be a substantial limitation running in favor of such person.

(ii) *Special rule.* For purposes of paragraph (c)(3) of this section only, if a condition which restricts or limits an employee's right (or direct or record owner's right) to dispose of his or her interest or stock also applies to the interest or stock in such organization held by a common owner pursuant to a bona fide reciprocal purchase arrangement, such condition shall not be treated as a substantial limitation or restriction. An example of a reciprocal purchase arrangement is an agreement whereby a common owner and the employee are given a right of first refusal with respect to stock of the employer corporation owned by the other party. If, however, the agreement also provides that the common owner has the right to purchase the stock of the employer corporation owned by the employee in the event the corporation should discharge the employee for reasonable cause, the purchase arrangement would not be reciprocal within the meaning of this subdivision.

(7) *Control.* For purposes of paragraphs (b)(6) and (c)(4) of this section, the term "control" means control in fact. The determination of whether there exists control in fact will depend upon all of the facts and circumstances of each case, without regard to whether such control is legally enforceable and irrespective of the method by which such control is exercised or exercisable.

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

Example (1). ABC Partnership owns 70 percent of the capital interest and of the profits interest in the DEF Partnership. The remaining capital interest and profits interest in DEF is owned as follows: 4 percent by A (a general partner in ABC), and 26 percent by D (a limited partner in ABC). ABC satisfies the 50-percent capital interest or profits interest ownership requirement of paragraph (b)(1)(iii) of this section with respect to DEF. Since A and D are partners and ABC, under paragraph (b)(4) of this section the capital and profits interests in DEF owned by A and D are treated as not outstanding for purposes of determining whether ABC and DEF are members of a parent-subsidary group of trades or businesses under common control under § 1.414(c)-2(b). Thus, ABC is considered to own 100 percent (70 ÷ 70) of the capital interest and profits interest in DEF. Accordingly, ABC and DEF are members of a parent-subsidary group of trades or businesses under common control.

Example (2). Assume the same facts as in example (1) and assume further that A owns 15 shares of the 100 shares of the only class of stock of S Corporation and DEF Partnership owns 75 shares of such stock. ABC

satisfies the 50 percent stock requirement of paragraph (b)(1)(i) of this section with respect to S since ABC is considered as owning 52.5 percent (70 percent × 75 percent) of the S stock with the application of § 1.414(c)-4(b)(2). Since A is a partner of ABC, the S stock owned by A is treated as not outstanding for purposes of determining whether S is a member of a parent-subsidary group of trades or businesses under common control. Thus, DEF Partnership is considered to own stock possessing 88.2 percent (75 ÷ 85) of the voting power and value of the S stock. Accordingly, ABC Partnership, DEF Partnership, and S Corporation are members of a parent-subsidary group of trades or businesses under common control.

Example (3). ABC Partnership owns 60 percent of the only class of stock of Corporation Y. D, the president of Y, owns the remaining 40 percent of the stock of Y. D has agreed that if she offers her stock in Y for sale she will first offer the stock to ABC at a price equal to the fair market value of the stock on the first date the stock is offered for sale. Since D is an employee of Y within the meaning of section 3306(i) of the Code and her stock in Y is subject to a condition which substantially restricts or limits her right to dispose of such stock and runs in favor of ABC Partnership, under paragraph (b)(5) of this section such stock is treated as not outstanding for purposes of determining whether ABC and Y are members of a parent-subsidary group of trades or businesses under common control. Thus, ABC Partnership is considered to own stock possessing 100 percent of the voting power and value of the stock of Y. Accordingly, ABC Partnership and Y Corporation are members of a parent-subsidary group of trades or businesses under common control. The result would be the same if D's husband, instead of D, owned directly the 40 percent stock interest in Y and such stock was subject to a right of first refusal running in favor of ABC Partnership.

(f) *Exception—(1) In general.* If an interest in an organization (including stock of a corporation) is owned by a person directly or with the application of the rules of paragraph (b) of § 1.414(c)-4 and such ownership results in the membership of that organization in a group of two or more trades or businesses under common control for any period, then the interest will not be treated as an excluded interest under paragraph (b) or (c) of this section if the result of applying such provisions is that the organization is not a member of a group of two or more trades or businesses under common control for the period.

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

Example. Corporation P owns directly 50 of the 100 shares of the only class of stock of corporation S. A, an officer of P, owns directly 30 shares of S stock which P has an option to acquire. If, under paragraph (b)(4) of this section, the 30 shares owned directly by

A are treated as not outstanding, P would be treated as owning stock possessing only 71 percent (50/70) of the total voting power and value of S stock, and S should not be a member of a parent-subsidary group of trades or businesses under common control. However, because the 30 shares owned by A that P has an option to purchase are considered as owned by P under paragraph (b)(2) of this section, and that ownership plus P's direct ownership of 50 shares result in S's membership in a parent-subsidary group of trades or businesses under common control for 1985, the provisions of this paragraph apply. Therefore, A's stock is not treated as an excluded interest and S is a member of a parent-subsidary group consisting of P and S.

§ 1.414(c)-4 Rules for determining ownership.

(a) *In general.* In determining the ownership of an interest in an organization for purposes of § 1.414(c)-2 and § 1.414(c)-3, the constructive ownership rules of paragraph (b) of this section shall apply, subject to the operating rules contained in paragraph (c). For purposes of this section the term "interest" means: in the case of a corporation, stock; in the case of a trust or estate, an actuarial interest; in the case of a partnership, an interest in the profits or capital; and in the case of a sole proprietorship, the proprietorship.

(b) *Constructive ownership—(1) Options.* If a person has an option to acquire any outstanding interest in an organization, such interest shall be considered as owned by such person. For this purpose, an option to acquire an option, and each one of a series of such options shall be considered as an option to acquire such interest.

(2) *Attribution from partnerships—(i) General.* An interest owned, directly or indirectly, by or for a partnership shall be considered as owned by any partner having an interest of 5 percent or more in either the profits or capital of the partnership in proportion to such partner's interest in the profits or capital, whichever such proportion is greater.

(ii) *Example.* The provisions of paragraph (b)(2)(i) of this section may be illustrated by the following example:

Example. A, B, and C, unrelated individuals, are partners in the ABC Partnership. The partners' interest in the capital and profits of ABC are as follows:

(In percent)

Partner	Capital	Profits
A	36	25
B	60	71
C	4	4

The ABC Partnership owns the entire outstanding stock (100 shares) of X Corporation. Under paragraph (b)(2)(i) of this section, A is considered to own the stock of X owned by the partnership in proportion to his interest in capital (36 percent) or profits (25 percent), whichever such proportion is greater. Therefore, A is considered to own 36 shares of X stock. Since B has a greater interest in the profits of the partnership than in the capital, B is considered to own X stock in proportion to his interest in such profits. Therefore, B is considered to own 71 shares of X stock. Since C does not have an interest of 5 percent or more in either the capital or profits of ABC, he is not considered to own any shares of X stock.

(3) *Attribution from estates and trusts*—(i) *In general.* An interest in an organization (hereinafter called an "organization interest") owned, directly or indirectly, by or for an estate or trust shall be considered as owned by any beneficiary of such estate or trust who has an actuarial interest of 5 percent or more in such organization interest, to the extent of such actuarial interest. For purposes of this subparagraph, the actuarial interest of each beneficiary shall be determined by assuming the maximum exercise of discretion by the fiduciary in favor of such beneficiary and the maximum use of the organization interest to satisfy the beneficiary's rights. A beneficiary of an estate or trust who cannot under any circumstances receive any part of an organization interest held by the estate or trust, including the proceeds from the disposition thereof, or the income therefrom, does not have an actuarial interest in such organization interest. Thus, where stock owned by a decedent's estate has been specifically bequeathed to certain beneficiaries and the remainder of the estate has been specifically bequeathed to other beneficiaries, the stock is attributable only to the beneficiaries to whom it is specifically bequeathed. Similarly a remainderman of a trust who cannot under any circumstances receive any interest in the stock of a corporation which is a part of the corpus of the trust (including any accumulated income therefrom or the proceeds from a disposition thereof) does not have an actuarial interest in such stock. However, an income beneficiary of a trust does have an actuarial interest in stock if he has any right to the income from such stock even though under the terms of the trust instrument such stock can never be distributed to him. The factors and methods prescribed in § 20.2031-7 or § 20.2031-10 (Estate Tax

Regulations), whichever is appropriate for use in ascertaining the value of an interest in property for estate tax purposes shall be used for purposes of this subdivision in determining a beneficiary's actuarial interest in an organization interest owned directly or indirectly by or for an estate or trust.

(ii) *Special rules for estates.* (A) For purposes of this paragraph (b)(3) with respect to an estate, property of a decedent shall be considered as owned by his or her estate if such property is subject to administration by the executor or administrator for the purposes of paying claims against the estate and expenses of administration notwithstanding that, under local law, legal title to such property vests in the decedent's heirs, legatees or devisees immediately upon death.

(B) For purposes of this paragraph (b)(3) with respect to an estate, the term "beneficiary" includes any person entitled to receive property of a decedent pursuant to a will or pursuant to laws of descent and distribution.

(C) For purposes of this paragraph (b)(3) with respect to an estate, a person shall no longer be considered a beneficiary of an estate when all the property to which he or she is entitled has been received by him or her, when he or she no longer has a claim against the estate arising out of having been a beneficiary, and when there is only a remote possibility that it will be necessary for the estate to seek the return of property from him or her or to seek payment from him or her by contribution or otherwise to satisfy claims against the estate or expenses of administration.

(iii) *Grantor trusts, etc.* An interest owned, directly or indirectly, by or for any portion of a trust of which a person is considered the owner under subpart E, part I, subchapter J of the Code (relating to grantors and others treated as substantial owners) is considered as owned by such person.

(4) *Attribution from corporations*—(i) *General.* An interest owned, directly or indirectly, by or for a corporation shall be considered as owned by any person who owns (directly and, in the case of a parent-subsidiary group of trades or businesses under common control, with the application of paragraph (b)(1) of this section, or in the case of a brother-sister group of trades or business under common control, with the application of this section), 5 percent or more in value of the stock in that proportion which the value of the stock which such person so owns bears to the total value of all the stock in such corporation.

(ii) *Example.* The provisions of paragraph (b)(4)(i) of this section may be illustrated by the following example:

Example. B, an individual, owns 60 of the 100 shares of the only class of outstanding stock of corporation P. C, an individual, owns 4 shares of the P stock, and corporation X owns 36 shares of the P stock. Corporation P owns, directly and indirectly, 50 shares of the stock of corporation S. Under this subparagraph, B is considered to own 30 shares of the S stock ($60/100 \times 50$), and X is considered to own 18 shares of S stock ($36/100 \times 50$). Since C does not own 5 percent or more in the value of P stock, he is not considered as owning any of the S stock owned by P. If in this example, C's wife had owned directly 1 share of the P stock, C and his wife would each be considered as owning 5 shares of the P stock, and therefore C and his wife would be considered as owning 2.5 shares of the S stock ($5/100 \times 50$).

(5) *Spouse*—(i) *General rule.* Except as provided in paragraph (b)(5)(ii) of this section, an individual shall be considered to own an interest owned, directly or indirectly, by or for his or her spouse, other than a spouse who is legally separated from the individual under a decree of divorce, whether interlocutory or final, or a decree of separate maintenance.

(ii) *Exception.* An individual shall not be considered to own an interest in an organization owned, directly or indirectly, by or for his or her spouse on any day of a taxable year of such organization, provided that each of the following conditions are satisfied with respect to such taxable year:

(A) Such individual does not, at any time during such taxable year, own directly any interest in such organization;

(B) Such individual is not a member of the board of directors, a fiduciary, or an employee of such organization and does not participate in the management of such organization at any time during such taxable year;

(C) Not more than 50 percent of such organization's gross income for such taxable year was derived from royalties, rents, dividends, interest, and annuities; and

(D) Such interest in such organization is not, at any time during such taxable year, subject to conditions which substantially restrict or limit the spouse's right to dispose of such interest and which run in favor of the individual or the individual's children who have not attained the age of 21 years. The principles of § 1.414(c)-3(d)(6)(i) shall apply in determining whether a condition is a condition described in the preceding sentence.

(iii) *Definitions.* For purposes of paragraph (b)(5)(ii)(C) of this section,

the gross income of an organization shall be determined under section 61 and the regulations thereunder. The terms "interest", "royalties", "rents", "dividends", and "annuities" shall have the same meaning such terms are given for purposes of section 1244(c) and § 1.1244(c)-1(e)(1).

(6) *Children, grandchildren, parents, and grandparents*—(i) *Children and parents*. An individual shall be considered to own an interest owned, directly or indirectly, by or for the individual's children who have not attained the age of 21 years, and if the individual has not attained the age of 21 years, an interest owned, directly or indirectly, by or for the individual's parents.

