

Internal Revenue Code and Regulations  
Selected Sections  
2023



## **Introduction**

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This book contains the following materials. It is designed for tax courses taught in 2023.

### **Edited Table of Contents**

The edited table of contents is not the table of contents of this volume. Rather, it is an edited table of contents of the entire Internal Revenue Code (USC title 26), to provide a sense of the structure of the Code.

### **Inflation-Adjusting Revenue Procedure**

This revenue procedure, Rev. Proc. 2022-38, provides inflation adjustments for 2023.

### **Depreciation Revenue Procedure (Excerpts)**

This revenue procedure, Rev. Proc. 87-57, provides tables to assist with determining depreciation.

### **Selected Sections of the Internal Revenue Code**

The selected sections of the Internal Revenue Code are drawn from a government website that permits downloading of the United States Code:

<https://uscode.house.gov/download/download.shtml>

This Code is up to date as of June 30, 2023.

### **Selected Sections of Regulations**

The selected sections of the regulations, 26 CFR, are drawn from a government website that permits downloading of the Code of Federal Regulations:

<https://www.ecfr.gov/current/title-26/chapter-I/subchapter-A/part-1>

These regulations are up to date as of February 23, 2023.

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### SECTION 1. PURPOSE

This revenue procedure sets forth inflation-adjusted items for 2023 for various Code provisions as in effect on October 18, 2022. The inflation adjusted items for the Code sections set forth in section 3 of this revenue procedure are generally determined by reference to § 1(f) of the Code. To the extent amendments to the Code are enacted for 2023 after October 18, 2022, taxpayers should consult additional guidance to determine whether these adjustments remain applicable for 2023.

### SECTION 2. CHANGES

.01 For taxable years beginning after December 31, 2022, § 13303(a)(1) of Public Law 117-169, 136 Stat. 1818 (August 16, 2022), commonly known as the Inflation Reduction Act of 2022 (IRA), modifies the maximum amount of the energy efficient commercial buildings deduction under § 179D.

(1) For taxable years beginning in 2023, the applicable dollar value used to determine the maximum allowance of the deduction under § 179D(b) is \$0.50 increased (but not above \$1.00) by \$0.02 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent.

(2) For taxable years beginning in 2023, the applicable dollar value used to determine the increased deduction amount for certain property under § 179D(b)(3)(A) is \$2.50 increased (but not above \$5.00) by \$0.10 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent.

.02 The amounts set forth in section 2.01 of this revenue procedure are adjusted for inflation for taxable years beginning in 2023.

### SECTION 3. 2023 ADJUSTED ITEMS

.01 Tax Rate Tables. For taxable years beginning in 2023, the tax rate tables under § 1 are as follows:

TABLE 1 - Section 1(j)(2)(A) - Married Individuals Filing Joint Returns and Surviving Spouses

<b>If Taxable Income Is:</b>	<b>The Tax Is:</b>
Not over \$22,000	10% of the taxable income
Over \$22,000 but not over \$89,450	\$2,200 plus 12% of the excess over \$22,000
Over \$89,450 but not over \$190,750	\$10,294 plus 22% of the excess over \$89,450
Over \$190,750 but not over \$364,200	\$32,580 plus 24% of the excess over \$190,750
Over \$364,200 but not over \$462,500	\$74,208 plus 32% of the excess over \$364,200
Over \$462,500 but not over \$693,750	\$105,664 plus 35% of the excess over \$462,500
Over \$693,750	\$186,601.50 plus 37% of the excess over \$693,750

TABLE 2 - Section 1(j)(2)(B) – Heads of Households

<b>If Taxable Income Is:</b>	<b>The Tax Is:</b>
Not over \$15,700	10% of the taxable income
Over \$15,700 but not over \$59,850	\$1,570 plus 12% of the excess over \$15,700
Over \$59,850 but not over \$95,350	\$6,868 plus 22% of the excess over \$59,850
Over \$95,350 but not over \$182,100	\$14,678 plus 24% of the excess over \$95,350
Over \$182,100 but not over \$231,250	\$35,498 plus 32% of the excess over \$182,100
Over \$231,250 but not over \$578,100	\$51,226 plus 35% of the excess over \$231,250
Over \$578,100	\$172,623.50 plus 37% of the excess over \$578,100

TABLE 3 - Section 1(j)(2)(C) – Unmarried Individuals (other than Surviving Spouses and Heads of Households)

<b>If Taxable Income Is:</b>	<b>The Tax Is:</b>
Not over \$11,000	10% of the taxable income
Over \$11,000 but not over \$44,725	\$1,100 plus 12% of the excess over \$11,000
Over \$44,725 but not over \$95,375	\$5,147 plus 22% of the excess over \$44,725
Over \$95,375 but not over \$182,100	\$16,290 plus 24% of the excess over \$95,375
Over \$182,100 but not over \$231,250	\$37,104 plus 32% of the excess over \$182,100
Over \$231,250 but	\$52,832 plus 35% of

<b>If Taxable Income Is:</b>	<b>The Tax Is:</b>
not over \$578,125	the excess over \$231,250
Over \$578,125	\$174,238.25 plus 37% of the excess over \$578,125

TABLE 4 - Section 1(j)(2)(D) – Married Individuals Filing Separate Returns

<b>If Taxable Income Is:</b>	<b>The Tax Is:</b>
Not over \$11,000	10% of the taxable income
Over \$11,000 but not over \$44,725	\$1,100 plus 12% of the excess over \$11,000
Over \$44,725 but not over \$95,375	\$5,147 plus 22% of the excess over \$44,725
Over \$95,375 but not over \$182,100	\$16,290 plus 24% of the excess over \$95,375
Over \$182,100 but not over \$231,250	\$37,104 plus 32% of the excess over \$182,100
Over \$231,250 but not over \$346,875	\$52,832 plus 35% of the excess over \$231,250
Over \$346,875	\$93,300.75 plus 37% of the excess over \$346,875

TABLE 5 - Section 1(j)(2)(E) – Estates and Trusts

<b>If Taxable Income Is:</b>	<b>The Tax Is:</b>
Not over \$2,900	10% of the taxable income
Over \$2,900 but not over \$10,550	\$290 plus 24% of the excess over \$2,900
Over \$10,550 but not over \$14,450	\$2,126 plus 35% of the excess over \$10,550
Over \$14,450	\$3,491 plus 37% of the excess over \$14,450

.02 Unearned Income of Minor Children Subject to the “Kiddie Tax”. For taxable years beginning in 2023, the amount in § 1(g)(4)(A)(ii)(I), which is used to reduce the net unearned income reported on the child’s return that is subject to the “kiddie tax,” is \$1,250. This \$1,250 amount is the same as the amount provided in § 63(c)(5)(A), as adjusted for inflation. The same \$1,250 amount is used for purposes of § 1(g)(7) to determine whether a parent may elect to include a child’s gross income in the parent’s gross income and to calculate the “kiddie tax.” For example, one of the requirements for the parental election is that a child’s gross income is more than the amount referenced in § 1(g)(4)(A)(ii)(I) but less than 10 times that amount; thus, a child’s gross income for 2023 must be more than \$1,250 but less than \$12,500.

.03 Maximum Capital Gains Rate (§1(h), §1(j)(5)). For taxable years beginning in 2023, the maximum zero rate amounts and maximum 15 percent rate amounts under § 1(j)(5)(B) are as follows:

<b>Filing Status</b>	<b>Maximum Zero Rate Amount</b>	<b>Maximum 15% Rate Amount</b>
Married Individuals Filing Joint Returns and Surviving Spouse	\$89,250	\$553,850
Married Individuals Filing Separate Returns	\$44,625	\$276,900

<b>Filing Status</b>	<b>Maximum Zero Rate Amount</b>	<b>Maximum 15% Rate Amount</b>
Heads of Household	\$59,750	\$523,050
All Other Individuals	\$44,625	\$492,300
Estates and Trusts	\$3,000	\$14,650

.04 Adoption Credit. For taxable years beginning in 2023, under § 23(a)(3) the credit allowed for an adoption of a child with special needs is \$15,950. For taxable years beginning in 2023, under § 23(b)(1) the maximum credit allowed for other adoptions is the amount of qualified adoption expenses up to \$15,950. The available adoption credit begins to phase out under § 23(b)(2)(A) for taxpayers with modified adjusted gross income in excess of \$239,230 and is completely phased out for taxpayers with modified adjusted gross income of \$279,230 or more. See section 3.19 of this revenue procedure for the adjusted items relating to adoption assistance programs.

.05 Child Tax Credit. For taxable years beginning in 2023, the amount used in § 24(d)(1)(A) to determine the amount of credit under § 24 that may be refundable is \$1,600.

.06 Earned Income Credit.

(1) In general. For taxable years beginning in 2023, the following amounts are used to determine the earned income credit under § 32(b). The “earned income amount” is the amount of earned income at or above which the maximum amount of the earned income credit is allowed. The “threshold phaseout amount” is the amount of adjusted gross income (or, if greater, earned income) above which the maximum amount of the credit begins to phase out. The “completed phaseout amount” is the amount of adjusted gross income (or, if greater, earned income) at or above which no credit is allowed. The threshold phaseout amounts and the completed phaseout amounts shown in the table below for married taxpayers filing a joint return include the increase provided in § 32(b)(2)(B), as adjusted for inflation for taxable years beginning in 2023. The threshold phaseout amounts and the completed phaseout amounts shown in the table below for single, surviving spouse, or head of household taxpayers also apply to married taxpayers who are not filing a joint return and satisfy the special rules for separated spouses in § 32(d).

**Number of Qualifying Children**

<b>Item</b>	<b>One</b>	<b>Two</b>	<b>Three or More</b>	<b>None</b>
Earned Income Amount	\$11,750	\$16,510	\$16,510	\$7,840
Maximum Amount of Credit	\$3,995	\$6,604	\$7,430	\$600
Threshold Phaseout Amount (Single, Surviving Spouse, or Head of Household)	\$21,560	\$21,560	\$21,560	\$9,800
Completed Phaseout Amount (Single, Surviving Spouse, or Head of Household)	\$46,560	\$52,918	\$56,838	\$17,640
Threshold Phaseout Amount (Married Filing Jointly)	\$28,120	\$28,120	\$28,120	\$16,370



Item	One	Two	Three or More	None
Completed Phaseout Amount (Married Filing Jointly)	\$53,120	\$59,478	\$63,398	\$24,210

The instructions for the Form 1040 series provide tables showing the amount of the earned income credit for each type of taxpayer.

(2) Excessive Investment Income. For taxable years beginning in 2023, the earned income tax credit is not allowed under § 32(i) if the aggregate amount of certain investment income exceeds \$11,000.