(ii) *Children, grandchildren, parents, and grandparents*. In an individual is in effective control (within the meaning of § 1.414(c)-2(c)(2)), directly and with the application of the rules of this paragraph without regard to this subdivision, of an organization, then such individual shall be considered to own an interest in such organization owned, directly or indirectly, by or for the individual's parents, grandparents, grandchildren, and children who have attained the age of 21 years.

(iii) *Adopted children*. For purposes of this section, a legally adopted child of an individual shall be treated as a child of such individual.

(iv) *Example*. The provisions of this subparagraph (6) may be illustrated by the following example:

Example—(A) Facts. Individual F owns directly 40 percent of the profits interest of the DEF Partnership. His son, M, 20 years of age, owns directly 30 percent of the profits interest of DEF, and his son, A, 30 years of age, owns directly 20 percent of the profits interest of DEF. The 10 percent remaining of the profits interest and 100 percent of the capital interest of DEF is owned by an unrelated person.

(B) *F's ownership*. F owns 40 percent of the profits interest in DEF directly and is considered to own the 30 percent profits interest owned directly by M. Since, for purposes of the effective control test contained in paragraph (b)(6)(ii) of this section, F is treated as owning 70 percent of the profits interest of DEF, F is also considered as owning the 20 percent profits interest of DEF owned by his adult son, A. Accordingly, F is considered as owning a total of 90 percent of the profits interest in DEF.

(C) *M's ownership*. Minor son, M, owns 30 percent of the profits interest in DEF directly, and is considered to own the 40 percent profits interest owned directly by his father, F. However, M is not considered to own the 20 percent profits interest of DEF owned directly by his brother, A, and constructively by F, because an interest constructively owned by F by reason of family attribution is not considered as owned by him for purposes

of making another member of his family the constructive owner of such interest. (See paragraph (c)(2) of this section.) Accordingly, M is considered as owning a total of 70 percent of the profits interest of the DEF Partnership.

(D) *A's ownership*. Adult son, A, owns 20 percent of the profits interest in DEF directly. Since, for purposes of determining whether A effectively controls DEF under paragraph (b)(6)(ii) of this section, A is treated as owning only the percentage of profits interest he owns directly, he does not satisfy the condition precedent for the attribution of the DEF profits interest from his father. Accordingly, A is considered as owning only the 20 percent profits interest in DEF which he owns directly.

(c) *Operating rules*—(1) *In general*. Except as provided in paragraph (c)(2) of this section, an interest constructively owned by a person by reason of the application of paragraph (b) (1), (2), (3), (4), (5), or (6) of this section shall, for the purposes of applying such paragraph, be treated as actually owned by such person.

(2) *Members of family*. An interest constructively owned by an individual by reason of the application of paragraph (b) (5) or (6) of this section shall not be treated as owned by such individual for purposes of again applying such subparagraphs in order to make another the constructive owner of such interest.

(3) *Precedence of option attribution*. For purposes of this section, if an interest may be considered as owned under paragraph (b)(1) of this section (relating to option attribution) and under any other subparagraph of paragraph (b) of this section, such interest shall be considered as owned by such person under paragraph (b)(1) of this section.

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

Example (1). A, 30 years of age, has a 90 percent interest in the capital and profits of DEF Partnership. DEF owns all the outstanding stock of corporation X and X owns 60 shares of the 100 outstanding shares of corporation Y. Under paragraph (c)(1) of this section, the 60 shares of Y constructively owned by DEF by reason of paragraph (b)(4) of this section are treated as actually owned by DEF for purposes of applying paragraph (b)(2) of this section. Therefore, A is considered as owning 54 shares of the Y stock (90 percent of 60 shares).

Example (2). Assume the same facts as in example (1). Assume further that B, who is 20 years of age and the brother of A, directly owns 40 shares of Y stock. Although the stock of Y owned by B is considered as owned by C (the father of A and B) under paragraph (b)(6)(i) of this section, under paragraph (c)(2) of this section such stock may not be treated as owned by C for purposes of applying paragraph (b)(6)(ii) of this section in order to make A the constructive owner of such stock.

Example (3). Assume the same facts as in example (2), and further assume that C has an option to acquire the 40 shares of Y stock owned by his son, B. The rule contained in paragraph (c)(2) of this section does not prevent the reattribution of such 40 shares to A because, under paragraph (c)(3) of this section, C is considered as owning the 40 shares by reason of option attribution and not by reason of family attribution. Therefore, since A is in effective control of Y under paragraph (b)(6)(ii) of this section, the 40 shares of Y stock constructively owned by C are reattributed to A. A is considered as owning a total of 94 shares of Y stock.

§ 1.414(c)-5 Effective date.

(a) *General rule*. Except as provided in paragraph (b), (c), (e), or (f) of this section, the provisions of § 1.414(b)-1 and §§ 1.414(c)-1 through 1.414(c)-4 shall apply for plan years beginning after September 2, 1974.

(b) *Existing plans*. In the case of a plan in existence on January 1, 1974, unless paragraph (c) of this section applies, the provisions of "§ 1.414 (b)-1 and §§ 1.414(c)-1 through 1.414(c)-4 shall apply for plan years beginning after December 31, 1975. For definition of the term "existing plan", see § 1.410(a)-2(c).

(c) *Existing plans electing new provisions*. In the case of a plan in existence on January 1, 1974, for which the plan administrator makes an election under § 1.410 (a)-2 (d), the provisions of § 1.414 (b)-1 and §§ 1.414 (c)-1 through 1.414 (c)-4 shall apply to the plan years elected under § 1.410 (a)-2 (d).

(d) *Application*. For purposes of the Employee Retirement Income Security Act of 1974, the provisions of § 1.414 (b)-1 and §§ 1.414 (c)-1 through 1.414 (c)-4 do not apply for any period of time before the plan years described in paragraph (a), (b), or (c) of this section, whichever is applicable.

(e) *Special rule*. Notwithstanding paragraph (a), (b), or (c) of this section, § 1.414 (c)-3 (f) is effective April 1, 1988.

(f) *Transitional rule*—(1) *In general*. The amendments made by T.D. 8179 apply to the plan years or period described in paragraphs (a), (b), or (c) of this section, whichever is applicable.

(2) *Exception*. In the case of a plan year or period beginning before March 2, 1988, if an organization—

(i) Is a member of a brother-sister group of trades or businesses under common control under § 1.414 (c)-2 (c), as in effect before removal by T.D. 8179 ("old group"), for such plan year or period, and

(ii) Is not such a member for such plan year or period because of the

amendments made by such Treasury decision,

such member (whether or not a corporation) nevertheless will be treated as a member of such old group for purposes of section 414(c) for that plan year or period to the extent provided in § 1.1563-1 (d)(2). Also, such member will be treated as a member of an old group for all purposes of the Code for such plan year or period if all the organizations (whether or not corporations) that are members of the old group meet all the requirements of § 1.1563-1 (d)(3) with respect to such plan year or period.

Par. 4. Section 1.1563-1 is amended as follows.

1. Paragraph (a)(3)(i) is amended by deleting "singly or in combination," and by adding a new flush paragraph at the end of (a)(3)(i)(b) as set forth below.

2. Paragraph (a)(3) is amended by revising Examples (1) and (2) and by adding new Examples (3) and (4) in paragraph (a)(3)(ii) and by adding a new paragraph (a)(3)(iii) as set forth below.

3. Paragraph (c)(2)(iv) is amended by revising the charts in Examples (1) and (2) as set forth below.

4. Paragraph (d) is added to read as set forth below.

§ 1.1563-1 Definition of controlled group of corporations and component members.

(a) *Controlled group of corporations.*

* * *

(3) *Brother-sister controlled group.* (i)

* * *

The five or fewer persons whose stock ownership is considered for purposes of the 80 percent requirement must be the same persons whose stock ownership is considered for purposes of the more-than-50 percent requirement.

(ii)

Example (1). The outstanding stock of corporations P, Q, R, S, and T, which have only one class of stock outstanding is owned by the following unrelated individuals:

CORPORATIONS

Individuals	P	Q	R	S	T	Identical ownership
A.....	55%	51%	55%	55%	55%	51% (45% in P & Q).
B.....	45%	49%				
C.....			45%			
D.....				45%		
E.....					45%	
Total.....	100%	100%	100%	100%	100%	

Corporations P and Q are members of a brother-sister controlled group of corporations. Although the more-than-50 percent identical ownership requirement is met for all 5 corporations, corporations R, S, and T are not members because at least 80 percent of the stock of each of those corporations is not owned by the same 5 or fewer persons whose stock ownership is considered for purposes of the more-than-50 percent identical ownership requirement.

Example (2). The outstanding stock of corporations U and V, which have only one class of stock outstanding, is owned by the following unrelated individuals:

Individuals	Corporations	
	U (percent)	V (percent)
A.....	12	12
B.....	12	12
C.....	12	12
D.....	12	12
E.....	13	13
F.....	13	13
G.....	13	13
H.....	13	13
Total.....	100	100

Any group of five of the shareholders will own more than 50 percent of the stock in each corporation, in identical holdings. However, U and V are not members of brother-sister controlled group because at least 80 percent of the stock of each corporation is not owned by the same five or fewer persons.

Example (3). Corporation X and Y each

have two classes of stock outstanding, voting common and non-voting common. (None of this stock is excluded from the definition of stock under section 1563(c).) Unrelated individuals A and B own the following percentages of the class of stock entitled to vote (voting) and of the total value of shares of all classes of stock (value) in each of corporations X and Y:

Individuals	Corporations	
	X	Y
A.....	100% voting, 60% value.	75% voting, 60% value.
B.....	0% voting, 10% value.	25% voting, 10% value.

No other shareholder of X owns (or is considered to own) any stock in Y. X and Y are a brother-sister controlled group of corporations. The group meets the more-than-50 percent ownership requirements because A and B own more than 50 percent of the total value of shares of all classes of stock X and Y in identical holdings. (The group also meets the more-than-50 percent ownership requirement because of A's voting stock ownership.) The group meets the 80 percent requirement because A and B own at least 80 percent of the total combined voting power of all classes of stock entitled to vote.

Example (4). Assume the same facts as in example (3) except that the value of the stock owned by A and B is not more than 50 percent of the total value of shares of all classes of stock of each corporation in identical holdings. X and Y are not a brother-sister controlled group of corporations. The group meets the more-than-50 percent ownership requirement because A owns more

than 50 percent of the total combined voting power of the voting stock of each corporation. For purposes of the 80 percent requirement, B's voting stock in Y cannot be combined with A's voting stock in Y since B, who does not own any voting stock in X, is not a person whose ownership is considered for purposes of the more-than-50 percent requirement. Because no other shareholder owns stock in both X and Y, these other shareholders' stock ownership is not counted towards meeting either the more-than-50 percent ownership requirement or the 80-percent ownership requirement.

(iii) Paragraph (a)(3) of this section, as amended, by T.D. 8179 applies to taxable years ending on or after December 31, 1970. See, however, the transitional rule in paragraph (d) of this section.

* * *

(c) *Overlapping groups.* * * *

(2) *Brother-sister controlled groups.* * * *

(iv) * * *

Example (1). * * *

Individuals	Corporations		
	M	N	P
A.....	55%	40%	5%
B.....	40%	20%	40%
C.....	5%	40%	55%

Example (2). * * *

Individuals	Corporations				
	S	T	W	X	Z
D.....	52%	52%	52%	52%	52%
E.....	40%	2%	2%	2%	2%
F.....	2%	40%	2%	2%	2%
G.....	2%	2%	40%	2%	2%
H.....	2%	2%	2%	40%	2%
I.....	2%	2%	2%	2%	40%

(d) *Transitional rules*—(1) *In general.* Treasury decision 8179 amended paragraph (a)(3) of this section to revise the definition of a brother-sister controlled group of corporations. In general, those amendments are effective for taxable years ending on or after December 31, 1970.

(2) *Limited nonretroactivity.* (i) Under the authority of section 7805(b), the Internal Revenue Service will treat an old group as a brother-sister controlled group of corporations for purposes of applying sections 401, 404(a), 408(k), 409A, 410, 411, 412, 414, 415, and 4971 of the Code and sections 202, 203, 204, and 302 of the Employment Retirement Income Security Act of 1974 (ERISA) in a plan year or taxable year beginning before March 2, 1988. To the extent necessary to prevent an adverse effect on any old member (or any other corporation), or on any plan or other entity described in such sections (including plans, etc., of corporations not part of such old group), that would result solely from the retroactive effect of the amendment to this section by T.D. 8179. An adverse effect includes the disqualification of a plan or the disallowance of a deduction or credit for a contribution to a plan. The Internal Revenue Service, however, will not treat an old member as a member of an old group to the extent that such treatment will have an adverse effect on that old member.

(ii) Section 7805(b) will not be applied pursuant to paragraph (d)(2)(i) of this section to treat an old member of an old group as a member of a brother-sister controlled group to prevent an adverse effect for a taxable year if, for that taxable year, that old member treats or has treated itself as not being a member of that old group for purposes of section 401, 404(a), 408(k), 409A, 410, 411, 412, 414, 415, and 4971 of the Code and sections 202, 203, 204, and 302 and Title IV of ERISA for such taxable year (such as by filing, with respect to such taxable year, a return, amended return, or claim for credit or refund in which the amount of any deduction, credit, limitation, or tax due is determined by treating itself as not being a member of the old group for purposes of those sections).

However, the fact that one or more (but not all) of the old members do not qualify for section 7805(b) treatment because of the preceding sentence will not preclude that old member (or members) from being treated as a member of the old group under paragraph (d)(2)(i) of this section in order to prevent the disallowance of a deduction or credit of another old member (or other corporation) or to prevent the disqualification of, or other adverse effect on, another old member's plan (or other entity) described in the sections of the Code and ERISA enumerated in such paragraph.

(3) *Election of general nonretroactivity.* In the case of a taxable year ending on or after December 31, 1970, and before March 2, 1988. An old group will be treated as a brother-sister controlled group of corporations for all purposes of the Code for such taxable year if—

(i) Each old member files a statement consenting to such treatment for such taxable year with the District Director having audit jurisdiction over its return within six months after March 2, 1988, and

(ii) No old member (A) files or has filed, with respect to such taxable year, a return, amended return, or claim for credit or refund in which the amount of any deduction, credit, limitation, or tax due is determined by treating any old member as not a member of the old group or (B) treats the employees of all members of the old group as not being employed by a single employer for purposes of sections 401, 404(a), 408(k), 409A, 410, 411, 412, 414, 415, and 4971 of the Code and sections 202, 203, 204, and 302 of ERISA for such taxable year.

(4) *Definitions.* For purposes of this paragraph (d) of this section—

(i) An "old group" is a brother-sister controlled group of corporations, determined by applying paragraph (a)(3) of this section as in effect before the amendments made by Treasury decision 8179, that is not a brother-sister controlled group of corporations, determined by applying paragraph (a)(3) of this section as amended by such Treasury decision, and

(ii) An "old member" is any corporation that is a member of an old group.

(5) *Election to choose between membership in more than one controlled group.* If—

(i) An old member has filed an election under paragraph (c)(2) of this section to be treated as a component member of an old group for a December 31 before March 2, 1988, and

(ii) That corporation would (without regard to such paragraph) be a component member of more than one brother-sister controlled group (not including an old group) on the December 31, that corporation may make an election under that paragraph by filing an amended return on or before September 2, 1988. This paragraph (d)(5) does not apply to a corporation that is treated as a member of an old group under paragraph (d)(3) of this section.

(6) *Refunds.* See section 6511(a) for period of limitation on filing claims for credit or refund.

Par. 5. Section 1.1563-3 is amended by revising Example (3) in paragraph (d)(3) as set forth below.

§ 1.1563-3 Rules for determining stock ownership.

(d) *Special rule of section 1563(f)(3)(B)*

(3) *Examples.*

Example (3). Unrelated individuals A and B each own 49 percent of all the outstanding stock of corporation R, which in turn owns 70 percent of the only class of outstanding stock of corporation S. The remaining 30 percent of the stock of corporation S is owned by unrelated individual C. C also owns the remaining 2 percent of the stock of corporation R. Under the attribution rule of paragraph (b)(4) of this section A and B are each considered to own 34.3 percent of the stock of corporation S. Accordingly, since five or fewer persons own at least 80 percent of the stock of corporations R and S and also own more than 50 percent identically (A's and B's identical ownership each is 34.3 percent, C's identical ownership is 2 percent), on December 31, 1970, corporations R and S are treated as component members of the same brother-sister controlled group.

§ 1.7476-1 [Amended]

Par. 6. Section 1.7476-1 is amended by removing from paragraph (b)(2)(i) "§ 11.414 (c)-3 of this chapter (Temporary Income Tax Regulations under the Employee Retirement Income Security Act of 1974)" and adding instead "§ 1.414 (c)-3".

PART 11—TEMPORARY INCOME TAX REGULATIONS UNDER THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974

Par. 7. The authority citation for Part 11 continues to read in part:

Authority: 26 U.S.C. 7805. * * *
§§ 11.414(c)-1 through 11.414(c)-5
[Removed]

Par. 8. Sections 11.414 (c)-1 through 11.414 (c)-5 are removed.

PART 13—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX REFORM ACT OF 1969

Par. 9. The authority citation for Part 13 continues to read in part:

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

§§ 13.16 and 13.16-1 [Removed]

Par. 10. Sections 13.16 and 13.16-1 are removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 11. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 12. Section 602.101(c) is amended by adding the following citations to the table in the appropriate places:

§ 1.52-1(h).....	1545-0797
§ 1.414(c)-5(f).....	1545-0797
§ 1.1563-1(d).....	1545-0797

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved: February 9, 1988.

O. Donaldson Chapoton,

Assistant Secretary of the Treasury.

[FR Doc. 88-4238 Filed 3-1-88; 8:45 am]

BILLING CODE 4830-01-M

26 CFR Parts 1 and 602

[T.D. 8183]

Income Taxes; Investment Credit for Qualified Progress Expenditures

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the investment credit for qualified progress expenditures. Changes in the applicable tax law were made by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Revenue Act of 1978. These regulations provide the public with guidance needed to comply with the law.

DATES: The amendments to the Income Tax Regulations under the Tax Reduction Act of 1975 (1975 Act) (new § 1.46-5) are effective upon publication and apply to taxable years ending after December 31, 1974. The amendments under the Tax Reform Act of 1976 (1976 Act) (§ 1.46-5(m) as applied to certain property) are effective upon publication and apply to taxable years ending after December 31, 1976. The amendments under section 312(b)(2) of the Revenue Act of 1978 (§ 1.46-5(m) as applied to certain property) are effective upon

publication and apply to taxable years ending after December 31, 1978.

FOR FURTHER INFORMATION CONTACT:

Michel A. Daze of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, Attention: CC:LR:T (202-566-6456, not a toll free call).

SUPPLEMENTARY INFORMATION:

Background

This document contains final amendments to the Income Tax Regulations (26 CFR Part 1) under section 46(d) of the Internal Revenue Code of 1954, relating to the investment credit for qualified progress expenditures. These regulations were published in proposed form in the *Federal Register* on January 30, 1979 (44 FR 5910). A public hearing was held on June 27, 1979. After consideration of all comments regarding the proposed amendments, those amendments are adopted, as revised, by this Treasury Decision.

Before the 1975 Act, the investment credit was available only in the year in which property was placed in service. Section 46(d) (as added by the 1975 Act) allows taxpayers to elect the investment credit for qualified progress expenditures made during construction of certain property. The property must be new section 38 property that takes at least two years to construct and has an estimated useful life of 7 years or more.

This Treasury decision adds a new § 1.46-5 to provide rules for claiming the investment credit under section 46(d) for qualified progress expenditures. Under these rules, qualified progress expenditures made during a taxable year are added to a taxpayer's qualified investment otherwise determined under § 1.46-3 for that year. However, expenditures made in a taxable year beginning before 1980 are not allowed in full in computing qualified investment for that year, but are phased-in over a 5-year period.

The final regulations amend §§ 1.47-1 and 1.47-3 to provide rules for recapturing the investment credit for progress expenditure property. In general, those rules are similar to the rules for recapture for other section 38 property. Special rules apply, however, for recapture involving certain leased property.

The final regulations also reflect certain amendments made by section 301 of the 1975 Act, sections 1701(b) and 1703 of the Tax Reform Act of 1976, and sections 311(a) and 312(b)(2) of the Revenue Act of 1978. Section 301 of the

1975 Act provides an alternative limitation on the amount of tax liability that may be offset by investment credit for public utility property. Sections 1701(b) and 1703 of the 1976 Act provide a similar limitation for railroad and airline property. Section 312(b)(2) of the 1978 Act consolidates the alternative limitations on railroad and airline property into section 46(a)(8) before its repeal by section 205(b)(2)(A) of the Tax Equity and Fiscal Responsibility Act of 1982. The final regulations apply the alternative limitation to progress expenditure property that is public utility, railroad, or airline property for the period that those limitations are in effect.

The final regulations do not reflect subsequent amendments to the Code, such as those relating to recovery property made to section 46(d) by the Economic Recovery Tax Act of 1981, or the repeal of the alternative limitations on the investment credit for utility, airline, and railroad property.

Definition of Construction

Section 46(d)(2)(A) defines progress expenditure property, in part, as any property which is being constructed by or for the taxpayer, which has a normal construction period of two years or more, and which will be new section 38 property in the hands of the taxpayer when it is placed in service. Section 1.46-5(c)(2)(ii) of the proposed regulations defined construction as building or manufacturing property from materials and component parts. That section further provided that construction did not include activities such as cultivating orchards, raising livestock, or creating a motion picture film or videotape. Some commentators argued that the exclusion of these activities from the meaning of construction is not supported by section 46(d) or the legislative history. The commentators contended specifically that orchards may be treated as new section 38 property in the year in which they reach an income-producing stage and that there is no basis to exclude any particular type of new section 38 property from progress expenditure treatment. They also argued that the proposed regulations were inconsistent with Rev. Rul. 69-249 (1969-1 C.B. 31), which held that the underlying purpose and principles of "construction" as used in section 48(b) of the Code are equally applicable to the planting and development of an orchard.

As evidenced by the examples of ships, pipelines, and machinery in the legislative history (H.R. Rep. No. 19, 94th Cong., 1st Sess. 37-43 (1975)), Congress

intended in defining progress expenditure property that the term "construction" have its ordinary meaning. Section 48(b) contains a transitional rule which determines the portion of the basis of property to be taken into account when computing the investment credit. For purposes of the transitional rule, property is divided into two categories: property constructed by the taxpayer and property acquired by the taxpayer. Although an orchard is not constructed in the ordinary sense of the word, an orchard was properly assigned to that category in order to apply section 48(b) to the facts of the ruling. Because the provisions of sections 46(d) and 48(b) have different purposes, a similar stretching of the meaning of "construction" is neither mandated nor intended in order to implement section 46(d). Accordingly, § 1.46-5(d) of the final regulations provides that property, which is being constructed by or for the taxpayer, is progress expenditure property only if it is built or manufactured from materials and component parts. Thus, progress expenditure property does not include property such as orchards, vineyards, livestock, or motion picture films or videotapes.

Another commentator suggested that the proposed definition of construction would arguably exclude from the definition of qualified progress expenditures for non-self-constructed property an amount paid for designs or plans or to acquire materials to be used in construction because it is not an amount paid "for construction" under section 46(d)(3)(B)(i). To clarify the interpretation of "for construction", § 1.46-5(j)(1) of the final regulations provides examples of expenditures for construction of non-self-constructed property. Whether an amount paid to acquire materials for use by a taxpayer's employees in construction of a portion of non-self-constructed property is a qualified progress expenditure is determined under § 1.46-5(j)(2) of the final regulations (see discussion of qualified progress expenditures below). Materials acquired by a taxpayer and delivered to a manufacturer or contractor for construction may constitute an amount paid in the form of property under §§ 1.46-5(d)(3)(iii) and 1.46-5(j)(4) of the proposed and final regulations, respectively.

Normal Construction Period

General Rule

Under section 46(d)(2)(B), the normal construction period begins on the date physical work on construction of the

property begins and ends on the date when it is expected that the property will be available for placing in service. For a determination of the normal construction period, § 1.46-5(c)(2)(i) of the proposed regulations provided that physical work on construction does not include preliminary activities such as planning or designing, securing financing, exploring, researching or developing. One commentator recommended that the final regulations provide a general rule and examples describing the types of activities that constitute the commencement of physical work on construction. Other commentators suggested that the normal construction period should be measured from the earlier of the beginning of on-site construction of progress expenditure property or the start of off-site manufacture of a component unique to the progress expenditure property. Instead of a general rule, § 1.46-5(e)(1) of the final regulations provides that the time when physical work on construction commences is based on the facts and circumstances of each case, because of the diversity of activities that may mark the onset of construction. That section also provides that physical work on construction may include the manufacture of a component to be placed in service as part of the property if designated specifically for that property. Generally, physical work on construction does not include physical activity that is not necessary to complete construction of the property, nor does it include physical work on construction of a building or other property that will not be new section 38 property when placed in service.

Taxpayers also observed that a blanket description of research and development as not constituting the beginning of physical work on construction was overly broad and could be construed to disqualify work on property and part of the cost of which is deductible under section 174. Accordingly, these activities have been removed from the list of excluded activities in § 1.46-5(e)(1)(i) of the final regulations. Section 1.46-5(e)(1)(iii) clarifies that research and development activities in a laboratory or experimental setting are not physical work on construction. Whether other activities mark the beginning of physical work on construction will be determined from the facts and circumstances of each case as provided in § 1.46-5(e)(1)(ii) of the final regulations.