.07 Refundable Credit for Coverage Under a Qualified Health Plan. For taxable years beginning in 2023, the limitation on tax imposed under § 36B(f)(2)(B) for excess advance credit payments is determined using the following table:

If the household income (expressed as a percent of poverty line) is:	The limitation amount for unmarried individuals (other than surviving spouses and heads of household) is:	The limitation amount for all other taxpayers is:
Less than 200%	\$350	\$700
At least 200% but less than 300%	\$900	\$1,800
At least 300% but less than 400%	\$1,500	\$3,000

.08 Rehabilitation Expenditures Treated as Separate New Building. For calendar year 2023, the per low-income unit qualified basis amount under § 42(e)(3)(A)(ii)(II) is \$7,900.

.09 Low-Income Housing Credit. For calendar year 2023, the amount used under § 42(h)(3)(C)(ii) to calculate the State housing credit ceiling for the low-income housing credit is the greater of (1) \$2.75 multiplied by the State population, or (2) \$3,185,000.

.10 Employee Health Insurance Expense of Small Employers. For taxable years beginning in 2023, the dollar amount in effect under § 45R(d)(3)(B) is \$30,700. This amount is used under § 45R(c) for limiting the small employer health insurance credit and under § 45R(d)(1)(B) for determining who is an eligible small employer for purposes of the credit.

.11 Exemption Amounts for Alternative Minimum Tax. For taxable years beginning in 2023, the exemption amounts under § 55(d)(1) are:

Joint Returns or Surviving Spouses	\$126,500
Unmarried Individuals (other than Surviving Spouses)	\$81,300
Married Individuals Filing Separate Returns	\$63,250
Estates and Trusts	\$28,400

For taxable years beginning in 2023, under § 55(b)(1), the excess taxable income above which the 28 percent tax rate applies is:

Married Individuals Filing Separate Returns	\$110,350
All Other Taxpayers	\$220,700

For taxable years beginning in 2023, the amounts used under § 55(d)(2) to determine the phaseout of the exemption amounts are:

	<b>Threshold Phaseout amount</b>	<b>Complete Phaseout amount</b>
Joint Returns or Surviving Spouses	\$1,156,300	\$1,662,300
Unmarried Individuals (other than Surviving Spouses)	\$578,150	\$903,350
Married Individuals Filing Separate Returns	\$578,150	\$831,150
Estates and Trusts	\$94,600	\$208,200

.12 Alternative Minimum Tax Exemption for a Child Subject to the “Kiddie Tax.” For taxable years beginning in 2023, for a child to whom the § 1(g) “kiddie tax” applies, the exemption amount under §§ 55(d) and 59(j) for purposes of the alternative minimum tax under § 55 may not exceed the sum of (1) the child’s earned income for the taxable year, plus (2) \$8,800.

.13 Certain Expenses of Elementary and Secondary School Teachers. For taxable years beginning in 2023, under § 62(a)(2)(D) the amount of the deduction allowed under § 162 that consists of expenses paid or incurred by an eligible educator in connection with books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom is \$300.

.14 Transportation Mainline Pipeline Construction Industry Optional Expense Substantiation Rules for Payments to Employees Under Accountable Plans. For calendar year 2023, an eligible employer may pay certain welders and heavy equipment mechanics an amount up to \$20 per hour for rig-related expenses that are deemed substantiated under an accountable plan if paid in accordance with Rev. Proc. 2002-41, 2002-1 C.B. 1098. If the employer provides fuel or otherwise reimburses fuel expenses, an amount up to \$13 per hour is deemed substantiated if paid under Rev. Proc. 2002- 41.

.15 Standard Deduction.

(1) In general. For taxable years beginning in 2023, the standard deduction amounts under § 63(c)(2) are as follows:

<b>Filing Status</b>	<b>Standard Deduction</b>
Married Individuals Filing Joint Returns and Surviving Spouses (§ 1(j)(2)(A))	\$27,700
Heads of Households (§ 1(j)(2)(B))	\$20,800
Unmarried Individuals (other than Surviving Spouses and Heads of Households) (§ 1(j)(2)(C))	\$13,850
Married Individuals Filing Separate Returns (§ 1(j)(2)(D))	\$13,850

(2) Dependent. For taxable years beginning in 2023, the standard deduction amount under § 63(c)(5) for an individual who may be claimed as a dependent by another taxpayer cannot exceed the greater of (1) \$1,250, or (2) the sum of \$400 and the individual's earned income.

(3) Aged or blind. For taxable years beginning in 2023, the additional standard deduction amount under § 63(f) for the aged or the blind is \$1,500. The additional standard deduction amount is increased to \$1,850 if the individual is also unmarried and not a surviving spouse.

.16 Cafeteria Plans. For taxable years beginning in 2023, the dollar limitation under § 125(i) on voluntary employee salary reductions for contributions to health flexible spending arrangements is \$3,050. If the cafeteria plan permits the carryover of unused amounts, the maximum carryover amount is \$610.

.17 Qualified Transportation Fringe Benefit. For taxable years beginning in 2023, the monthly limitation under § 132(f)(2)(A) regarding the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass is \$300. The monthly limitation under § 132(f)(2)(B) regarding the fringe benefit exclusion amount for qualified parking is \$300.

.18 Income from United States Savings Bonds for Taxpayers Who Pay Qualified

Higher Education Expenses. For taxable years beginning in 2023, the exclusion under § 135, regarding income from United States savings bonds for taxpayers who pay qualified higher education expenses, begins to phase out for modified adjusted gross income above \$137,800 for joint returns and \$91,850 for all other returns. The exclusion is completely phased out for modified adjusted gross income of \$167,800 or more for joint returns and \$106,850 or more for all other returns.

.19 Adoption Assistance Programs. For taxable years beginning in 2023, under § 137(a)(2), the amount that can be excluded from an employee's gross income for the adoption of a child with special needs is \$15,950. For taxable years beginning in 2023, under § 137(b)(1) the maximum amount that can be excluded from an employee's gross income for the amounts paid or expenses incurred by an employer for qualified adoption expenses furnished pursuant to an adoption assistance program for adoptions by the employee is \$15,950. The amount excludable from an employee's gross income begins to phase out under § 137(b)(2)(A) for taxpayers with modified adjusted gross income in excess of \$239,230 and is completely phased out for taxpayers with modified adjusted gross income of \$279,230 or more. (See section 3.04 of this revenue procedure for the adjusted items relating to the adoption credit.)

.20 Private Activity Bonds Volume Cap. For calendar year 2023, the amounts used under § 146(d) to calculate the State ceiling for the volume cap for private activity bonds is the greater of (1) \$120 multiplied by the State population, or (2) \$358,845,000.

.21 Loan Limits on Agricultural Bonds. For calendar year 2023, the loan limit amount on agricultural bonds under § 147(c)(2)(A) for first-time farmers is \$616,100.

.22 General Arbitrage Rebate Rules. For bond years ending in 2023, the amount of the computation credit determined under § 1.148-3(d)(4) of the Income Tax Regulations is \$1,960.

.23 Safe Harbor Rules for Broker Commissions on Guaranteed Investment Contracts or Investments Purchased for a Yield Restricted Defeasance Escrow. For calendar year 2023, under § 1.148-5(e)(2)(iii)(B)(1), a broker's commission or similar fee for the acquisition of a guaranteed investment contract or investments purchased for a yield restricted defeasance escrow is reasonable if (1) the amount of the fee that the issuer treats as a qualified administrative cost does not exceed the lesser of (A) \$46,000, and (B) 0.2 percent of the computational base (as defined in § 1.148-5(e)(2)(iii)(B)(2)) or, if more, \$5,000; and (2) for any issue, the issuer does not treat more than \$130,000 in brokers' commissions or similar fees as qualified administrative costs for all guaranteed investment contracts and investments for yield restricted defeasance escrows purchased with gross proceeds of the issue.

.24 Gross Income Limitation for a Qualifying Relative. For taxable years beginning in 2023, the exemption amount referenced in § 152(d)(1)(B) is \$4,700.

.25 Election to Expense Certain Depreciable Assets. For taxable years beginning in 2023, under § 179(b)(1), the aggregate cost of any § 179 property that a taxpayer elects to treat as an expense cannot exceed \$1,160,000 and under § 179(b)(5)(A), the cost of any sport utility vehicle that may be taken into account under § 179 cannot exceed \$28,900. Under § 179(b)(2), the \$1,160,000 limitation under § 179(b)(1) is reduced (but not below zero) by the amount by which the cost of § 179 property placed in service during the 2023 taxable year exceeds \$2,890,000.

.26 Energy Efficient Commercial Building Deduction. For taxable years beginning in 2023, the applicable dollar value used to determine the maximum allowance of the deduction under § 179D(b)(2) is \$0.54 increased (but not above \$1.07) by \$0.02 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent. For taxable years beginning in 2023, the applicable dollar value used to determine the increased deduction amount for certain property under § 179D(b)(3) is \$2.68 increased (but not above \$5.36) by \$0.11 for each percentage point by which the total annual energy and power costs for the building are certified to be reduced by a percentage greater than 25 percent.

.27 Qualified Business Income. For taxable years beginning in 2023, the threshold amounts under § 199A(e)(2) and phase-in range amounts under § 199A(b)(3)(B) and § 199A(d)(3)(A) are:

<b>Filing Status</b>	<b>Threshold amount</b>	<b>Phase-in range amount</b>
Married Individuals Filing Joint Returns	\$364,200	\$464,200
Married Individuals Filing Separate Returns	\$182,100	\$232,100
All Other Returns	\$182,100	\$232,100

.28 Eligible Long-Term Care Premiums. For taxable years beginning in 2023, the limitations under § 213(d)(10), regarding eligible long-term care premiums includible in the term “medical care,” are as follows:

<b>Attained Age Before the Close of the Taxable Year</b>	<b>Limitation on Premiums</b>
40 or less	\$480
More than 40 but not more than 50	\$890
More than 50 but not more than 60	\$1,790
More than 60 but not more than 70	\$4,770
More than 70	\$5,960

.29 Medical Savings Accounts.

(1) Self-only coverage. For taxable years beginning in 2023, the term “high deductible health plan” as defined in § 220(c)(2)(A) means, for self-only coverage, a health plan that has an annual deductible that is not less than \$2,650 and not more than \$3,950, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed \$5,300.

(2) Family coverage. For taxable years beginning in 2023, the term “high deductible health plan” means, for family coverage, a health plan that has an annual deductible that is not less than \$5,300 and not more than \$7,900, and under which the annual out-of-pocket expenses required to be paid (other than for premiums) for covered benefits do not exceed \$9,650.