Section 1.46-5(c)(2)(iv) of the proposed regulations, interpreting section 46(d)(2)(B)(ii), provided that the normal construction period ends on the

date it is expected the property will be available to be placed in service. One commentator believed that the phrase in the statute "available for placing in service" should be interpreted in the same manner as the phrase "placed in service" so that the regulations under section 46(d) coincide with § 1.46-3(d). The rule remains unchanged in the final regulations (§ 1.46-5(e)(1)(iv)). There is no support in the legislative history for construing obviously different phrases similarly. Further, § 1.46-3(d) provides rules for determining when section 38 property is placed in service for purposes of computing qualified investment and claiming the investment credit in the proper taxable year. The provision of the final regulations only determines the time when construction of property has been completed, not when the investment credit for that property is allowed.

Estimate of Normal Construction Period

Section 1.46-5(c)(2)(iii) of the proposed regulations required a taxpayer to attach to its income tax return a statement of the basis relied upon in estimating the normal construction period. In response to several comments, § 1.46-5(e)(2) of the final regulations requires a taxpayer to attach a statement only if the estimate is not based on normal industry practice. The rule in the final regulations is prospective only.

Integrated Unit

Both the proposed and final regulations provide that, if property is to be placed in service as part of an integrated unit, the normal construction period is determined for the unit as a whole. Under § 1.46-5(c)(2)(v) of the proposed regulations, property is part of an integrated unit only if the operation of that item is essential to the performance of the function to which the unit is assigned. Although one commentator urged that the definition was too restrictive and difficult to apply, the definition remains unchanged in § 1.46-5(e)(3)(ii) of the final regulations. The definition has been amplified, however, to explain that property essential to the performance of the function to which the unit is assigned includes property the use of which is significantly connected to that function and which effects the safe, proper, or efficient performance of the unit. The final regulations also provide that generally property must be placed in service at the same time to be considered part of the same integrated unit.

In response to several comments, § 1.46-5(e)(3)(iii) clarifies that physical work on construction of an integrated unit may commence at a site different from the main construction site of the unit.

Qualified Progress Expenditures

Whether progress expenditure property is self-constructed or non-self-constructed determines what amounts attributable to construction of the property may be treated as qualified progress expenditures. Self-constructed property, as defined in section 46(d)(5)(A), is property more than half of the construction expenditures for which it is reasonable to believe will be made directly by the taxpayer. All other property is non-self-constructed (section 46(d)(5)(B)). Under section 46(d)(3)(B), qualified progress expenditures for non-self-constructed property are amounts actually paid to another person for construction, but only to the extent that the payments represent progress in construction. Progress is generally measured by the percentage of construction completed during a taxable year. Construction is presumed to occur not more rapidly than ratably throughout the construction period unless the taxpayer establishes otherwise by clear and convincing evidence. For self-constructed property, qualified progress expenditures are amounts properly chargeable to capital account during a taxable year with respect to that property (section 46(d)(3)(A)). Section 1.46-5(h)(1) of the final regulations makes clear that those amounts include both direct costs (for example, labor, materials, and parts) and indirect costs (for example, overhead and insurance). Because progress is expected to correspond to progress expenditures in the case of self-constructed property, the expenditures are not subject to the requirement of actual payment and the percentage-of-completion limitation applicable to expenditures for non-self-constructed property.

Commentators observed that the proposed regulations did not adequately consider property that is not entirely self-constructed or non-self-constructed. Section 1.46-5(h)(2) of the final regulations provides that amounts paid by the taxpayer to another person for construction of a portion of an item of self-constructed property are not subject to the limitations of section 46(d)(3)(B) (relating to actual payment and progress in construction) imposed upon expenditures for non-self-constructed property. For example, the percentage-of-completion limitation does not apply to payments made to a manufacturer for

a turbine used in a ship if that ship is self-constructed property. Those payments are eligible for progress expenditure treatment when properly chargeable to capital account. Section 1.46-5(h)(3) of the final regulations provides rules for determining when amounts paid or incurred with respect to self-constructed property are properly chargeable to capital account.

For property that is non-self-constructed, but for which the taxpayer makes some construction expenditures directly, section 1.46-5(j)(2) of the final regulations provides that the rules of section 46(d)(3)(B) (relating to actual payment and progress in construction) and paragraph (j) of the regulations apply to determine if any expenditure (whether or not made directly by the taxpayer) is a qualified progress expenditure for non-self-constructed property. Wages actually paid to a taxpayer's employees are presumed to correspond to progress in construction. Other amounts, including expenditures for materials, parts, and overhead, must be actually paid, not borrowed from the payee, and attributable to progress made in construction.

Section 1.46-5(d)(3)(ii) of the proposed regulations required that a taxpayer apply the percentage-of-completion limitation to amounts paid to each manufacturer or contractor in each taxable year. Thus, progress is measured on a manufacturer by manufacturer basis, so that the taxpayer takes into account only those progress expenditures made to a manufacturer that was made progress (H.R. Rep. No. 19, *supra*, at 39). In response to comments that the proposed rule is unduly burdensome if applied at a subcontractor level, § 1.46-5(j)(3) of the final regulations applies the requirement only with respect to persons that have a direct contractual relationship with the taxpayer (taking into account the progress made by those persons' subcontractors), rather than with respect to each subcontractor.

If, after the first year of construction, there is a change in either the total cost to the taxpayer or the total cost of construction by another person, § 1.46-5(d)(3)(vi) of the proposed regulations required the taxpayer to recompute the percentage-of-completion limitation on the basis of the revised cost. Under the proposed rule, the recomputation would affect only years subsequent to the taxable year of change. Commentators contend that the recomputation should also apply to the taxable year in which the change occurs. This suggestion is adopted in § 1.46-5(j)(6)(ii) of the final regulations.

While § 1.46-5(c)(2)(i) of the proposed regulations excluded certain preliminary activities from a determination of the normal construction period, the proposed regulations did not specifically exclude from the definition of qualified progress expenditures amounts incurred prior to the commencement of the normal construction period. Taxpayers suggested that, once property has been determined to have a normal construction period of two years or more, such amounts should be eligible for progress expenditure treatment and should be included in qualified investment when made, or in any case, no later than in the year in which physical work on construction commences. The suggestion is not adopted. The regulations interpret the statute in a manner consistent with the legislative history, which provides that "progress expenditures", as well as "progress", are not to be taken into account to the extent that they occur before the start of the normal construction period (H.R. Rep. No. 19, *supra*, at 39). Accordingly, § 1.46-5(g)(2)(i) of the final regulations excludes such amounts from the definition of qualified progress expenditures. That section also summarizes other amounts that are ineligible for progress expenditure treatment.

Section 46(d)(4)(A) does provide a limited "catchup" rule. Under that section, property which is to be a component of, or otherwise included in, progress expenditure property is to be taken into account (1) at a time not earlier than the time it is irrevocably devoted to use in the progress expenditure property, and (2) as if the taxpayer (at that time) had expended an amount equal to that portion of the cost of the component which is properly chargeable to capital account with respect to the property. Thus, under § 1.46-5(h)(3)(i), expenditures for component parts and materials for self-constructed property may not be considered chargeable to capital account until physical work on construction begins and the materials or parts become irrevocably devoted to use in the property.

Taxpayers have suggested that section 46(d)(4)(A) is also applicable to non-self-constructed property, and that once a component part is irrevocably devoted to the property and chargeable to capital account, the taxpayer is treated as having (*i.e.*, paid) an amount equal to the cost of the component part that has been charged to capital account. This amount, therefore, is a qualified progress expenditure without

the application of the payment, progress, or borrowing rule. This suggestion is not adopted. Section 46(d)(4)(A) refers to the cost of a component part or other property which is properly chargeable to capital account with respect to the progress expenditure property in which the component part or other property is to be included, thus paralleling the definition of qualified progress expenditures for self-constructed property in section 46(d)(3)(A). Furthermore, the committee report refers specifically to self-constructed property in its explanation of "irrevocably devoted" as used in section 46(d)(4)(A) (H.R. Rep. No. 19, *supra*, at 38). There is no indication that Congress intended section 46(d)(4)(A) to override the payment, progress, and borrowing rules.

Definition of Self-Constructed Property

Self-constructed property is defined in section 46(d)(5)(A) as property more than half of the construction expenditures for which it is reasonable to believe will be made directly by the taxpayer. Under § 1.46-5(d)(5) of the proposed regulations, construction expenditures are considered made "directly" by the taxpayer only if the taxpayer uses its own employees to construct the property. The majority of comments objected that this rule is unduly restrictive and inconsistent with the interpretation of the terms "construction completed by the taxpayer" in section 48(b) and "constructed by the taxpayer" in § 1.48-2(b)(1).

Under § 1.48-2(b)(1), property is constructed by the taxpayer if the work is done for him in accordance with his specifications. Courts interpreting this provision have focused on the taxpayer's right of control over construction (*Public Service Company of New Mexico v. United States*, 431 F.2d 980 (10th Cir. 1970); *Lykes Bros. Steamship Co., Inc. v. United States*, 513 F.2d 1342 (Ct. Cl. 1975)). In both cases, the property for which the investment credit was claimed was held to be acquired within the meaning of section 48(b)(2), rather than constructed by the taxpayer. The Service has announced that it will follow *Lykes Bros.* and a similar case, *Pacific Far East Line, Inc. v. United States*, 513 F.2d 1355 (Ct. Cl. 1975), in cases with identical factual situations. If a taxpayer engages the services of a contractor to construct property and the facts and circumstances show sufficient involvement of the taxpayer in the construction, the property is considered constructed by the taxpayer for purposes of section 48(b) (Rev. Rul. 77-107, 1977-1 C.B. 6).

As discussed in connection with the

definition of construction, sections 46(d) and 48(b) have different purposes and need not be read *in pari materia*. Congress, aware of the distinction in section 48(b) between property constructed by the taxpayer and acquired property, used different terminology and established two different categories of progress expenditure property under section 46(d). The operating rules of section 46(d) governing expenditures for non-self-constructed property are designed to ensure that the investment credit is allowed only if the taxpayer has borne sufficient economic detriment and to prevent manipulation of the timing of the credit. These policy concerns exist whether the property is constructed by either a closely supervised or a completely independent contractor. Section 1.46-5(k)(1) of the final regulations, therefore, adopts the proposed rule for determining whether expenditures for construction are made directly by the taxpayer.

Section 1.46-5(k)(1) clarifies that construction expenditures include both direct costs, such as wages and materials, and indirect costs, such as overhead, attributable to construction of the property. Expenditures are considered made directly by the taxpayer only to the extent that the expenditures directly benefit the construction of the property by the taxpayer's employees. Thus, expenditures for materials and supplies, which are used by employees of the taxpayer to construct progress expenditure property, are considered made directly by the taxpayer.

Election

Under § 1.46-5(g)(1) of the proposed regulations, the election under section 46(d) is binding for all progress expenditure property constructed or acquired by the taxpayer. Several commentators argued that the election should be made on a project-by-project basis. Because section 46(d) prescribes the timing of a credit, its effect is analogous to prescribing a method of accounting. The final regulations adopt the proposed rule, requiring a taxpayer to apply the progress expenditure election consistently to all eligible property.

Section 1.46-5(g)(1) of the proposed regulations also requires that the election under section 46(d) be made by each partner rather than by a partnership. The suggestion that the partnership make the election is not adopted because the investment credit affects the computation of tax and not the computation of taxable income. Thus, section 703(b), which generally requires a partnership to make elections

affecting the computation of taxable income, is not applicable to the election under section 46(d). Section 1.46-5(o)(1) of the final regulations adopts the proposed rule to give each partner the flexibility to choose progress expenditure treatment and to ensure that the election binds the taxpayer even if it leaves the partnership. The final regulations also make clear that the election applies to all of a partner's progress expenditure property including property held in its own capacity.

Under § 1.46-5(g)(1) of the proposed regulations, an election under section 46(d) must be made by filing a written statement containing specified information with the original return for the first taxable year to which the election will apply. In response to several comments, this requirement is not adopted in the final regulations. Instead § 1.46-5(o)(2) provides that the election under section 46(d) is to be made on Form 3468. A transitional rule is also provided so that elections before the adoption of the final regulations will not be invalidated.

Transferred Property

Under § 1.46-5(a)(2) of the proposed regulations, a transferee is entitled to qualified progress expenditures in the year the transferor, as a result of the transfer, must recapture the credit for progress expenditures previously allowed, and in subsequent years, if the transferee otherwise would be entitled to claim the credit with respect to that property. Taxpayers commented that it was unclear whether the transferee could treat the full amount paid to the transferor as qualified progress expenditures in addition to future payments for construction.

Section 1.46-5(r) of the final regulations contains a more comprehensive rule for transferred property with respect to which the transferor's election does not carry over to the transferee, and with respect to which the transferor must recapture the credit (if claimed). The transferee may treat the amount paid to the transferor as a payment for construction of the property to the extent that (A) it is properly includible in the basis of the property, (B) the taxpayer can show the amount is attributable to construction costs paid or chargeable to capital account after physical work on construction of the property began, and (C) it does not exceed the amount by which the transferor has increased qualified investment for qualified progress expenditures incurred with respect to the property (or would have increased qualified investment if the transferor had made an election under

section 46(d)), plus an amount that would have been treated as a qualified progress expenditure by the transferor had the property not been transferred.

Once the status of the property as self-constructed property or non-self-constructed property in the hands of the transferee has been determined, all rules governing that type of property apply in determining the amount of the credit for qualified progress expenditures allowed to the transferee for that property. For example, the transferred property must have a normal construction period of two years or more in the hands of the transferee. Also, if the property is non-self-constructed property in the hands of the transferee, the transferee's expenditures with respect to the property (including the amounts paid to the transferor that are treated as amounts paid for construction) are subject to the limitations of section 46(d)(3)(B) (relating to actual payment and progress in construction). In the case of non-self-constructed property, however, the transferee determines the limitations of section 46(d)(3)(B) using the normal construction period of the transferor.

Executive Order 12291 and Regulatory Flexibility Act

The Commissioner of Internal Revenue has determined that this final order is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. The Internal Revenue Service had concluded that the final regulations contained herein are interpretative and that the notice and public procedure requirements of 5 U.S.C. 553 do not apply. Accordingly, these final regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. Chapter 6).

Paperwork Reduction Act

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1980. These requirements have been approved by OMB.

Drafting Information

The principal author of these final regulations is Michel A. Dazé of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations, both on matters of substance and style.

List of Subjects

26 CFR 1.0-1—1.58-8

Income taxes, Tax liability, Tax rates, Credits.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of amendments to the regulations

Accordingly, 26 CFR Parts 1 and 602 are amended as follows:

PART 601—[AMENDED]

Paragraph 1. The authority for Part 1 is amended by adding the following citation:

Authority: 26 U.S.C. 7805. * * * Section 1.46-5 also issued under 26 U.S.C. 46(d)(6) and 26 U.S.C. 47(a)(3)(C).

Par. 2. Section 1.46-1 is amended by adding at the end of paragraph (g) a new paragraph (g)(6) and by adding at the end of paragraph (n) new examples (6) and (7) to read as set forth below.

§ 1.46-1 Determination of amount.

(g) *Transitional rule for regular and ESOP credit.* * * *

(6) *Qualified progress expenditures.* For progress expenditure property that is constructed, reconstructed, or erected by the taxpayer within the meaning of § 1.46-2(b), the ten-percent credit applies in the year the property is placed in service to the portion of the qualified investment that remains after reduction for qualified progress expenditures under section 46(c)(4), but only to the extent that the remaining qualified investment is attributable to construction, reconstruction, or erection after January 21, 1975. For progress expenditure property that is acquired by the taxpayer (within the meaning of § 1.46-2(b)) after January 21, 1975, and placed in service after that date, the ten-percent credit applies in the year the property is placed in service to the entire portion of qualified investment that remains after reduction for qualified progress expenditures.

(n) *Examples.* * * *

Example (6) (i) Corporation X, a calendar year taxpayer, constructs a ship on which it begins construction on January 1, 1973, and which, when placed in service on December 31, 1980, has a basis of \$450,000. Of that amount \$100,000 is attributable to construction before January 22, 1975. X makes an election under section 46(d) (qualified progress expenditures) for taxable years after 1975.

(ii) For 1976, 1977, 1978, and 1979, qualified progress expenditures total \$200,000. The ten-percent credit applies to those expenditures.

(iii) For 1980, qualified investment for the ship is \$450,000. Under section 46(c)(4), X must reduce this amount by \$200,000, the amount of qualified progress expenditures taken into account. The ten-percent credit applies to the portion of the remaining qualified investment attributable to construction after January 21, 1975 (\$150,000). The seven-percent credit applies to the portion of qualified investment attributable to construction before January 22, 1975 (\$100,000).

Example (7). (i) Corporation Y agrees to build a ship for Corporation X, which uses the calendar year. In 1973, Y begins construction of the ship which X acquires and places in service on December 31, 1980. X makes an election under section 46(d) for taxable years after 1974. The contract price is \$400,000.

(ii) For 1975, 1976, 1977, 1978, and 1979, qualified progress expenditures total \$250,000. The ten-percent credit applies to those expenditures.

(iii) For 1980, qualified investment for the ship is \$400,000, which is the contract price. X must reduce qualified investment by \$250,000, the amount of qualified progress expenditures. The ten-percent credit applies to the \$150,000 of qualified investment that remains after reduction for qualified progress expenditures.

Par. 3. Section 1.46-3 is amended by adding a new sentence at the end of paragraph (a)(1) to read as follows:

§ 1.46-3 Qualified investment.

(a) *In general.* * * *

(1) * * * See § 1.46-5 for special rules for progress expenditure property.

Par. 4. A new § 1.46-5 is added immediately after § 1.46-4 to read as follows:

§ 1.46-5 Qualified progress expenditures.

(a) *Effective date.* This section applies to taxable years ending after December 31, 1974. This section reflects amendments to the Internal Revenue Code made only by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, and the Revenue Act of 1978.

(b) *General rule.* Under section 46(d), a taxpayer may elect to take the investment credit for qualified progress expenditures (as defined in paragraph (g) of this section). In general, qualified progress expenditures are amounts paid (paid or incurred in the case of self-constructed property) for construction of progress expenditure property. The taxpayer must reasonably estimate that the property will take at least 2 years to construct and that the useful life of the property will be 7 year or more. Qualified progress expenditures may not

be taken into account if made before the later of January 22, 1975, or the first taxable year to which an election under section 46(d) applies. In general, qualified progress expenditures are not allowed for the year property is placed in service, nor for the first year or any subsequent year recapture is required under section 47(a)(3). There is a percentage limitation on qualified progress expenditures for taxable years beginning before January 1, 1980. For a special rule relating to transfers of progress expenditure property, see paragraph (r) of this section.

(c) *Reduction of qualified investment.* Under section 46(c)(4), a taxpayer must reduce qualified investment for the year property is placed in service by qualified progress expenditures taken into account by that person or a predecessor. A "predecessor" of a taxpayer is a person whose election under section 46(d) carries over to the taxpayer under paragraph (o)(3) of this section.

(d) *Progress expenditure property.* Progress expenditure property is property constructed by or for the taxpayer, with a normal construction period of 2 years or more. The taxpayer must reasonably believe that the property will be new section 38 property with a useful life of 7 years or more when placed in service. Whether property is progress expenditure property is determined on the basis of facts known at the close of the taxable year of the taxpayer in which construction begins (or, if later, at the close of the first taxable year to which an election under section 46(d) applies). For purposes of this paragraph (d), property is constructed by or for the taxpayer only if it is built or manufactured from materials and component parts. Accordingly, progress expenditure property does not include property such as orchards, vineyards, livestock, or motion picture films or videotapes.

(e) *Normal construction period—(1) In general.* (i) The normal construction period is the period the taxpayer reasonably expects will be required to construct the property. The period begins on the date physical work on construction of the property commences and ends on the date the property is available to be placed in service. The normal construction period does not include, however, construction before January 22, 1975, nor construction before the first day of the first taxable year for which an election under section 46(d) is in effect. Physical work on construction of property does not include preliminary activities such as planning, designing,

preparing blueprints, exploring, or securing financing.

(ii) The determination of the time when physical work on construction commences is based on the facts and circumstances of each case. Physical work on construction of property may include the physical work done by a subcontractor on a component specifically designated as part of the property. Also, the commencement of physical work on construction may occur at a site different from the main site of construction of the property. For example, if a shipyard orders a turbine before it begins work on building a ship, the normal construction period of the ship is measured from the time the subcontractor commences physical work on construction of the turbine (if it is normal for such work to precede the work of the main contractor).

(iii) Generally, physical work on construction does not include physical activity that is not necessary to complete construction of the property, nor does it include physical work on construction of a building or other property that will not be new section 38 property when placed in service. Physical work on construction also does not include research and development activities in a laboratory or experimental setting.

(iv) The normal construction period of property ends on the date it is expected the property will be available to be placed in service. Property is considered available to be placed in service when construction is completed and the property is available for delivery to the site of its assigned function. It is not necessary that property be in a state of readiness for a specifically assigned function. Nor is it necessary that it actually be delivered to the site of its assigned function.

(2) *Estimates.* Taxpayers should refer to normal industry practice in estimating the normal construction period of particular items. A different period may be used if special circumstances exist making it impractical to make the estimate on the basis of normal industry practice. The estimate must be based on information available at the close of the taxable year in which physical work on construction of the property begins, or, if later, at the close of the first taxable year for which an election under section 46(d) is in effect for the taxpayer. If the estimate is reasonable when made, the actual time it takes to complete the work is, in general, irrelevant in determining whether property is progress expenditure property. However, if there is a significant error in estimating the normal construction period, it may be

evidence that the estimate was unreasonable when made. For taxable years ending after April 1, 1988, a taxpayer not relying on normal industry practice to estimate the normal construction period of particular property must attach to the tax return for the taxable year in which physical work on construction of the property begins (or, if later, the first taxable year for which an election under section 46(d) is in effect) a statement of the basis relied upon in estimating the normal construction period of the property.

(3) *Integrated unit.* (i) In determining whether property has a normal construction period of 2 years or more, property that will be placed in service separately is to be considered separately. For example, if two ships are contracted for at the same time, each ship is considered separately under this paragraph. However, for property that will be placed in service as an integrated unit, the taxpayer must determine the normal construction period of the integrated unit. If the normal construction period of the integrated unit is 2 years or more, the normal construction period of each item of new section 38 property that is a part of the integrated unit is considered to be 2 years or more. Thus, the normal construction period of an integrated unit may be 2 years or more even if no part of the unit has a normal construction period of 2 years or more.

(ii) Property is part of an integrated unit only if the operation of that item is essential to the performance of the function to which the unit is assigned. Property essential to the performance of the function to which the unit is assigned includes property the use of which is significantly connected to that function and which effects the safe, proper, or efficient performance of the unit. Generally, property must be placed in service at the same time to be considered part of the same integrated unit. Properties are not an integrated unit, however, solely because they are to be placed in service at the same time.

(iii) The normal construction period for an integrated unit begins on the date the normal construction period of the first item of new section 38 property that is part of the unit begins. It is not necessary that physical work commence at the main construction site of the integrated unit.

The period ends on the date the last item of new section 38 property that is part of that unit is available to be placed in service. Property that is not new section 38 property, such as a building, is not considered part of an integrated unit for purposes of determining the

normal construction period of that unit. For example, if a manufacturing plant has a normal construction period of two years or more but the equipment (*i.e.*, new section 38 property) to be installed in the plant has a normal construction period of less than two years, the plant and the equipment do not constitute an integrated unit with a construction period of two years or more and the equipment is not progress expenditure property.

(4) *Examples.* The following examples illustrate this paragraph (e).

Example (1). On July 1, 1974, corporation X begins physical work on construction of a machine with an estimated useful life when placed in service of more than 7 years. For its taxable year ending June 30, 1975, X makes an election under section 46(d). For purposes of determining on June 30, 1975, whether the machine is "progress expenditure property", the normal construction period is treated as having begun on January 22, 1975. Thus, the machine will be considered to be progress expenditure property on June 30, 1975, only if the estimated time required to complete construction after June 30 is at least 18 months and 22 days (*i.e.*, 2 years less the period January 22, 1975, through June 30, 1975).

Example (2). (i) Corporation X constructs a pipeline in two sections and simultaneously begins physical work on construction of each section on January 1, 1976. One section extends from city M to city N. The other extends from city N to city O. Oil will be transferred to storage tanks at both city N and city O. Corporation X also begins construction on January 1, 1976, of a pumping station necessary to the operation of the pipeline from city M to city N. Construction of a pumping station necessary to the operation of the pipeline from city N to city O begins on June 30, 1977. For 1976, corporation X makes an election under section 46(d).

(ii) The section of pipeline from city M to city N and the associated pumping station will be available to be placed in service on January 1, 1977. Construction of the section of the pipeline from city N to city O will be completed on June 30, 1977. However, that section of the pipeline will not be available to be placed in service until completion of the associated pumping station on January 1, 1978.

(iii) The section of pipeline from city M to city N and the section from city N to city O must be considered separately in determining the normal construction period of the property. Each section will be placed in service separately. However, each section of the pipeline and the associated pumping station may be considered an integrated unit. The pumping stations are essential to the operation of each section of pipeline. Each section of pipeline and the associated pumping station are placed in service at the same time.

(iv) The section of pipeline from city M to city N and the associated pumping station are not progress expenditure property, because the normal construction period of that unit is only 1 year (January 1, 1976 to January 1, 1977).