.30 Interest on Education Loans. For taxable years beginning in 2023, the \$2,500 maximum deduction for interest paid on qualified education loans under § 221 begins to phase out under § 221(b)(2)(B) for taxpayers with modified adjusted gross income in excess of \$75,000 (\$155,000 for joint returns), and is completely phased out for taxpayers with modified adjusted gross income of \$90,000 or more (\$185,000 or more for joint returns).

.31 Limitation on Use of Cash Method of Accounting. For taxable years beginning in 2023, a corporation or partnership meets the gross receipts test of § 448(c) for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed \$29,000,000.

.32 Threshold for Excess Business Loss. For taxable years beginning in 2023, in determining a taxpayer's excess business loss, the amount under § 461(l)(3)(A)(ii)(II) is \$289,000 (\$578,000 for joint returns).

.33 Treatment of Dues Paid to Agricultural or Horticultural Organizations. For taxable years beginning in 2023, the limitation under § 512(d)(1), regarding the exemption of annual dues required to be paid by a member to an agricultural or horticultural organization, is \$191.

.34 Insubstantial Benefit Limitations for Contributions Associated with Charitable

Fund-Raising Campaigns.

(1) Low cost article. For taxable years beginning in 2023, for purposes of defining the term "unrelated trade or business" for certain exempt organizations under § 513(h)(2), "low cost articles" are articles costing \$12.50 or less.

(2) Other insubstantial benefits. For taxable years beginning in 2023, under § 170, the \$5, \$25, and \$50 guidelines in section 3 of Rev. Proc. 90-12, 1990-1 C.B. 471 (as amplified by Rev. Proc. 92-49, 1992-1 C.B. 987, and modified by Rev. Proc. 92-102, 1992-2 C.B. 579), for the value of insubstantial benefits that may be received by a donor in return for a contribution, without causing the contribution to fail to be fully deductible, are \$12.50, \$62.50 and \$125, respectively.

.35 Special Rules for Credits and Deductions. For taxable years beginning in 2023, the amount of the deduction under § 642(b)(2)(C)(i) is \$4,700.

.36 Tax on Insurance Companies Other than Life Insurance Companies. For taxable years beginning in 2023, under § 831(b)(2)(A)(i) the amount of the limit on net written premiums or direct written premiums (whichever is greater) is \$2,650,000 to elect the alternative tax for certain small companies under § 831(b)(1) to be taxed only on taxable investment income.

.37 Expatriation to Avoid Tax. For calendar year 2023, under § 877A(g)(1)(A), unless an exception under § 877A(g)(1)(B) applies, an individual is a covered expatriate if the individual's "average annual net income tax" under § 877(a)(2)(A) for the five taxable years ending before the expatriation date is more than \$190,000.

.38 Tax Responsibilities of Expatriation. For taxable years beginning in 2023, the amount that would be includible in the gross income of a covered expatriate by reason of § 877A(a)(1) is reduced (but not below zero) by \$821,000 pursuant to § 877A(a)(3).

.39 Foreign Earned Income Exclusion. For taxable years beginning in 2023, the foreign earned income exclusion amount under § 911(b)(2)(D)(i) is \$120,000.

.40 Debt Instruments Arising Out of Sales or Exchanges. For calendar year 2023, a qualified debt instrument under § 1274A(b) has stated principal that does not exceed \$6,734,800, and a cash method debt instrument under § 1274A(c)(2) has stated principal that does not exceed \$4,810,600.

.41 Unified Credit Against Estate Tax. For an estate of any decedent dying in calendar year 2023, the basic exclusion amount is \$12,920,000 for determining the amount of the unified credit against estate tax under § 2010.

.42 Valuation of Qualified Real Property in Decedent's Gross Estate. For an estate of a decedent dying in calendar year 2023, if the executor elects to use the special use valuation method under § 2032A for qualified real property, the aggregate decrease in the value of qualified real property resulting from electing to use § 2032A for purposes of the estate tax cannot exceed \$1,310,000.

.43 Annual Exclusion for Gifts.

(1) For calendar year 2023, the first \$17,000 of gifts to any person (other than gifts of future interests in property) are not included in the total amount of taxable gifts under § 2503 made during that year.

(2) For calendar year 2023, the first \$175,000 of gifts to a spouse who is not a citizen of the United States (other than gifts of future interests in property) are not included in the total amount of taxable gifts under §§ 2503 and 2523(i)(2) made during that year.

.44 Tax on Arrow Shafts. For calendar year 2023, the tax imposed under § 4161(b)(2)(A) on the first sale by the manufacturer, producer, or importer of any shaft of a type used in the manufacture of certain arrows is \$0.59 per shaft.

.45 Passenger Air Transportation Excise Tax. For calendar year 2023, the tax under § 4261(b)(1) on the amount paid for each domestic segment of taxable air transportation is \$4.80. For calendar year 2023, the tax under § 4261(c)(1) on any amount paid (whether within or without the United States) for any international air transportation, if the transportation begins or ends in the United States, generally is \$21.10. Under § 4261(c)(3), however, a lower rate of tax applies under § 4261(c)(1) to a domestic segment beginning or ending in Alaska or Hawaii, and the tax applies only to departures. For calendar year 2023, the rate of tax is \$10.60.

.46 Reporting Exception for Certain Exempt Organizations with Nondeductible Lobbying Expenditures. For taxable years beginning in 2023, the annual per person, family, or entity dues limitation to qualify for the reporting exception under § 6033(e)(3) (and section 5.05 of Rev. Proc. 98-19, 1998-1 C.B. 547), regarding certain exempt organizations with nondeductible lobbying expenditures, is \$132 or less.

.47 Notice of Large Gifts Received from Foreign Persons. For taxable years beginning in 2023, § 6039F authorizes the Secretary of the Treasury or her delegate to require recipients of gifts from certain foreign persons to report these gifts if the aggregate value of gifts received in the taxable year exceeds \$18,567.

.48 Persons Against Whom a Federal Tax Lien Is Not Valid. For calendar year 2023, a federal tax lien is not valid against (1) certain purchasers under § 6323(b)(4) who purchased personal property in a casual sale for less than \$1,810, or (2) a mechanic's lien or under § 6323(b)(7) who repaired or improved certain residential property if the contract price with the owner is not more than \$9,030.

.49 Property Exempt from Levy. For calendar year 2023, the value of property exempt from levy under § 6334(a)(2) (fuel, provisions, furniture, and other household personal effects, as well as arms for personal use, livestock, and poultry) cannot exceed \$10,810. The value of property exempt from levy under § 6334(a)(3) (books and tools necessary for the trade, business, or profession of the taxpayer) cannot exceed \$5,400.

.50 Exempt Amount of Wages, Salary, or Other Income. For taxable years beginning in 2023, the dollar amount used to calculate the amount determined under § 6334(d)(4)(B) is \$4,700.

.51 Interest on a Certain Portion of the Estate Tax Payable in Installments. For an estate of a decedent dying in calendar year 2023, the dollar amount used to determine the "2-percent portion" (for purposes of calculating interest under § 6601(j)) of the estate tax extended as provided in § 6166 is \$1,750,000.

.52 Failure to File Tax Return. In the case of any return required to be filed in 2024, the amount of the addition to tax under § 6651(a) for failure to file an income tax return within 60 days of the due date of such return (determined with regard to any extensions of time for filing) will not be less than the lesser of \$485 or 100 percent of the amount required to be shown as tax on such return.

.53 Failure to File Certain Information Returns, Registration Statements, etc. For returns required to be filed in 2024, the penalty amounts under § 6652(c) are:

(1) for failure to file a return required under § 6033(a)(1) (relating to returns by exempt organization) or § 6012(a)(6) (relating to returns by political organizations):

Scenario	Daily Penalty	Maximum Penalty
Organization (§ 6652(c)(1)(A))	\$20	Lesser of \$12,000 or 5% of gross receipts of the organization for the year.
Organization with gross receipts exceeding \$1,208,500 (§ 6652(c)(1)(A))	\$120	\$60,000
Managers (§ 6652(c)(1)(B))	\$10	\$6,000
Public inspection of annual returns and reports (§ 6652(c)(1)(C))	\$20	\$12,000
Public inspection of applications for exemption and notice of status (§ 6652(c)(1)(D))	\$20	No Limit

(2) for failure to file a return required under § 6034 (relating to returns by certain trust) or § 6043(b) (relating to terminations, etc., of exempt organizations):

Scenario	Daily Penalty	Maximum Penalty
Organization or trust (§ 6652(c)(2)(A))	\$10	\$6,000
Managers (§ 6652(c)(2)(B))	\$10	\$6,000
Split-Interest Trust (§ 6652(c)(2)(C)(ii))	\$20	\$12,000
Any trust with gross income exceeding \$302,000 (§ 6652(c)(2)(C)(ii))	\$120	\$60,000

(3) for failure to file a disclosure required under § 6033(a)(2):

Scenario Daily Penalty Maximum Penalty

Tax-exempt entity (§ 6652(c)(3)(A))	\$120	\$60,000
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Failure to comply with written demand (§ 6652(c)(3)(B)(ii))	\$120	\$12,000
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.54 Other Assessable Penalties With Respect to the Preparation of Tax Returns for Other Persons. In the case of any failure relating to a return or claim for refund filed in 2024, the penalty amounts under § 6695 are:

Scenario	Per Return or Claim for Refund	Maximum Penalty
Failure to furnish copy to taxpayer (§ 6695(a))	\$60	\$30,000
Failure to sign return (§ 6695(b))	\$60	\$30,000
Failure to furnish identifying number (§ 6695(c))	\$60	\$30,000
Failure to retain copy or list (§ 6695(d))	\$60	\$30,000
Failure to file correct information returns (§ 6695(e))	\$60 per return and item in return	\$30,000
Negotiation of check (§ 6695(f))	\$600 per check	No limit

Failure to be diligent in determining eligibility for head of household filing status, child tax credit, American Opportunity tax credit, and earned income credit (§ 6695(g)) \$600 per failure No limit

.55 Failure to File Partnership Return. In the case of any return required to be filed in 2024, the dollar amount used to determine the amount of the penalty under § 6698(b)(1) is \$235.

.56 Failure to File S Corporation Return. In the case of any return required to be filed in 2024, the dollar amount used to determine the amount of the penalty under § 6699(b)(1) is \$235.