(v) The section of pipeline from city N to city O and the associated pumping station are progress expenditure property, because the normal construction period of that integrated unit is 2 years (January 1, 1976 to January 1, 1978). It is immaterial that neither the construction period of that section of pipeline (January 1, 1976 to June 30, 1977) nor the construction period of the associated pumping station (June 30, 1977 to January 1, 1978) is 2 years.

(vi) Assume the pumping station associated with the pipeline from city N to city O includes backup pumping equipment that will be used only if the primary pumping equipment fails. The backup equipment is part of the integrated unit because it serves to effect the safe or efficient performance of the unit.

(f) *New section 38 property with a 7-year useful life—(1) In general.* The taxpayer must determine if property will be new section 38 property with a useful life of 7 years or more when placed in service. The determination must be made at the close of the taxable year in which construction begins or, if later, at the close of the first taxable year to which an election under section 46(d) applies for the taxpayer.

(2) *Determination based on reasonably expected use.* The determination of whether property will be "new section 38 property" (within the meaning of §§ 1.48-1 and 1.48-2 when placed in service must be based on the reasonably expected use of the property by the taxpayer. There is a presumption that property will be new section 38 property if it would be new section 38 property if placed in service by the taxpayer when the determination is made. For example, in determining if property is an integral part of manufacturing under section 48(a)(1)(B)(i), it will be presumed that property will be new section 38 property if the taxpayer is engaged in manufacturing when the determination is made. Also, significant steps taken to establish a trade or business will be evidence the taxpayer will be engaged in that trade or business when the property is placed in service.

(3) *Estimated useful life.* The determination of whether property will have an estimated useful life of 7 years or more when placed in service must be made by applying the principles of § 1.46-3(e). If the estimated useful life is less than 7 years when the property is actually placed in service, the credit previously allowed under section 46(d) must be recomputed under section 47(a)(3)(B).

(g) *Definition of qualified progress expenditures—(1) In general.* A taxpayer's qualified progress expenditures are the sum of qualified progress expenditures for self-

constructed property (determined under paragraph (h) of this section), plus qualified progress expenditures for non-self-constructed property (determined under paragraph (j) of this section). Only amounts includible under § 1.46-3(c) in the basis of new section 38 property may be considered as qualified progress expenditures.

(2) *Excluded amounts.* Qualified progress expenditures do not include:

(i) In the case of non-self-constructed property, amounts incurred (whether or not paid)—

(A) Before the normal construction period begins, or

(B) Before the later of January 22, 1975, or the first day of the first taxable year for which an election under section 46(d) applies for the taxpayer;

(ii) In the case of self-constructed property, amounts chargeable to capital account—

(A) Before the normal construction period begins, or

(B) Before the later of January 22, 1975, or the first day of the first taxable year for which an election under section 46(d) applies for the taxpayer.

(See, however, section 46(d)(4)(A) and paragraph (h)(3)(i) of this section, relating to the time when amounts for component parts and materials are properly chargeable to capital account);

(iii) Expenditures with respect to particular property in the earlier of—

(A) The taxable year in which the property is placed in service, or

(B) The taxable year in which the taxpayer must recapture investment credit under section 47(a)(3) for the property or any subsequent year;

(iv) Expenditures for construction, reconstruction, or erection of property that is not section 38 property; or

(v) Amounts treated as an expense and deducted in the year paid or accrued.

(h) *Qualified progress expenditures for self-constructed property—(1) In general.* Qualified progress expenditures for self-constructed property (as defined in paragraph (k) of this section) are amounts properly chargeable to capital account in connection with that property. In general, amounts paid or incurred are chargeable to capital account if under the taxpayer's method of accounting they are properly includible in computing basis under § 1.46-3. Qualified progress expenditures for self-constructed property include both direct costs (*e.g.*, labor, material, parts) and indirect costs (*e.g.*, overhead, insurance) associated with construction of property to the extent those costs are properly chargeable to capital account.

(2) *Property partially non-self constructed.* If an item of property is self-constructed because more than half of the construction expenditures are made directly by the taxpayer, then any expenditures (whether or not made directly by the taxpayer) for construction of that item of property are not subject to the limitations of section 46(d)(3)(B) and paragraph (j) of this section (relating to actual payment and progress in construction).

(3) *Time when amounts paid or incurred are properly chargeable to capital account.* (i) In general, expenditures for component parts and materials to be used in construction of self-constructed property are not properly chargeable to capital account until consumed or physically attached in the construction process. Component parts and materials that have been neither consumed nor physically attached in the construction process, but which have been irrevocably allocated to construction of that property are properly chargeable to capital account. Component parts and materials designed specifically for the self-constructed property may be considered irrevocably allocated to construction of that property at the time of manufacture of the component parts and materials. Component parts and materials not designed specifically for the property may be considered irrevocably allocated to construction at the time of delivery to the construction site if they would be economically impractical to remove. For example, pumps delivered to sites of construction of a tundra pipeline may be treated as irrevocably allocated to that pipeline on the date of delivery, even if they would be usable, but for their location on the tundra, in connection with other property. Component parts and materials are not to be considered irrevocably allocated to use in self-constructed property until physical work on construction of that property has begun (as determined under paragraph (e)(1)(ii) of this section). Mere bookkeeping notations are not sufficient evidence that the necessary allocation has been made.

(ii) A taxpayer's procedure for determining the time when an expenditure is properly chargeable to capital account for self-constructed property is a method of accounting. Under section 446(e), the method of accounting, once adopted, may not be changed without consent of the Secretary.

(4) *Records requirement.* The taxpayer shall maintain detailed records which permit specific identification of the amounts properly chargeable by the

taxpayer during each taxable year to capital account for each time of self-constructed property.

(i) [Reserved].

(j) *Qualified progress expenditures for non-self-constructed property—(1) In general.* Qualified progress expenditures for non-self-constructed property (as defined in paragraph (l) of this section) are amounts actually paid by the taxpayer to another person for construction of the property, but only to the extent progress is made in construction. For example, such expenditures may include payments to the manufacturer of an item of progress expenditure property, payments to a contractor building progress expenditure property, or payments for engineering designs or blueprints that are drawn up during the normal construction period.

(2) *Property partially self-constructed.* If an item of property is non-self-constructed, but a taxpayer uses its own employees to construct a portion of the property, expenditures for construction of that portion are made directly by the taxpayer (see § 1.46-5(h)(1)). Subject to the limitations of paragraph (g) of this section, those expenditures are qualified progress expenditures for non-self-constructed property if they satisfy the requirements of paragraph (j) (4), (5), and (6) of this section. Wages actually paid to the taxpayer's employees are presumed to correspond to progress in construction. Other amounts, including expenditures for materials, parts, and overhead, must be actually paid, not borrowed from the payee, and attributable to progress made in construction by the taxpayer.

(3) *Property constructed by more than one person.* The percentage of completion limitation (as prescribed in paragraph (j)(6) of this section), including the presumption of ratable progress in construction, applies to an item of progress expenditure property as a whole. However, if several manufacturers or contractors do work in connection with the same property, the progress that each person makes toward completion of construction of the property must be determined separately. Section 46(d)(3)(B) is then applied separately to amounts paid to each manufacturer or contractor based on each person's progress in construction. For example, assume the taxpayer contracts with three persons to build an item of equipment. The taxpayer contracts with A to build the frame, B to build the motor, and C to assemble the frame and motor. Assume each contract represents 33 1/3 percent of the construction costs of the property. If, within the taxable year in which

construction begins, A and B each complete 50 percent of the construction of the frame and motor, respectively, amounts paid to A during that taxable year not in excess of 16 2/3 percent of the overall cost of the property, and amounts paid to B during that taxable year not in excess of 16 2/3 percent of the overall cost of the property, are qualified progress expenditures. Section 46(d)(3)(B) does not apply, however, to persons, such as lower-tier subcontractors, that do not have a direct contractual relationship with the taxpayer. If, in the above example, A engages a subcontractor to construct part of the frame, section 46(d)(3)(B) is applied only to amounts paid by the taxpayer to A, B, and C, but the portion of construction completed by A during a taxable year includes the portion completed by A's subcontractor.

(4) *Requirement of actual payment.* Qualified progress expenditures for non-self-constructed property must be actually paid and not merely incurred. Amounts paid during the taxable year to another person for construction of non-self-constructed property may be in the form of money or property (e.g., materials). However, property given as payment may be considered only to the extent it will be includible under § 1.46-3(c) in the basis of the non-self-constructed property when it is placed in service.

(5) *Certain borrowing disregarded.* Qualified progress expenditures for non-self-constructed property do not include any amount paid to another person (the "payee") for construction if the amount is paid out of funds borrowed directly or indirectly from the payee. Amounts borrowed directly or indirectly from the payee by any person that is related to the taxpayer (within the meaning of section 267) or that is a member of the same controlled group of corporations (as defined in section 1563(a)) will be considered borrowed indirectly from the payee. Similarly, amounts borrowed under any financing arrangement that has the effect of making the payee a surety will be considered amounts borrowed indirectly by the taxpayer from the payee.

(6) *Percentage of completion limitation.* (i) Under section 46(d)(3)(B)(ii), payments made in any taxable year may be considered qualified progress expenditures for non-self-constructed property only to the extent they are attributable to progress made in construction (percentage of completion limitation). Progress will generally be measured in terms of the manufacturer's incurred cost, as a fraction of the anticipated cost (as

adjusted from year to year).

Architectural or engineering estimates will be evidence of progress made in construction. Cost accounting records also will be evidence of progress. Progress will be presumed to occur not more rapidly than ratably over the normal construction period. However, the taxpayer may rebut the presumption by clear and convincing evidence of a greater percentage of completion.

(ii) If, after the first year of construction, there is a change in either the total cost to the taxpayer or the total cost of construction by another person, the taxpayer must recompute the percentage of completion limitation on the basis of revised cost. However, the recomputation will affect only amounts allowed as qualified progress expenditures in the taxable year in which the change occurs and in subsequent taxable years. The recomputation remains subject to the presumption of pro rata completion.

(iii) If, for any taxable year, the amount paid to another person for construction of an item of property under section 46(d)(3)(B)(i) exceeds the percentage of completion limitation in section 46(d)(3)(B)(ii), the excess is treated as an amount paid to the other person for construction for the succeeding taxable year. If for any taxable year the percentage of completion limitation for an item of property exceeds the amount paid to another during the taxable year for construction, the excess is added to the percentage of completion limitation for that property for the succeeding taxable year.

(iv) The taxpayer must maintain detailed records which permit specific identification of the amounts paid to each person for construction of each item of property and the percentage of construction completed by each person for each taxable year.

(7) *Example.* The following example illustrates paragraph (j)(6) of this section.

Example. (i) Corporation X agrees to build an airplane for corporation Y, a calendar year taxpayer. The airplane is non-self-constructed progress expenditure property. Physical work on construction begins on January 1, 1980. The normal construction period for the airplane is five years and the airplane is delivered and placed in service on December 31, 1984.

(ii) The cost of construction to corporation X is \$500,000. The contract price is \$550,000. Corporation Y makes a \$110,000 payment in each of the years 1980 and 1981, an \$85,000 payment in 1982, a \$135,000 payment in 1983, and a \$110,000 payment in 1984.

(iii) For 1980, corporation Y makes an election under section 46(d). Progress is presumed to occur ratably over the 5-year

construction period, which is 20 percent in each year. Twenty percent of the contract price is \$110,000. The percentage of completion limitation for each year, thus, is \$110,000.

(iv) For each of the years 1980 and 1981, the \$110,000 payments may be treated as qualified progress expenditures. The payments equal the percentage of completion limitation.

(v) For 1982, the \$85,000 payment may be treated as a qualified progress expenditure, because it is less than the percentage of completion limitation. The excess of the percentage of completion limitation (\$110,000) over the 1982 payment (\$85,000) is added to the percentage of completion limitation for 1983. One hundred and ten thousand dollars minus \$85,000 equals \$25,000. Twenty-five thousand dollars plus \$110,000 equals \$135,000, which is the percentage of completion limitation for 1983.

(vi) For 1983, the entire \$135,000 payment may be treated as a qualified progress expenditure. The payment equals the percentage of completion limitation for 1983.

(vii) For 1984, no qualified progress expenditures may be taken into account, because the airplane is placed in service in that year.

(viii) See example (2) of paragraph (r)(4) of this section for the result if Y sells its contract rights to the property on December 31, 1982.