.57 Failure to File Correct Information Returns. In the case of any failure relating to a return required to be filed in 2024, the penalty amounts under § 6721 are:

(1) for persons with average annual gross receipts for the most recent three taxable years of more than \$5,000,000, for failure to file correct information returns:

Scenario	Penalty Per Return	Calendar Year Maximum
General Rule (§ 6721(a)(1))	\$310	\$3,783,000
Corrected on or before 30 days after required filing date (§ 6721(b)(1))	\$60	\$630,500
Corrected after 30th day but on or before August 1, 2024 (§ 6721(b)(2))	\$120	\$1,891,500



(2) for persons with average annual gross receipts for the most recent three taxable years of \$5,000,000 or less, for failure to file correct information returns:

<b>Scenario</b>	<b>Penalty Per Return</b>	<b>Calendar Year Maximum</b>
General Rule (§ 6721(d)(1)(A))	\$310	\$1,261,000
Corrected on or before 30 days after required filing date (§ 6721(d)(1)(B))	\$60	\$220,500
Corrected after 30th day but on or before August 1, 2023 (§ 6721(d)(1)(C))	\$120	\$630,500

(3) for failure to file correct information returns due to intentional disregard of the filing requirement (or the correct information reporting requirement):

<b>Scenario</b>	<b>Penalty Per Return</b>	<b>Calendar Year Maximum</b>
Return other than a return required to be filed under §§ 6045(a), 6041A(b), 6050H, 6050I, 6050J, 6050K, or 6050L (§ 6721(e)(2)(A))	Greater of (i) \$630, or (ii) 5% of aggregate amount of items required to be reported correctly	No limit
Return required to be filed under §§ 6045(a), 6050K, or 6050L (§ 6721(e)(2)(B))	Greater of (i) \$630, or (ii) 5% of aggregate amount of items required to be reported correctly	No limit
Return required to be filed under § 6050I(a) (§ 6721(e)(2)(C))	Greater of (i) \$31,520, or (ii) amount of cash received up to \$126,000	No limit
Return required to be filed under § 6050V (§ 6721(e)(2)(D))	Greater of (i) \$630, or (ii) 10% of the value of the benefit of any contract with respect to which information is required to be included on the return	No limit

.58 Failure to Furnish Correct Payee Statements. In the case of any failure relating to a statement required to be furnished in 2024, the penalty amounts under § 6722 are:

(1) for persons with average annual gross receipts for the most recent three taxable years of more than \$5,000,000, for failure to furnish correct payee statements:

<b>Scenario</b>	<b>Penalty Per Statement</b>	<b>Calendar Year Maximum</b>
General Rule (§ 6722(a)(1))	\$310	\$3,783,000
Corrected on or before 30 days after required furnishing date (§ 6722(b)(1))	\$60	\$630,500
Corrected after 30th day but on or before August 1, 2024 (§ 6722(b)(2))	\$120	\$1,891,500

(2) for persons with average annual gross receipts for the most recent 3 taxable years of \$5,000,000 or less, for failure to furnish correct payee statements:

<b>Scenario</b>	<b>Penalty Per Statement</b>	<b>Calendar Year Maximum</b>
General Rule (§ 6722(d)(1)(A))	\$310	\$1,261,000
Corrected on or before 30 days after required furnishing date (§ 6722(d)(1)(B))	\$60	\$220,500
Corrected after 30th day but on or before August 1, 2024 (§ 6722(d)(1)(C))	\$120	\$630,500

(3) for failure to furnish correct payee statements due to intentional disregard of the requirement to furnish a payee statement (or the correct information reporting requirement):

<b>Scenario</b>	<b>Penalty Per Statement</b>	<b>Calendar Year Maximum</b>
Payee statement other than a statement required under §§ 6045(b), 6041A(e) (in respect of a return required under § 6041A(b)), 6050H(d), 6050J(e), 6050K(b), or 6050L(c) (§ 6722(e)(2)(A))	Greater of (i) \$630, or (ii) 10% of aggregate amount of items required to be reported correctly	No limit
Payee statement required under §§ 6045(b), 6050K(b), or 6050L(c) (§ 6722(e)(2)(B))	Greater of (i) \$630, or (ii) 5% of aggregate amount of items required to be reported correctly	No limit

.59 Revocation or Denial of Passport in Case of Certain Tax Delinquencies. For calendar year 2023, the amount of a serious delinquent tax debt under § 7345 is \$59,000.

.60 Attorney Fee Awards. For fees incurred in calendar year 2023, the attorney fee award limitation under § 7430(c)(1)(B)(iii) is \$230 per hour.

.61 Periodic Payments Received Under Qualified Long-Term Care Insurance

Contracts or Under Certain Life Insurance Contracts. For calendar year 2023, the stated dollar amount of the per diem limitation under § 7702B(d)(4), regarding periodic payments received under a qualified long-term care insurance contract or periodic payments received under a life insurance contract that are treated as paid by reason of the death of a chronically ill individual, is \$420.

.62 Qualified Small Employer Health Reimbursement Arrangement. For taxable years beginning in 2023, to qualify as a qualified small employer health reimbursement arrangement under § 9831(d), the arrangement must provide that the total amount of payments and reimbursements for any year cannot exceed \$5,850 (\$11,800 for family coverage).

#### SECTION 4. EFFECTIVE DATE

.01 General Rule. Except as provided in section 4.02 of this revenue procedure, this revenue procedure applies to taxable years beginning in 2023.

.02 Calendar Year Rule. This revenue procedure applies to transactions or events occurring in calendar year 2023 for purposes of sections 3.08 (rehabilitation expenditures treated as separate new building), 3.09 (low-income housing credit), 3.14 (transportation mainline pipeline construction industry optional expense substantiation rules

for payments to employees under accountable plans), 3.20 (private activity bonds volume cap), 3.21 (loan limits on agricultural bonds), 3.22 (general arbitrage rebate rules), 3.23 (safe harbor rules for broker commissions on guaranteed investment contracts or investments purchased for a yield restricted defeasance escrow), 3.37 (expatriation to avoid taxes), 3.40 (debt instruments arising out of sales or exchanges),

3.41 (unified credit against estate tax), 3.42 (valuation of qualified real property in decedent's gross estate), 3.43 (annual exclusion for gifts), 3.44 (tax on arrow shafts),

3.45 (passenger air transportation excise tax), 3.48 (persons against whom a federal tax lien is not valid), 3.49 (property exempt from levy), 3.51 (interest on a certain portion of the estate tax payable in installments), 3.59 (revocation or denial of passport in case of certain tax delinquencies), 3.60 (attorney fee awards), and 3.61 (periodic payments received under qualified long-term care insurance contracts or under certain life insurance contracts) of this revenue procedure.

## SECTION 5. DRAFTING INFORMATION

The principal author of this revenue procedure is William Ruane of the Office of Associate Chief Counsel (Income Tax & Accounting). For further information regarding this revenue procedure, contact Mr. Ruane at (202) 317-4718 (not a toll-free call) or Kyle Walker at (202) 317-5394 (not a toll-free call).

Revenue Procedure 87-57  
Excerpts

## 8. OPTIONAL TABLES

.01. This section contains optional depreciation tables that may be used by certain taxpayers in computing annual depreciation allowances under section 168 of the Code. The depreciation tables may be used with respect to any item of property placed in service in a taxable year. For all items of property placed in service in a taxable year for which the depreciation tables are not used, depreciation allowances must be computed in the manner prescribed in sections 2-7 of this revenue procedure.

.02. The optional depreciation tables specify schedules of annual depreciation rates to be applied to the unadjusted basis of property in each taxable year. If a taxpayer uses a table to compute the annual depreciation allowance for any item of property, the taxpayer must use the table to compute the annual depreciation allowances for the entire recovery period of such property. However, a taxpayer may not continue to use the table if there are any adjustments to the basis of the property for reasons other than (1) depreciation allowed or allowable or (2) an addition or an improvement to such property that is subject to depreciation as a separate item of property. Use of the tables in this revenue procedure to compute depreciation allowances does not require the filing of any notice with the Internal Revenue Service.

Taxpayers use the appropriate table for any property based on the depreciation system, the applicable depreciation method, the applicable recovery period, and the applicable convention. The tables list the percentage depreciation rates to be applied to the unadjusted basis of property in each taxable year.

In Tables 1-5, for the general depreciation system, the listed depreciation rates reflect the 200 percent declining balance method switching to the straight line method for property with applicable recovery periods of 3, 5, 7 or 10 years and the 150 percent declining balance method switching to straight line method for property with applicable recovery periods of 15 and 20 years.

Table 1. General Depreciation System

Applicable Depreciation Method: 200 or 150 Percent Declining Balance

Switching to Straight Line

Applicable Recovery Periods: 3, 5, 7, 10, 15, 20 years

Applicable Convention: Half-year

If the Recovery Year is:	and the Recovery Period is:					
	3-year	5-year	7-year	10-year	15-year	20-year
	the Depreciation Rate is:					
1	33.33	20.00	14.29	10.00	5.00	3.750
2	44.45	32.00	24.49	18.00	9.50	7.219
3	14.81	19.20	17.49	14.40	8.55	6.677
4	7.41	11.52	12.49	11.52	7.70	6.177
5		11.52	8.93	9.22	6.93	5.713
6		5.76	8.92	7.37	6.23	5.285
7			8.93	6.55	5.90	4.888
8			4.46	6.55	5.90	4.522
9				6.56	5.91	4.462
10				6.55	5.90	4.461
11				3.28	5.91	4.462
12					5.90	4.461
13					5.91	4.462
14					5.90	4.461
15					5.91	4.462
16					2.95	4.461
17						4.462
18						4.461
19						4.462
20						4.461
21						2.231

Internal Revenue Code  
Selected Sections

## §1. TAX IMPOSED

### (a) Married individuals filing joint returns and surviving spouses

There is hereby imposed on the taxable income of—

(1) every married individual (as defined in section 7703) who makes a single return jointly with his spouse under section 6013, and

(2) every surviving spouse (as defined in section 2(a)),  
a tax determined in accordance with the following table:

<b>If taxable income is:</b>	<b>The tax is:</b>
Not over \$36,900	15% of taxable income.
Over \$36,900 but not over \$89,150	\$5,535, plus 28% of the excess over \$36,900.
Over \$89,150 but not over \$140,000	\$20,165, plus 31% of the excess over \$89,150.
Over \$140,000 but not over \$250,000	\$35,928.50, plus 36% of the excess over \$140,000.
Over \$250,000	\$75,528.50, plus 39.6% of the excess over \$250,000.

### (b) Heads of households

There is hereby imposed on the taxable income of every head of a household (as defined in section 2(b)) a tax determined in accordance with the following table:

<b>If taxable income is:</b>	<b>The tax is:</b>
Not over \$29,600	15% of taxable income.
Over \$29,600 but not over \$76,400	\$4,440, plus 28% of the excess over \$29,600.
Over \$76,400 but not over \$127,500	\$17,544, plus 31% of the excess over \$76,400.
Over \$127,500 but not over \$250,000	\$33,385, plus 36% of the excess over \$127,500.
Over \$250,000	\$77,485, plus 39.6% of the excess over \$250,000.

### (c) Unmarried individuals (other than surviving spouses and heads of households)

There is hereby imposed on the taxable income of every individual (other than a surviving spouse as defined in section 2(a) or the head of a household as defined in section 2(b)) who is not a married individual (as defined in section 7703) a tax determined in accordance with the following table:



**If taxable income is: The tax is:**

Not over \$22,100	15% of taxable income.
Over \$22,100 but not over \$53,500	\$3,315, plus 28% of the excess over \$22,100.
Over \$53,500 but not over \$115,000	\$12,107, plus 31% of the excess over \$53,500.
Over \$115,000 but not over \$250,000	\$31,172, plus 36% of the excess over \$115,000.
Over \$250,000	\$79,772, plus 39.6% of the excess over \$250,000.

**(d) Married individuals filing separate returns**

There is hereby imposed on the taxable income of every married individual (as defined in section 7703) who does not make a single return jointly with his spouse under section 6013, a tax determined in accordance with the following table:

**If taxable income is: The tax is:**

Not over \$18,450	15% of taxable income.
Over \$18,450 but not over \$44,575	\$2,767.50, plus 28% of the excess over \$18,450.
Over \$44,575 but not over \$70,000	\$10,082.50, plus 31% of the excess over \$44,575.
Over \$70,000 but not over \$125,000	\$17,964.25, plus 36% of the excess over \$70,000.
Over \$125,000	\$37,764.25, plus 39.6% of the excess over \$125,000.

**(f) Phaseout of marriage penalty in 15-percent bracket; adjustments in tax tables so that inflation will not result in tax increases**

**(1) In general** Not later than December 15 of 1993, and each subsequent calendar year, the Secretary shall prescribe tables which shall apply in lieu of the tables contained in subsections (a), (b), (c), (d), and (e) with respect to taxable years beginning in the succeeding calendar year.

**(2) Method of prescribing tables** The table which under paragraph (1) is to apply in lieu of the table contained in subsection (a), (b), (c), (d), or (e), as the case may be, with respect to taxable years beginning in any calendar year shall be prescribed—

**(A)** except as provided in paragraph (8), by increasing the minimum and maximum dollar amounts for each bracket for which a tax is imposed under such table by the cost-of-living adjustment for such calendar year, determined—

**(i)** except as provided in clause (ii), by substituting “1992” for “2016” in paragraph (3) (A)(ii), and

**(ii)** in the case of adjustments to the dollar amounts at which the 36 percent rate bracket

begins or at which the 39.6 percent rate bracket begins, by substituting “1993” for “2016” in paragraph (3)(A)(ii),

(B) by not changing the rate applicable to any rate bracket as adjusted under subparagraph (A), and

(C) by adjusting the amounts setting forth the tax to the extent necessary to reflect the adjustments in the rate brackets.

**(3) Cost-of-living adjustment** For purposes of this subsection—

(A) **In general** The cost-of-living adjustment for any calendar year is the percentage (if any) by which—

(i) the C-CPI-U for the preceding calendar year, exceeds

(ii) the CPI for calendar year 2016, multiplied by the amount determined under subparagraph (B).

(B) **Amount determined** The amount determined under this clause is the amount obtained by dividing—

(i) the C-CPI-U for calendar year 2016, by

(ii) the CPI for calendar year 2016.

(C) **Special rule for adjustments with a base year after 2016** For purposes of any provision of this title which provides for the substitution of a year after 2016 for “2016” in subparagraph (A)(ii), subparagraph (A) shall be applied by substituting “the C-CPI-U for calendar year 2016” for “the CPI for calendar year 2016” and all that follows in clause (ii) thereof.

**(4) CPI for any calendar year** For purposes of paragraph (3), the CPI for any calendar year is the average of the Consumer Price Index as of the close of the 12-month period ending on August 31 of such calendar year.

**(5) Consumer Price Index** For purposes of paragraph (4), the term “Consumer Price Index” means the last Consumer Price Index for all-urban consumers published by the Department of Labor. For purposes of the preceding sentence, the revision of the Consumer Price Index which is most consistent with the Consumer Price Index for calendar year 1986 shall be used.

**(6) C-CPI-U** For purposes of this subsection—

(A) **In general** The term “C-CPI-U” means the Chained Consumer Price Index for All Urban Consumers (as published by the Bureau of Labor Statistics of the Department of Labor). The values of the Chained Consumer Price Index for All Urban Consumers taken into account for purposes of determining the cost-of-living adjustment for any calendar year under this subsection shall be the latest values so published as of the date on which such Bureau publishes the initial value of the Chained Consumer Price Index for All Urban Consumers for the month of August for the preceding calendar year.

(B) **Determination for calendar year** The C-CPI-U for any calendar year is the average of the C-CPI-U as of the close of the 12-month period ending on August 31 of such calendar year.

## **(7) Rounding**

**(A) In general** If any increase determined under paragraph (2)(A), section 63(c)(4), section 68(b)(2) or section 151(d)(4) is not a multiple of \$50, such increase shall be rounded to the next lowest multiple of \$50.

**(B) Table for married individuals filing separately** In the case of a married individual filing a separate return, subparagraph (A) (other than with respect to sections 63(c)(4) and 151(d)(4)(A)) shall be applied by substituting “\$25” for “\$50” each place it appears.

**(8) Elimination of marriage penalty in 15-percent bracket** With respect to taxable years beginning after December 31, 2003, in prescribing the tables under paragraph (1)—

**(A)** the maximum taxable income in the 15-percent rate bracket in the table contained in subsection (a) (and the minimum taxable income in the next higher taxable income bracket in such table) shall be 200 percent of the maximum taxable income in the 15-percent rate bracket in the table contained in subsection (c) (after any other adjustment under this subsection), and

**(B)** the comparable taxable income amounts in the table contained in subsection (d) shall be  $\frac{1}{2}$  of the amounts determined under subparagraph (A).

## **(h) Maximum capital gains rate**

**(1) In general** If a taxpayer has a net capital gain for any taxable year, the tax imposed by this section for such taxable year shall not exceed the sum of—

**(A)** a tax computed at the rates and in the same manner as if this subsection had not been enacted on the greater of—

**(i)** taxable income reduced by the net capital gain; or

**(ii)** the lesser of—

**(I)** the amount of taxable income taxed at a rate below 25 percent; or

**(II)** taxable income reduced by the adjusted net capital gain;

**(B)** 0 percent of so much of the adjusted net capital gain (or, if less, taxable income) as does not exceed the excess (if any) of—

**(i)** the amount of taxable income which would (without regard to this paragraph) be taxed at a rate below 25 percent, over

**(ii)** the taxable income reduced by the adjusted net capital gain;

**(C)** 15 percent of the lesser of—

**(i)** so much of the adjusted net capital gain (or, if less, taxable income) as exceeds the amount on which a tax is determined under subparagraph (B), or

**(ii)** the excess of—

**(I)** the amount of taxable income which would (without regard to this paragraph) be taxed at a rate below 39.6 percent, over

(II) the sum of the amounts on which a tax is determined under subparagraphs (A) and (B),

(D) 20 percent of the adjusted net capital gain (or, if less, taxable income) in excess of the sum of the amounts on which tax is determined under subparagraphs (B) and (C),

(E) 25 percent of the excess (if any) of—

(i) the unrecaptured section 1250 gain (or, if less, the net capital gain (determined without regard to paragraph (11))), over

(ii) the excess (if any) of—

(I) the sum of the amount on which tax is determined under subparagraph (A) plus the net capital gain, over

(II) taxable income; and

(F) 28 percent of the amount of taxable income in excess of the sum of the amounts on which tax is determined under the preceding subparagraphs of this paragraph.

**(2) Net capital gain taken into account as investment income** For purposes of this subsection, the net capital gain for any taxable year shall be reduced (but not below zero) by the amount which the taxpayer takes into account as investment income under section 163(d)(4)(B)(iii).

**(3) Adjusted net capital gain** For purposes of this subsection, the term “adjusted net capital gain” means the sum of—

(A) net capital gain (determined without regard to paragraph (11)) reduced (but not below zero) by the sum of—

(i) unrecaptured section 1250 gain, and

(ii) 28-percent rate gain, plus

(B) qualified dividend income (as defined in paragraph (11)).

**(4) 28-percent rate gain** For purposes of this subsection, the term “28-percent rate gain” means the excess (if any) of—

(A) the sum of—

(i) collectibles gain; and

(ii) section 1202 gain, over

(B) the sum of—

(i) collectibles loss;

(ii) the net short-term capital loss; and

(iii) the amount of long-term capital loss carried under section 1212(b)(1)(B) to the taxable year.

**(5) Collectibles gain and loss** For purposes of this subsection—

(A) **In general** The terms “collectibles gain” and “collectibles loss” mean gain or loss (respectively) from the sale or exchange of a collectible (as defined in section 408(m)

without regard to paragraph (3) thereof) which is a capital asset held for more than 1 year but only to the extent such gain is taken into account in computing gross income and such loss is taken into account in computing taxable income.

**(B) Partnerships, etc.** For purposes of subparagraph (A), any gain from the sale of an interest in a partnership, S corporation, or trust which is attributable to unrealized appreciation in the value of collectibles shall be treated as gain from the sale or exchange of a collectible. Rules similar to the rules of section 751 shall apply for purposes of the preceding sentence.

**(6) Unrecaptured section 1250 gain** For purposes of this subsection—

**(A) In general** The term “unrecaptured section 1250 gain” means the excess (if any) of—

**(i)** the amount of long-term capital gain (not otherwise treated as ordinary income) which would be treated as ordinary income if section 1250(b)(1) included all depreciation and the applicable percentage under section 1250(a) were 100 percent, over

**(ii)** the excess (if any) of—

**(I)** the amount described in paragraph (4)(B); over

**(II)** the amount described in paragraph (4)(A).

**(B) Limitation with respect to section 1231 property** The amount described in subparagraph (A)(i) from sales, exchanges, and conversions described in section 1231(a)(3) (A) for any taxable year shall not exceed the net section 1231 gain (as defined in section 1231(c)(3)) for such year.

**(7) Section 1202 gain** For purposes of this subsection, the term “section 1202 gain” means the excess of—

**(A)** the gain which would be excluded from gross income under section 1202 but for the percentage limitation in section 1202(a), over

**(B)** the gain excluded from gross income under section 1202.

**(8) Coordination with recapture of net ordinary losses under section 1231** If any amount is treated as ordinary income under section 1231(c), such amount shall be allocated among the separate categories of net section 1231 gain (as defined in section 1231(c)(3)) in such manner as the Secretary may by forms or regulations prescribe.

**(9) Regulations** The Secretary may prescribe such regulations as are appropriate (including regulations requiring reporting) to apply this subsection in the case of sales and exchanges by pass-thru entities and of interests in such entities.