(k) *Definition of self-constructed property.*—(1) *In general.* Property is self-constructed property if it is reasonable to believe that more than half of the construction expenditures for the property will be made directly by the taxpayer. Construction expenditures made directly by the taxpayer include direct costs such as wages and materials and indirect costs such as overhead attributable to construction of the property. Expenditures for direct and indirect costs of construction will be treated as construction expenditures made directly by the taxpayer only to the extent that the expenditures directly benefit the construction of the property by employees of the taxpayer. Thus, wages paid to taxpayers's employees and expenditures for basic construction materials, such as sheet metal, lumber, glass, and nails, which are used by employees of the taxpayer to construct progress expenditure property, will be considered made directly by the taxpayer. Construction expenditures made by the taxpayer to a contractor or manufacturer, in general, will not be considered made directly by the taxpayer. Thus, the cost of component parts, such as boilers and turbines, which are purchased and merely installed or assembled by the taxpayer, will not be considered expenditures made directly by the taxpayer for construction. (See paragraph (h)(3) of this section to determine when such cost

is properly chargeable to capital account.)

(2) *Time when determination made.* The determination of whether property is self-constructed is to be made at the close of the taxable year in which physical work on construction of the property begins, or, if later, the close of the first taxable year to which an election under this section applies. Once it is reasonably estimated that more than half of construction expenditures will be made directly by the taxpayer, the fact the taxpayer actually makes half, or less than half, of the expenditures directly will not affect classification of the property as self-constructed property. Similarly, once a determination has been made, classification of property as self-constructed property is not affected by a change in circumstances in a later taxable year. However, a significant error unrelated to a change in circumstances may be evidence that the estimate was unreasonable when made.

(3) *Determination based on certain expenditures.* For purposes of determining whether more than half of the expenditures for construction of an item of property will be made directly by the taxpayer, the taxpayer may take into account only expenditures properly includable by the taxpayer in the basis of the property under the provisions of § 1.46-3(c). Thus, property is self-constructed property only if more than half of the estimated basis of the property to be used for purposes of determining the credit allowed by section 38 is attributable to expenditures made directly by the taxpayer.

(l) *Definition of non-self-constructed property.* Non-self-constructed property is property that is not self-constructed property. Thus, property is non-self-constructed property if it is reasonable to believe that only half, or less than half, of the expenditures for construction will be made directly by the taxpayer.

(m) *Alternative limitations for public utility, railroad, or airline property.* The alternative limitations on qualified investment under section 46(a) (7) and (8) for public utility, railroad, or airline property (whichever applies) apply in determining the credit for qualified progress expenditures. The determination of whether progress expenditure property will be public utility, railroad, or airline property (whichever applies) when placed in service must be made at the close of the taxable year in which physical work on construction begins or, if later, at the close of the first taxable year for which an election under section 46(d) is in effect. If, at that time, the taxpayer is in

a trade or business as a public utility, railroad, or airline (as described in section 46(c)(3)(B) and 46(a)(8) (D) and (E), respectively), it is evidence the property will be public utility, railroad, or airline property when placed in service.

(n) *Leased property.* A lessor of progress expenditure property may not elect under section 48(d) to treat a lessee (or a person who will be a lessee) as having made qualified progress expenditures.

(o) *Election—(1) In general.* The election under section 46(d)(6) to increase qualified investment by qualified progress expenditures may be made for any taxable year ending after December 31, 1974. Except as provided in paragraph (o)(2) of this section, the election is effective for the first taxable year for which it is made and for all taxable years thereafter unless it is revoked with the consent of the Commissioner. Except as provided in paragraphs (o) (2) and (3) of this section, the election applies to all qualified progress expenditures made by the taxpayer during the taxable year for construction of any progress expenditure property. Thus, the taxpayer may not make the election for one item of progress expenditure property and not for other items. If progress expenditure property is being constructed by or for a partnership, S corporation (as defined in section 1361(a)), trust, or estate, an election under section 46(d)(6) must be made separately by each partner or shareholder, or each beneficiary if the beneficiary, in determining his tax liability, would be allowed investment credit under section 38 for property subject to the election. The election may not be made by a partnership or S corporation, and may be made by a trust or estate only if the trust or estate, in determining its tax liability, would be allowed investment credit under section 38 for property subject to the election. The election of any partner, shareholder, beneficiary, trust, or estate will be effective for that person, even if a related partner, shareholder, beneficiary, trust, or estate does not make the election. An election made by a partner, shareholder, beneficiary, trust, or estate applies to all progress expenditure property of that person. For example, an election made by corporation X, which is a partner in the XYZ partnership, applies to progress expenditure property the corporation holds in its own capacity and also to its interest in progress expenditure property of the partnership.

(2) *Time and manner of making election.* An election under section 46(d)(6) must be made on Form 3468 and filed with the original income tax return for the first taxable year ending after December 31, 1974 to which the election will apply. An election made before March 2, 1988, by filing a written statement (whether or not attached to the income tax return) will be considered valid. The election may not be made on an amended return filed after the time prescribed for filing the original return (including extensions) for that taxable year. However, an election under this section may be made or revoked by filing a statement with an amended return filed on or before May 31, 1988, if the due date for filing a return for the first taxable year to which the election applies is before May 31, 1988.

(3) *Carryover of election in certain transactions.* In general, and election under section 46(d)(6) does not carry over to the transferee of progress expenditure property (or an interest therein). However, if under section 47(b) the property does not cease to be progress expenditure property because of the transfer, the election will carry over to the transferee. If so, the election will apply only to the property transferred. For rules relating to the determination of qualified progress expenditures of the transferee, see paragraph (r) of this section.

(p) *Partnerships, S corporations, trusts, or estates—(1) In general.* Each partner, shareholder, trust estate, or beneficiary of a trust or estate that makes an election under section 46(d) shall take into account its share of qualified progress expenditures (determined under paragraph (p)(2) of this section) made by the partnership, S corporation, trust, or estate. In determining qualified investment for the year in which the property is placed in service, the basis of the property is apportioned as provided in §§ 1.46-3(f), 1.48-6, or 1.48-5 (whichever applies). Each partner, shareholder, trust, estate, or beneficiary that made the election must reduce qualified investment under section 46(c)(4) for the year the property is placed in service by qualified progress expenditures taken into account by that person.

(2) *Determination of share of qualified progress expenditures.* The share of qualified progress expenditures of each partner, shareholder, trust, estate, or beneficiary that makes an election under section 46(d) must be determined in accordance with the same ratio used under §§ 1.46-3(f)(2), 1.48-5(a)(1), or 1.48-6(a)(1) (whichever applies) to determine its share of basis (or cost).

The last sentence of § 1.46-3(f)(2)(i) must be applied by referring to the date on which qualified progress expenditures are paid or chargeable to capital amount (whichever is applicable).

(3) *Examples.* The following examples illustrate this paragraph (p).

Example (1). (i) Corporation X contracts to build a ship for partnership AB that qualifies as progress expenditure property. The contract price is \$100,000. Physical work on construction of the ship begins on January 1, 1980. The ship is placed in service on December 31, 1983.

(ii) The AB partnership reports income on the calendar year basis. Partners A and B share profits equally. For A's taxable year ending December 31, 1980, A makes an election under section 46(d) B does not make the election.

(iii) For each of the years 1980, 1981, 1982, and 1983, the AB partnership makes \$25,000 payments to corporation X. The payments made in 1980, 1981, and 1982 are qualified progress expenditures. The 1983 payment is not a qualified progress expenditure, because the ship is placed in service in that year.

(iv) For each of the years 1980, 1981, and 1982, A may take into account qualified progress expenditures of \$12,500 because A had a 50 percent partnership interest in each of those years.

(v) For 1983, qualified investment for the ship is \$100,000. A and B's share are \$50,000 each, because each had a 50 percent partnership interest in 1983. However, A must reduce its \$50,000 share for 1983 by \$37,500, the amount of qualified progress expenditures taken into account by A. B's share is not reduced, because B did not take into account qualified progress expenditures.

Example (2). (i) The facts are the same as in example (1) except that on June 30, 1983, the partnership agreement is amended to admit a new partner, C. The partners agree to share profits equally. There is no special allocation in effect under section 704 with respect to the ship.

(ii) For each of the years 1980, 1981, and 1982, A may take into account qualified progress expenditures of \$12,500 because A has a 50 percent partnership interest in those years.

(iii) For 1983, A, B, and C's share of qualified investment is \$33,333 each, because each had a 33 1/3 percent partnership interest in that year. A must reduce its share to zero, because it took \$37,500 into account as qualified progress expenditures. In addition, the excess of the \$37,500 over the \$33,333 applied as a reduction is subject to recapture under section 47(a)(3)(B). B and C's shares are not reduced, because neither taxpayer took into account qualified progress expenditures.

(g) *Limitation on qualified progress expenditures for taxable years beginning before 1980—(1) In general.* (i) Under section 46(d)(7), qualified progress expenditures for any taxable year beginning before January 1, 1980, are limited. The taxpayer must apply the limitation under section 46(d)(7) on an item by item basis. In general, the taxpayer

may take into account the applicable percentage (as determined under the table in section 46(d)(7)(A)) of qualified progress expenditures for each of those years. In addition, the taxpayer may take into account for each of those years 20 percent of qualified investment for each of the preceding taxable years determined without applying the limitations of section 46(d)(7).

(ii) The applicable percentage under section 46(d)(7)(A) may be applied only for one taxable year that ends within a calendar year in determining qualified investment for an item of progress expenditure property. For example, calendar year partners of a calendar year partnership may increase qualified investment for 1976 by 20 percent of qualified progress expenditures made in 1975 for an item of property. If the partnership incorporates in 1976 and the taxable year of the corporation begins on July 1, 1976, and ends on June 30, 1977, qualified investment of the corporation for its taxable year beginning on July 1, 1976, cannot be increased by 20 percent of the 1975 expenditure.

(2) *Example.* The following example illustrates this paragraph (q).

Example. (i) Corporation X contracts with A on January 1, 1976, to build an electric generator that qualifies as non-self-constructed progress expenditure property. A will build the generator at a cost of \$125,000. Corporation X agrees to pay A \$150,000. Corporation X reports income on the calendar year basis. Corporation X makes an election under section 46(d) for 1976. Physical work on construction begins on January 1, 1976. Corporation X makes payments of \$30,000 to A for construction of the generator in each of the years 1976, 1977, 1978, 1979, and 1980. A incurs a cost of \$25,000 in each of those years for construction of the property. The property is placed in service in 1980.

(ii) For 1976, X may increase qualified investment by \$12,000, 40 percent of the payment made in 1976.

(iii) For 1977, corporation X may increase qualified investment by \$24,000. Eighteen thousand dollars of that amount is 60 percent of the 1977 payment. The remaining \$6,000 is 20 percent of the \$30,000 payment made in 1976.

(iv) For 1978, corporation X may increase qualified investment by \$36,000. Twenty-four thousand dollars of that amount is 80 percent of the 1978 payment. The remaining \$12,000 is 20 percent of the \$30,000 payment made in 1976, plus 20 percent of the \$30,000 payment made in 1977.

(v) For 1979, corporation X may increase qualified investment by \$48,000. Thirty thousand dollars of that amount is 100 percent of the 1979 payment. The remaining \$18,000 of that amount is 20 percent of the \$30,000 payments made in each of the years 1976, 1977, and 1978.

(vi) Qualified investment for corporation X for 1980 is \$30,000. The \$30,000 is the basis (or cost) of the generator (\$150,000), reduced by qualified progress expenditures allowed with respect to that property (\$120,000).

(r) *Special rules for transferred property—(1) In general.* A transferee of progress expenditure property (or an

interest therein) may take into account qualified progress expenditures for the property only if—

(i) The property is progress expenditure property in the hands of the transferee, and

(ii) The transferee makes an election under section 46(d) or the election made by the transferor (or its predecessor) carries over to the transferee under paragraph (o)(3) of this section.

(2) *Status as progress expenditure property.* (i) If the transfer requires recapture under section 47(a)(3) and § 1.47-1(g) (or would require recapture if the transferor had made an election under section 46(d)), then—

(A) For purposes of determining if the property is progress expenditure property in the hands of the transferee, the normal construction period for the property begins on the date of the transfer, or, if later, on the first day of the first taxable year for which the transferee makes an election under section 46(d), and

(B) For purposes of determining whether the property is self-constructed or non-self-constructed in the hands of the transferee, the amount paid or incurred for the transfer of the property will not be considered a construction expenditure made directly by the transferee.

(ii) If the transfer does not require recapture under section 47(a)(3) and § 1.47-1(g), and the election carries over to the taxpayer under paragraph (o)(3) of this section, the property does not lose its status as progress expenditure property because of the transfer.

(3) *Amount of qualified progress expenditures for transferee.* (i) If the transfer does not require recapture under section 47(a)(3) and § 1.47-1(g), and the election carries over to the taxpayer under paragraph (o)(3) of this section, the transferee must determine its qualified progress expenditures—

(A) By using the same normal construction period used by the transferor,

(B) By treating the property as having the same status as self-constructed or non-self-constructed as the property had in the hands of the transferor, and

(C) In the case of non-self-constructed property, by taking into account any excess described in section 46(d)(4)(C)(i) (relating to the excess of payments over the percentage-of-completion limitation) or section 46(d)(4)(C)(ii) (relating to the excess of the percentage-of-completion limitation over the amount of payments) that the transferor would have taken into account with respect to that property.