**(10) Pass-thru entity defined** For purposes of this subsection, the term “pass-thru entity” means—

**(A)** a regulated investment company;

**(B)** a real estate investment trust;

**(C)** an S corporation;

**(D)** a partnership;

- (E) an estate or trust;
- (F) a common trust fund; and
- (G) a qualified electing fund (as defined in section 1295).

**(11) Dividends taxed as net capital gain**

**(A) In general** For purposes of this subsection, the term “net capital gain” means net capital gain (determined without regard to this paragraph) increased by qualified dividend income.

**(B) Qualified dividend income** For purposes of this paragraph—

**(i) In general** The term “qualified dividend income” means dividends received during the taxable year from—

- (I) domestic corporations, and
- (II) qualified foreign corporations.

**(ii) Certain dividends excluded** Such term shall not include—

- (I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,
- (II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and
- (III) any dividend described in section 404(k).

**(iii) Coordination with section 246(c)** Such term shall not include any dividend on any share of stock—

- (I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) “60 days” for “45 days” each place it appears and by substituting “121-day period” for “91-day period”), or
- (II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

**(C) Qualified foreign corporations**

**(i) In general** Except as otherwise provided in this paragraph, the term “qualified foreign corporation” means any foreign corporation if—

- (I) such corporation is incorporated in a possession of the United States, or
- (II) such corporation is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information program.

**(ii) Dividends on stock readily tradable on United States securities market** A foreign corporation not otherwise treated as a qualified foreign corporation under clause (i) shall be so treated with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States.

(iii) **Exclusion of dividends of certain foreign corporations** Such term shall not include—

(I) any foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a passive foreign investment company (as defined in section 1297), and

(II) any corporation which first becomes a surrogate foreign corporation (as defined in section 7874(a)(2)(B)) after the date of the enactment of this subclause, other than a foreign corporation which is treated as a domestic corporation under section 7874(b).

(iv) **Coordination with foreign tax credit limitation** Rules similar to the rules of section 904(b)(2)(B) shall apply with respect to the dividend rate differential under this paragraph.

**(D) Special rules**

(i) **Amounts taken into account as investment income** Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under section 163(d)(4)(B).

(ii) **Extraordinary dividends** If a taxpayer to whom this section applies receives, with respect to any share of stock, qualified dividend income from 1 or more dividends which are extraordinary dividends (within the meaning of section 1059(c)), any loss on the sale or exchange of such share shall, to the extent of such dividends, be treated as long-term capital loss.

(iii) **Treatment of dividends from regulated investment companies and real estate investment trusts** A dividend received from a regulated investment company or a real estate investment trust shall be subject to the limitations prescribed in sections 854 and 857.

**(i) Rate reductions after 2000**

**(1) 10-percent rate bracket**

(A) **In general** In the case of taxable years beginning after December 31, 2000—

(i) the rate of tax under subsections (a), (b), (c), and (d) on taxable income not over the initial bracket amount shall be 10 percent, and

(ii) the 15 percent rate of tax shall apply only to taxable income over the initial bracket amount but not over the maximum dollar amount for the 15-percent rate bracket.

(B) **Initial bracket amount** For purposes of this paragraph, the initial bracket amount is—

(i) \$14,000 in the case of subsection (a),

(ii) \$10,000 in the case of subsection (b), and

(iii)  $\frac{1}{2}$  the amount applicable under clause (i) (after adjustment, if any, under subparagraph (C)) in the case of subsections (c) and (d).

(C) **Inflation adjustment** In prescribing the tables under subsection (f) which apply with respect to taxable years beginning in calendar years after 2003—

(i) the cost-of-living adjustment shall be determined under subsection (f)(3) by

substituting “2002” for “2016” in subparagraph (A)(ii) thereof, and

(ii) the adjustments under clause (i) shall not apply to the amount referred to in subparagraph (B)(iii).

If any amount after adjustment under the preceding sentence is not a multiple of \$50, such amount shall be rounded to the next lowest multiple of \$50.

**(2) 25-, 28-, and 33-percent rate brackets** The tables under subsections (a), (b), (c), (d), and (e) shall be applied—

(A) by substituting “25%” for “28%” each place it appears (before the application of subparagraph (B)),

(B) by substituting “28%” for “31%” each place it appears, and

(C) by substituting “33%” for “36%” each place it appears.

**(3) Modifications to income tax brackets for high-income taxpayers**

**(A) 35-percent rate bracket** In the case of taxable years beginning after December 31, 2012

(i) the rate of tax under subsections (a), (b), (c), and (d) on a taxpayer’s taxable income in the highest rate bracket shall be 35 percent to the extent such income does not exceed an amount equal to the excess of—

(I) the applicable threshold, over

(II) the dollar amount at which such bracket begins, and

(ii) the 39.6 percent rate of tax under such subsections shall apply only to the taxpayer’s taxable income in such bracket in excess of the amount to which clause (i) applies.

**(B) Applicable threshold** For purposes of this paragraph, the term “applicable threshold” means—

(i) \$450,000 in the case of subsection (a),

(ii) \$425,000 in the case of subsection (b),

(iii) \$400,000 in the case of subsection (c), and

(iv)  $\frac{1}{2}$  the amount applicable under clause (i) (after adjustment, if any, under subparagraph (C)) in the case of subsection (d).

**(C) Inflation adjustment** For purposes of this paragraph, with respect to taxable years beginning in calendar years after 2013, each of the dollar amounts under clauses (i), (ii), and (iii) of subparagraph (B) shall be adjusted in the same manner as under paragraph (1)(C)(i), except that subsection (f)(3)(A)(ii) shall be applied by substituting “2012” for “2016”.

**(4) Adjustment of tables** The Secretary shall adjust the tables prescribed under subsection (f) to carry out this subsection.

**(j) Modifications for taxable years 2018 through 2025**

**(1) In general** In the case of a taxable year beginning after December 31, 2017, and before



January 1, 2026—

(A) subsection (i) shall not apply, and

(B) this section (other than subsection (i)) shall be applied as provided in paragraphs (2) through (6).

**(2) Rate tables**

**(A) Married individuals filing joint returns and surviving spouses** The following table shall be applied in lieu of the table contained in subsection (a):

<b>If taxable income is:</b>	<b>The tax is:</b>
Not over \$19,050	10% of taxable income.
Over \$19,050 but not over \$77,400	\$1,905, plus 12% of the excess over \$19,050.
Over \$77,400 but not over \$165,000	\$8,907, plus 22% of the excess over \$77,400.
Over \$165,000 but not over \$315,000	\$28,179, plus 24% of the excess over \$165,000.
Over \$315,000 but not over \$400,000	\$64,179, plus 32% of the excess over \$315,000.
Over \$400,000 but not over \$600,000	\$91,379, plus 35% of the excess over \$400,000.
Over \$600,000	\$161,379, plus 37% of the excess over \$600,000.

**(B) Heads of households** The following table shall be applied in lieu of the table contained in subsection (b):

<b>If taxable income is:</b>	<b>The tax is:</b>
Not over \$13,600	10% of taxable income.
Over \$13,600 but not over \$51,800	\$1,360, plus 12% of the excess over \$13,600.
Over \$51,800 but not over \$82,500	\$5,944, plus 22% of the excess over \$51,800.
Over \$82,500 but not over \$157,500	\$12,698, plus 24% of the excess over \$82,500.
Over \$157,500 but not over \$200,000	\$30,698, plus 32% of the excess over \$157,500.
Over \$200,000 but not over \$500,000	\$44,298, plus 35% of the excess over \$200,000.
Over \$500,000	\$149,298, plus 37% of the excess over \$500,000.

**(C) Unmarried individuals other than surviving spouses and heads of households** The following table shall be applied in lieu of the table contained in subsection (c):

<b>If taxable income is:</b>	<b>The tax is:</b>
Not over \$9,525	10% of taxable income.
Over \$9,525 but not over \$38,700	\$952.50, plus 12% of the excess over \$9,525.
Over \$38,700 but not over \$82,500	\$4,453.50, plus 22% of the excess over \$38,700.
Over \$82,500 but not over \$157,500	\$14,089.50, plus 24% of the excess over \$82,500.
Over \$157,500 but not over \$200,000	\$32,089.50, plus 32% of the excess over \$157,500.
Over \$200,000 but not over \$500,000	\$45,689.50, plus 35% of the excess over \$200,000.
Over \$500,000	\$150,689.50, plus 37% of the excess over \$500,000.

**(D) Married individuals filing separate returns** The following table shall be applied in lieu of the table contained in subsection (d):

<b>If taxable income is:</b>	<b>The tax is:</b>
Not over \$9,525	10% of taxable income.
Over \$9,525 but not over \$38,700	\$952.50, plus 12% of the excess over \$9,525.
Over \$38,700 but not over \$82,500	\$4,453.50, plus 22% of the excess over \$38,700.
Over \$82,500 but not over \$157,500	\$14,089.50, plus 24% of the excess over \$82,500.
Over \$157,500 but not over \$200,000	\$32,089.50, plus 32% of the excess over \$157,500.
Over \$200,000 but not over \$300,000	\$45,689.50, plus 35% of the excess over \$200,000.
Over \$300,000	\$80,689.50, plus 37% of the excess over \$300,000.

**(E) Estates and trusts** The following table shall be applied in lieu of the table contained in subsection (e):

<b>If taxable income is:</b>	<b>The tax is:</b>
Not over \$2,550	10% of taxable income.
Over \$2,550 but not over \$9,150	\$255, plus 24% of the excess over \$2,550.

Over \$9,150 but	\$1,839, plus 35% of the
not over \$12,500	excess over \$9,150.
Over \$12,500	\$3,011.50, plus 37% of the excess over \$12,500.

**(F) References to rate tables** Any reference in this title to a rate of tax under subsection (c) shall be treated as a reference to the corresponding rate bracket under subparagraph (C) of this paragraph, except that the reference in section 3402(q)(1) to the third lowest rate of tax applicable under subsection (c) shall be treated as a reference to the fourth lowest rate of tax under subparagraph (C).

### **(3) Adjustments**

**(A) No adjustment in 2018** The tables contained in paragraph (2) shall apply without adjustment for taxable years beginning after December 31, 2017, and before January 1, 2019.

**(B) Subsequent years** For taxable years beginning after December 31, 2018, the Secretary shall prescribe tables which shall apply in lieu of the tables contained in paragraph (2) in the same manner as under paragraphs (1) and (2) of subsection (f) (applied without regard to clauses (i) and (ii) of subsection (f)(2)(A)), except that in prescribing such tables—

(i) subsection (f)(3) shall be applied by substituting “calendar year 2017” for “calendar year 2016” in subparagraph (A)(ii) thereof,

(ii) subsection (f)(7)(B) shall apply to any unmarried individual other than a surviving spouse or head of household, and

(iii) subsection (f)(8) shall not apply.