(ii) If the transfer requires recapture under section 47(a)(3) and § 1.47-1(g) (or

would require recapture if the transferor had made an election under section 46(d)), the amount paid or incurred for the transfer will be considered a payment for construction of that property to the extent that—

(A) It is properly includible in the basis of the property under § 1.46-3(c).

(B) The taxpayer can show the amount is attributable to construction costs paid or chargeable to capital account by the transferor or other person after physical work on construction of the property began, and

(C) It does not exceed the amount by which the transferor has increased qualified investment for qualified progress expenditures incurred with respect to the property (or would have increased qualified investment but for the "lesser of" limitation of section 46(d)(3)(B) or the absence of an election under section 46(d)), plus any amount that would have been treated as a qualified progress expenditure by the transferor had the property not been transferred.

Once the status of the property as self-constructed or non-self-constructed property in the hands of the transferee has been determined, all rules under this section for determining the amount of qualified progress expenditures for that type of property apply. For example, if the property is non-self-constructed in the hands of the transferee, amounts merely incurred (but not paid) for the transfer are not taken into account as qualified progress expenditures. Actual payment is necessary (see paragraph (j)(3) of this section). In applying section 46(d)(3)(B)(ii), the amount paid or incurred for the transfer (to the extent that it qualifies as a payment for construction under the first sentence of this paragraph (r)(3)(ii)) is considered to be part of the overall cost to the transferee of construction by another person, and the portion of construction which is completed during the taxable year is determined by taking into account construction that was completed before the constructed property was acquired by the transferee. If the transferee makes an election under section 46(d) and this section for the taxable year in which the transfer occurs, then for purposes of applying the presumption in section 46(d)(4)(D) that construction is deemed to occur not more rapidly than ratably over the normal construction period, the transferee's normal construction period is considered to have begun on the date on which physical work on construction of the acquired property began.

(4) *Examples.* The following examples illustrate this paragraph (r).

Example (1). Corporation X begins physical work on construction of progress expenditure property for corporation Y on January 1, 1976. Y accurately estimates a 3-year normal construction period and elects under section 46(d) on its return for its taxable year ending December 31, 1976. On January 1, 1978, Y sells the contract rights for construction of the property to corporation Z, which uses a fiscal year ending June 30. Qualified progress expenditures allowed to Y in 1976 and 1977 are subject to recapture under section 47(a)(3). Because Z's normal construction period for the property is less than 2 years (January 1, 1978 to January 1, 1979), the property is not progress expenditure property in Z's hands. Z may not elect progress expenditure treatment for the property.

Example (2). (i) Assume the same facts as in the example in paragraph (j)(7) of this section, except on, December 31, 1982, Y sells its contract rights to the property for \$340,000 to corporation Z, which also uses the calendar year. Z pays Y the full \$340,000 on that date. The property is still to be placed in service on December 31, 1984, and will not be available for placing in service at an earlier date. Z makes payments to X of \$135,000 on December 31, 1983, and \$110,000 on December 31, 1984.

(ii) The investment credit allowed Y in 1980 and 1981 for qualified progress expenditures is subject to recapture under section 47(a)(3) and Y may not treat its \$85,000 payment in 1982 as a qualified progress expenditure.

(iii) For purposes of determining if the airplane is qualified progress expenditure property with respect to Z, the normal construction period for the property for Z begins on December 31, 1982, the date of transfer. Since the remaining construction period is two years, the property is progress expenditure property if it otherwise qualifies in Z's hands.

(iv) Only \$305,000 of the \$340,000 payment to Y can qualify as a qualified progress expenditure, because only that amount is attributable to construction costs paid by Y and does not exceed the sum of the amount by which Y increased qualified investment in 1980 and 1981 for qualified progress expenditures (\$220,000) and the amount that Y would have treated as a qualified progress expenditure in 1982 (\$85,000).

(v) Assume that Z cannot establish that progress in construction has been completed more rapidly than ratably. If Z makes an election under section 46(d) for 1982, then for purposes of applying the percentage of completion limitation, Z's normal construction period is considered to begin on January 1, 1980. Progress is presumed to occur ratably over the 5-year construction period, which is 20 percent in each year.

(vi) For 1982, Z may treat the full \$305,000 as a qualified progress expenditure because it is less than the percentage of completion limitation, \$330,000 (\$110,000 a year for 1980, 1981, and 1982).

(vii) For 1983, Z may treat the entire \$135,000 payment as a qualified progress expenditure, since it does not exceed the percentage of completion limitation for that year, \$135,000 (\$110,000 plus the \$25,000 excess from 1982).

(viii) For Z's taxable year ending December 31, 1984, no qualified progress expenditures

may be taken into account because the property is placed in service during that year.

Par. 5. Section 1.47-1 is amended by adding a new sentence at the end of paragraph (a)(1)(i) and by adding a new paragraph (g) to read as follows:

§ 1.47-1 Recomputation of credit allowed by section 38.

(a) *General rule*—(1) *In general.* (i) * * * For special rules relating to recomputation of credit allowed by section 38 if progress expenditure property (as defined in § 1.46-5(d)) ceases to be progress expenditure property with respect to the taxpayer, see paragraph (g) of this section.

(g) *Special rules for progress expenditure property.* Under section 47(a)(3), a recapture determination is required if property ceases to be progress expenditure property (as defined in § 1.46-5(d)). Property ceases to be progress expenditure property if it is sold or otherwise disposed of before it is placed in service. For example, cancellation of the contract for progress expenditure property or abandonment of the project by the taxpayer will be considered a "disposition" within the meaning of § 1.47-2. A cessation occurs if progress expenditure property ceases to be property that will be section 38 property with a useful life of 7 years or more when placed in service. In general, a sale and leaseback is treated as a cessation. However, see paragraph (g)(2) of § 1.47-3 for special rules for certain sale and leaseback transactions. Recapture determinations for progress expenditure property are to be made in a way similar to that provided under §§ 1.47-1 through 1.47-6. Reduction of qualified investment must begin with the most recent credit year (*i.e.*, the most recent taxable year the property is taken into account in computing qualified investment under § 1.46-3 or 1.46-5).

Par. 6. Section 1.47-3 is amended by designating the existing text of paragraph (g) as (g)(1), adding a heading for (g)(1), and by adding a new paragraph (g)(2). These new and revised provisions read as set forth below.

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

(g) *Sale-and-leaseback transactions*—(1) *In general.* * * *

(2) *Special rule for progress expenditure property.* The sale and leaseback (or agreement or contract to leaseback) of progress expenditure property (including any contract rights to the property), in general, will be treated as a cessation described in section 47(a)(3)(A) with respect to the

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

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 7. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 8. Section 602.101 (c) is amended by inserting in the appropriate places in the table:

"§ 1.46-5 (e) (2).....	1545-0155",
"§ 1.46-5 (h) (4).....	1545-0155",
"§ 1.46-5 (j) (6) (iv).....	1545-0155",
"§ 1.46-5 (o) (2).....	1545-0155".

Lawrence B. Gibbs,

Commissioner of Internal Revenue.

Approved: February 9, 1988.

O. Donaldson Chapoton,

Assistant Secretary of the Treasury

[FR Doc. 88-4451 Filed 3-1-88; 8:45 am]

BILLING CODE 4830-01-M

26 CFR Part 41

[T.D. 8177]

Excise Tax on Use of Certain Highway Motor Vehicles; Reduction of Heavy Vehicle Use Tax for Foreign-Based Vehicles

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the imposition of the heavy vehicle use tax on foreign-based highway motor vehicles. Changes to the applicable law were made by the Surface Transportation and Uniform Relocation Assistance Act of 1987. The regulations affect owners of highway motor vehicles that have a base for registration purposes in a contiguous foreign country and provide them with the guidance needed to comply with the law.

DATES: The regulations are effective for taxable periods beginning after June 30, 1987.

FOR FURTHER INFORMATION CONTACT: William A. Jackson of the Legislation and Regulations Division, Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224, Attention: CC:LR:T (LR-33-87) (202) 566-3287, not a toll-free call.

SUPPLEMENTARY INFORMATION:

Background

On September 4, 1987, the *Federal Register* published a notice of proposed rulemaking proposing amendments to the Excise Tax Regulations (26 CFR Part 41) under sections 4481, 4483, 6001, and 6091 of the Internal Revenue Code of 1986 (Code) (52 FR 33602) by cross-reference to temporary regulations published the same day in the *Federal Register* (52 FR 33583). These amendments were proposed to conform the regulations to section 507 of the Highway Revenue Act of 1987 (Title V of the Surface Transportation and Uniform Relocation Assistance Act of 1987) (Pub. L. 100-17, 101 Stat. 260) which imposed the heavy vehicle use tax under section 4481 of the Code on foreign-based highway motor vehicles. The Internal Revenue Service did not receive any comments on the proposed regulations. No public hearing was requested or held. For this reason, the final regulations adopt the temporary regulations without any substantive changes.

Special Analysis

It has been determined that this regulation will not have a significant impact on a substantial number of small entities. The number of small entities affected is minimal. Accordingly, these final regulations are not subject to the Regulatory Flexibility Act of 1980 (5 U.S.C. Chapter 6). The Commissioner of Internal Revenue has determined that this regulation is not a major rule as defined in Executive Order 12291 and that a regulatory impact analysis therefore is not required.

Paperwork Reduction Act

The collection of information requirements contained in these regulations have been submitted to the Office of Management and Budget (OMB) for review under the Paperwork Reduction Act of 1980. These regulations have been approved by OMB.

Drafting Information

The principal author of these regulations is William A. Jackson of the Legislation and Regulations Division of the Office of Chief Counsel, Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations both on matters of substance and style.

List of Subjects in 26 CFR Part 41

Excise taxes, Motor vehicles.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 41 is amended as follows:

Paragraph 1. The authority for Part 41 is amended by removing the citation for § 41.6001-3T, and adding the following citation:

Authority: 26 U.S.C. 7805. * * * Section 41.6001-3 also issued under 101 Stat. 260.

Par. 2. Temporary regulations § 41.4483-7T and § 41.6001-3T, as published on September 4, 1987, in 52 FR 33583, are adopted as final regulations; the new sections are redesignated as § 41.4483-7 and § 41.6001-3, respectively.

Par. 3. In paragraph(a)(2)(ii) of § 41.4481-1, the language "\$ 4.4483-7T" is removed and the language "\$ 41.4483-7" is added in its place.

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved: February 9, 1988.

Donaldson Chapoton,
Assistant Secretary of the Treasury.
[[FR Doc. 88-4448 Filed 3-1-88; 8:45 am]
BILLING CODE 4830-01-M

26 CFR Part 51

[T.D. 8185]

Excise Tax Regulations Under the Crude Oil Windfall Profit Tax Act of 1980; Newly Discovered Oil

AGENCY: Internal Revenue Service, Treasury.

ACTION: Final regulations.

SUMMARY: This document provides final excise tax regulations relating to the

definition of the term "newly discovered oil" for purposes of the windfall profit tax. Changes to the applicable tax law were made by the Crude Oil Windfall Profit Tax Act of 1980, by the Economic Recovery Tax Act of 1981, and by the Tax Reform Act of 1986. The final requirements provide guidance on the requirements for the qualification of crude oil as newly discovered oil, as well as a definition of production in "commercial quantities" that affects the definition of property, the net income limitation on windfall profit, and the exemption for Alaskan oil.

DATE: The final regulations are effective with respect to all crude oil removed (or deemed removed) from the premises after February 29, 1980.

FOR FURTHER INFORMATION CONTACT: David R. Haglund of the Legislation and Regulations Division, Office of Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC 20224 (Attention: CC:LR:T) (202-566-3297).

SUPPLEMENTARY INFORMATION:

Background

On November 5, 1982, the *Federal Register* published proposed amendments to the Excise Tax Regulations Under the Crude Oil Windfall Profit Tax Act of 1980 (26 CFR Part 51) under sections 4988, 4991, and 4996 of the Internal Revenue Code of 1954 (47 FR 50306). The amendments were proposed to conform the regulations to section 101(a)(1) of the Crude Oil Windfall Profit Tax Act of 1980 (94 Stat. 230). A public hearing was held in April 12, 1983. After consideration of all comments regarding the proposed amendments, those amendments are adopted as revised by this Treasury decision.

Explanation of Provisions

Commercial Quantities—In General

The Conference Committee Report accompanying the Crude Oil Windfall Profit Tax Act of 1980 (Rep. No. 817, 96th Cong., 2d Sess. 97-8 (1980)) stated that it was the intention of the Committee that the term "newly discovered oil" should include production from a property that did not produce crude oil in commercial quantities in calendar year 1978. The report stated that this included production from a property on which oil was produced in 1978 if that 1978 production was incident to the drilling of exploratory or test wells and was not part of continuous or commercial production.

The proposed regulations defined crude oil produced in "commercial