[(4) Repealed. Pub. L. 116–94, div. O, title V, §501(a), Dec. 20, 2019, 133 Stat. 3180]

### **(5) Application of current income tax brackets to capital gains brackets**

**(A) In general** Section 1(h)(1) shall be applied—

(i) by substituting “below the maximum zero rate amount” for “which would (without regard to this paragraph) be taxed at a rate below 25 percent” in subparagraph (B)(i), and

(ii) by substituting “below the maximum 15-percent rate amount” for “which would (without regard to this paragraph) be taxed at a rate below 39.6 percent” in subparagraph (C)(ii)(I).

**(B) Maximum amounts defined** For purposes of applying section 1(h) with the modifications described in subparagraph (A)—

**(i) Maximum zero rate amount** The maximum zero rate amount shall be—

(I) in the case of a joint return or surviving spouse, \$77,200,

(II) in the case of an individual who is a head of household (as defined in section 2(b)), \$51,700,

(III) in the case of any other individual (other than an estate or trust), an amount equal to ½ of the amount in effect for the taxable year under subclause (I), and

(IV) in the case of an estate or trust, \$2,600.

**(ii) Maximum 15-percent rate amount** The maximum 15-percent rate amount shall be—

- (I) in the case of a joint return or surviving spouse, \$479,000 (½ such amount in the case of a married individual filing a separate return),
- (II) in the case of an individual who is the head of a household (as defined in section 2(b)), \$452,400,
- (III) in the case of any other individual (other than an estate or trust), \$425,800, and
- (IV) in the case of an estate or trust, \$12,700.

**(C) Inflation adjustment** In the case of any taxable year beginning after 2018, each of the dollar amounts in clauses (i) and (ii) of subparagraph (B) shall be increased by an amount equal to—

- (i) such dollar amount, multiplied by
- (ii) the cost-of-living adjustment determined under subsection (f)(3) for the calendar year in which the taxable year begins, determined by substituting “calendar year 2017” for “calendar year 2016” in subparagraph (A)(ii) thereof.

If any increase under this subparagraph is not a multiple of \$50, such increase shall be rounded to the next lowest multiple of \$50.

**(6) Section 15 not to apply** Section 15 shall not apply to any change in a rate of tax by reason of this subsection.

## §24. CHILD TAX CREDIT

### (a) Allowance of credit

There shall be allowed as a credit against the tax imposed by this chapter for the taxable year with respect to each qualifying child of the taxpayer for which the taxpayer is allowed a deduction under section 151 an amount equal to \$1,000.

### (b) Limitations

**(1) Limitation based on adjusted gross income** The amount of the credit allowable under subsection (a) shall be reduced (but not below zero) by \$50 for each \$1,000 (or fraction thereof) by which the taxpayer’s modified adjusted gross income exceeds the threshold amount. For purposes of the preceding sentence, the term “modified adjusted gross income” means adjusted gross income increased by any amount excluded from gross income under section 911, 931, or 933.

**(2) Threshold amount** For purposes of paragraph (1), the term “threshold amount” means—

- (A) \$110,000 in the case of a joint return,
- (B) \$75,000 in the case of an individual who is not married, and
- (C) \$55,000 in the case of a married individual filing a separate return.

For purposes of this paragraph, marital status shall be determined under section 7703.

**(c) Qualifying child**

For purposes of this section—

**(1) In general** The term “qualifying child” means a qualifying child of the taxpayer (as defined in section 152(c)) who has not attained age 17.

**(2) Exception for certain noncitizens** The term “qualifying child” shall not include any individual who would not be a dependent if subparagraph (A) of section 152(b)(3) were applied without regard to all that follows “resident of the United States”.

**(d) Portion of credit refundable**

**(1) In general** The aggregate credits allowed to a taxpayer under subpart C shall be increased by the lesser of—

**(A)** the credit which would be allowed under this section without regard to this subsection and the limitation under section 26(a) or

**(B)** the amount by which the aggregate amount of credits allowed by this subpart (determined without regard to this subsection) would increase if the limitation imposed by section 26(a) were increased by the greater of—

**(i)** 15 percent of so much of the taxpayer’s earned income (within the meaning of section 32) which is taken into account in computing taxable income for the taxable year as exceeds \$3,000, or

**(ii)** in the case of a taxpayer with 3 or more qualifying children, the excess (if any) of—

**(I)** the taxpayer’s social security taxes for the taxable year, over

**(II)** the credit allowed under section 32 for the taxable year.

The amount of the credit allowed under this subsection shall not be treated as a credit allowed under this subpart and shall reduce the amount of credit otherwise allowable under subsection (a) without regard to section 26(a). For purposes of subparagraph (B), any amount excluded from gross income by reason of section 112 shall be treated as earned income which is taken into account in computing taxable income for the taxable year.

**(2) Social security taxes** For purposes of paragraph (1)—

**(A) In general** The term “social security taxes” means, with respect to any taxpayer for any taxable year—

**(i)** the amount of the taxes imposed by sections 3101 and 3201(a) on amounts received by the taxpayer during the calendar year in which the taxable year begins,

**(ii)** 50 percent of the taxes imposed by section 1401 on the self-employment income of the taxpayer for the taxable year, and

**(iii)** 50 percent of the taxes imposed by section 3211(a) on amounts received by the taxpayer during the calendar year in which the taxable year begins.

**(B) Coordination with special refund of social security taxes** The term “social security taxes” shall not include any taxes to the extent the taxpayer is entitled to a special refund of

such taxes under section 6413(c).

**(C) Special rule** Any amounts paid pursuant to an agreement under section 3121(*I*) (relating to agreements entered into by American employers with respect to foreign affiliates) which are equivalent to the taxes referred to in subparagraph (A)(i) shall be treated as taxes referred to in such subparagraph.

**(3) Exception for taxpayers excluding foreign earned income** Paragraph (1) shall not apply to any taxpayer for any taxable year if such taxpayer elects to exclude any amount from gross income under section 911 for such taxable year.

**(e) Identification requirements**

**(1) Qualifying child identification requirement** No credit shall be allowed under this section to a taxpayer with respect to any qualifying child unless the taxpayer includes the name and taxpayer identification number of such qualifying child on the return of tax for the taxable year and such taxpayer identification number was issued on or before the due date for filing such return.

**(2) Taxpayer identification requirement** No credit shall be allowed under this section if the taxpayer identification number of the taxpayer was issued after the due date for filing the return for the taxable year.

**(f) Taxable year must be full taxable year**

Except in the case of a taxable year closed by reason of the death of the taxpayer, no credit shall be allowable under this section in the case of a taxable year covering a period of less than 12 months.

**(g) Restrictions on taxpayers who improperly claimed credit in prior year**

**(1) Taxpayers making prior fraudulent or reckless claims**

**(A) In general** No credit shall be allowed under this section for any taxable year in the disallowance period.

**(B) Disallowance period** For purposes of subparagraph (A), the disallowance period is—

**(i)** the period of 10 taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit under this section was due to fraud, and

**(ii)** the period of 2 taxable years after the most recent taxable year for which there was a final determination that the taxpayer's claim of credit under this section was due to reckless or intentional disregard of rules and regulations (but not due to fraud).

**(2) Taxpayers making improper prior claims** In the case of a taxpayer who is denied credit under this section for any taxable year as a result of the deficiency procedures under subchapter B of chapter 63, no credit shall be allowed under this section for any subsequent taxable year unless the taxpayer provides such information as the Secretary may require to demonstrate

eligibility for such credit.

**(h) Special rules for taxable years 2018 through 2025**

**(1) In general** In the case of a taxable year beginning after December 31, 2017, and before January 1, 2026, this section shall be applied as provided in paragraphs (2) through (7).

**(2) Credit amount** Subsection (a) shall be applied by substituting “\$2,000” for “\$1,000”.

**(3) Limitation** In lieu of the amount determined under subsection (b)(2), the threshold amount shall be \$400,000 in the case of a joint return (\$200,000 in any other case).

**(4) Partial credit allowed for certain other dependents**

**(A) In general** The credit determined under subsection (a) (after the application of paragraph (2)) shall be increased by \$500 for each dependent of the taxpayer (as defined in section 152) other than a qualifying child described in subsection (c).

**(B) Exception for certain noncitizens** Subparagraph (A) shall not apply with respect to any individual who would not be a dependent if subparagraph (A) of section 152(b)(3) were applied without regard to all that follows “resident of the United States”.

**(C) Certain qualifying children** In the case of any qualifying child with respect to whom a credit is not allowed under this section by reason of paragraph (7), such child shall be treated as a dependent to whom subparagraph (A) applies.

**(5) Maximum amount of refundable credit**

**(A) In general** The amount determined under subsection (d)(1)(A) with respect to any qualifying child shall not exceed \$1,400, and such subsection shall be applied without regard to paragraph (4) of this subsection.

**(B) Adjustment for inflation** In the case of a taxable year beginning after 2018, the \$1,400 amount in subparagraph (A) shall be increased by an amount equal to—

**(i)** such dollar amount, multiplied by

**(ii)** the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting “2017” for “2016” in subparagraph (A)(ii) thereof.

If any increase under this clause is not a multiple of \$100, such increase shall be rounded to the next lowest multiple of \$100.

**(6) Earned income threshold for refundable credit** Subsection (d)(1)(B)(i) shall be applied by substituting “\$2,500” for “\$3,000”.

**(7) Social security number required** No credit shall be allowed under this section to a taxpayer with respect to any qualifying child unless the taxpayer includes the social security number of such child on the return of tax for the taxable year. For purposes of the preceding sentence, the term “social security number” means a social security number issued to an individual by the Social Security Administration, but only if the social security number is issued—

(A) to a citizen of the United States or pursuant to subclause (I) (or that portion of subclause (III) that relates to subclause (I)) of section 205(c)(2)(B)(i) of the Social Security Act, and

(B) before the due date for such return.

**(i) Special rules for 2021**

In the case of any taxable year beginning after December 31, 2020, and before January 1, 2022—

**(1) Refundable credit** If the taxpayer (in the case of a joint return, either spouse) has a principal place of abode in the United States (determined as provided in section 32) for more than one-half of the taxable year or is a bona fide resident of Puerto Rico (within the meaning of section 937(a)) for such taxable year—

(A) subsection (d) shall not apply, and

(B) so much of the credit determined under subsection (a) (after application of subparagraph (A)) as does not exceed the amount of such credit which would be so determined without regard to subsection (h)(4) shall be allowed under subpart C (and not allowed under this subpart).

**(2) 17-year-olds eligible for treatment as qualifying children** This section shall be applied—

(A) by substituting “age 18” for “age 17” in subsection (c)(1), and

(B) by substituting “described in subsection (c) (determined after the application of subsection (i)(2)(A))” for “described in subsection (c)” in subsection (h)(4)(A).

**(3) Credit amount** Subsection (h)(2) shall not apply and subsection (a) shall be applied by substituting “\$3,000 (\$3,600 in the case of a qualifying child who has not attained age 6 as of the close of the calendar year in which the taxable year of the taxpayer begins)” for “\$1,000”.

**(4) Reduction of increased credit amount based on modified adjusted gross income**

(A) **In general** The amount of the credit allowable under subsection (a) (determined without regard to subsection (b)) shall be reduced by \$50 for each \$1,000 (or fraction thereof) by which the taxpayer’s modified adjusted gross income (as defined in subsection (b)) exceeds the applicable threshold amount.

(B) **Applicable threshold amount** For purposes of this paragraph, the term “applicable threshold amount” means—

(i) \$150,000, in the case of a joint return or surviving spouse (as defined in section 2(a)),<sup>1</sup>

(ii) \$112,500, in the case of a head of household (as defined in section 2(b)), and

(iii) \$75,000, in any other case.

**(C) Limitation on reduction**

(i) **In general** The amount of the reduction under subparagraph (A) shall not exceed the lesser of—



- (I) the applicable credit increase amount, or
- (II) 5 percent of the applicable phaseout threshold range.

**(ii) Applicable credit increase amount** For purposes of this subparagraph, the term “applicable credit increase amount” means the excess (if any) of—

- (I) the amount of the credit allowable under this section for the taxable year determined without regard to this paragraph and subsection (b), over
- (II) the amount of such credit as so determined and without regard to paragraph (3).

**(iii) Applicable phaseout threshold range** For purposes of this subparagraph, the term “applicable phaseout threshold range” means the excess of—

- (I) the threshold amount applicable to the taxpayer under subsection (b) (determined after the application of subsection (h)(3)), over
- (II) the applicable threshold amount applicable to the taxpayer under this paragraph.

**(D) Coordination with limitation on overall credit** Subsection (b) shall be applied by substituting “the credit allowable under subsection (a) (determined after the application of subsection (i)(4)(A))” for “the credit allowable under subsection (a)”.

#### **(j) Reconciliation of credit and advance credit**

**(1) In general** The amount of the credit allowed under this section to any taxpayer for any taxable year shall be reduced (but not below zero) by the aggregate amount of payments made under section 7527A to such taxpayer during such taxable year. Any failure to so reduce the credit shall be treated as arising out of a mathematical or clerical error and assessed according to section 6213(b)(1).

##### **(2) Excess advance payments**

**(A) In general** If the aggregate amount of payments under section 7527A to the taxpayer during the taxable year exceeds the amount of the credit allowed under this section to such taxpayer for such taxable year (determined without regard to paragraph (1)), the tax imposed by this chapter for such taxable year shall be increased by the amount of such excess. Any failure to so increase the tax shall be treated as arising out of a mathematical or clerical error and assessed according to section 6213(b)(1).

##### **(B) Safe harbor based on modified adjusted gross income**

**(i) In general** In the case of a taxpayer whose modified adjusted gross income (as defined in subsection (b)) for the taxable year does not exceed 200 percent of the applicable income threshold, the amount of the increase determined under subparagraph (A) with respect to such taxpayer for such taxable year shall be reduced (but not below zero) by the safe harbor amount.

**(ii) Phase out of safe harbor amount** In the case of a taxpayer whose modified adjusted gross income (as defined in subsection (b)) for the taxable year exceeds the applicable income threshold, the safe harbor amount otherwise in effect under clause (i) shall be reduced by the amount which bears the same ratio to such amount as such excess bears to the applicable income threshold.

**(iii) Applicable income threshold** For purposes of this subparagraph, the term “applicable income threshold” means—

- (I)** \$60,000 in the case of a joint return or surviving spouse (as defined in section 2(a)),
- (II)** \$50,000 in the case of a head of household, and
- (III)** \$40,000 in any other case.

**(iv) Safe harbor amount** For purposes of this subparagraph, the term “safe harbor amount” means, with respect to any taxable year, the product of—

- (I)** \$2,000, multiplied by
- (II)** the excess (if any) of the number of qualified children taken into account in determining the annual advance amount with respect to the taxpayer under section 7527A with respect to months beginning in such taxable year, over the number of qualified children taken into account in determining the credit allowed under this section for such taxable year.

## **(k) Application of credit in possessions**

### **(1) Mirror code possessions**

**(A) In general** The Secretary shall pay to each possession of the United States with a mirror code tax system amounts equal to the loss (if any) to that possession by reason of the application of this section (determined without regard to this subsection) with respect to taxable years beginning after 2020. Such amounts shall be determined by the Secretary based on information provided by the government of the respective possession.

**(B) Coordination with credit allowed against United States income taxes** No credit shall be allowed under this section for any taxable year to any individual to whom a credit is allowable against taxes imposed by a possession of the United States with a mirror code tax system by reason of the application of this section in such possession for such taxable year.

**(C) Mirror code tax system** For purposes of this paragraph, the term “mirror code tax system” means, with respect to any possession of the United States, the income tax system of such possession if the income tax liability of the residents of such possession under such system is determined by reference to the income tax laws of the United States as if such possession were the United States.

### **(2) Puerto Rico**

#### **(A) Application to taxable years in 2021**

- (i)** For application of refundable credit to residents of Puerto Rico, see subsection (i)(1).
- (ii)** For nonapplication of advance payment to residents of Puerto Rico, see section 7527A(e)(4)(A).

**(B) Application to taxable years after 2021** In the case of any bona fide resident of Puerto Rico (within the meaning of section 937(a)) for any taxable year beginning after December 31, 2021—

- (i) the credit determined under this section shall be allowable to such resident, and
- (ii) subsection (d)(1)(B)(ii) shall be applied without regard to the phrase “in the case of a taxpayer with 3 or more qualifying children”.

### **(3) American Samoa**

**(A) In general** The Secretary shall pay to American Samoa amounts estimated by the Secretary as being equal to the aggregate benefits that would have been provided to residents of American Samoa by reason of the application of this section for taxable years beginning after 2020 if the provisions of this section had been in effect in American Samoa (applied as if American Samoa were the United States and without regard to the application of this section to bona fide residents of Puerto Rico under subsection (i)(1)).

**(B) Distribution requirement** Subparagraph (A) shall not apply unless American Samoa has a plan, which has been approved by the Secretary, under which American Samoa will promptly distribute such payments to its residents.

### **(C) Coordination with credit allowed against United States income taxes**

**(i) In general** In the case of a taxable year with respect to which a plan is approved under subparagraph (B), this section (other than this subsection) shall not apply to any individual eligible for a distribution under such plan.

**(ii) Application of section in event of absence of approved plan** In the case of a taxable year with respect to which a plan is not approved under subparagraph (B)—

**(I)** if such taxable year begins in 2021, subsection (i)(1) shall be applied by substituting “bona fide resident of Puerto Rico or American Samoa” for “bona fide resident of Puerto Rico”, and

**(II)** if such taxable year begins after December 31, 2021, rules similar to the rules of paragraph (2)(B) shall apply with respect to bona fide residents of American Samoa (within the meaning of section 937(a)).

**(4) Treatment of payments** For purposes of section 1324 of title 31, United States Code, the payments under this subsection shall be treated in the same manner as a refund due from a credit provision referred to in subsection (b)(2) of such section.

## **§32. EARNED INCOME**

### **(a) Allowance of credit**

**(1) In general** In the case of an eligible individual, there shall be allowed as a credit against the tax imposed by this subtitle for the taxable year an amount equal to the credit percentage of so much of the taxpayer’s earned income for the taxable year as does not exceed the earned income amount.

**(2) Limitation** The amount of the credit allowable to a taxpayer under paragraph (1) for any taxable year shall not exceed the excess (if any) of—

(A) the credit percentage of the earned income amount, over

(B) the phaseout percentage of so much of the adjusted gross income (or, if greater, the earned income) of the taxpayer for the taxable year as exceeds the phaseout amount.

## **(b) Percentages and amounts**

For purposes of subsection (a)—

**(1) Percentages** The credit percentage and the phaseout percentage shall be determined as follows:

<b>In the case of an eligible individual with:</b>	<b>The credit percentage is:</b>	<b>The phaseout percentage is:</b>
1 qualifying child	34	15.98
2 qualifying children	40	21.06
3 or more qualifying children	45	21.06
No qualifying children	7.65	7.65

## **(2) Amounts**

**(A) In general** Subject to subparagraph (B), the earned income amount and the phaseout amount shall be determined as follows:

<b>In the case of an eligible individual with:</b>	<b>The earned income amount is:</b>	<b>The phaseout amount is:</b>
1 qualifying child	\$6,330	\$11,610
2 or more qualifying children	\$8,890	\$11,610
No qualifying children	\$4,220	\$5,280

**(B) Joint returns** In the case of a joint return filed by an eligible individual and such individual's spouse, the phaseout amount determined under subparagraph (A) shall be increased by \$5,000.

## **(c) Definitions and special rules**

For purposes of this section—

### **(1) Eligible individual**

**(A) In general** The term “eligible individual” means—

- (i) any individual who has a qualifying child for the taxable year, or

- (ii) any other individual who does not have a qualifying child for the taxable year, if—
  - (I) such individual’s principal place of abode is in the United States for more than one-half of such taxable year,
  - (II) such individual (or, if the individual is married, either the individual or the individual’s spouse) has attained age 25 but not attained age 65 before the close of the taxable year, and
  - (III) such individual is not a dependent for whom a deduction is allowable under section 151 to another taxpayer for any taxable year beginning in the same calendar year as such taxable year.

**(B) Qualifying child ineligible** If an individual is the qualifying child of a taxpayer for any taxable year of such taxpayer beginning in a calendar year, such individual shall not be treated as an eligible individual for any taxable year of such individual beginning in such calendar year.

**(C) Exception for individual claiming benefits under section 911** The term “eligible individual” does not include any individual who claims the benefits of section 911 (relating to citizens or residents living abroad) for the taxable year.

**(D) Limitation on eligibility of nonresident aliens** The term “eligible individual” shall not include any individual who is a nonresident alien individual for any portion of the taxable year unless such individual is treated for such taxable year as a resident of the United States for purposes of this chapter by reason of an election under subsection (g) or (h) of section 6013.

**(E) Identification number requirement** No credit shall be allowed under this section to an eligible individual who does not include on the return of tax for the taxable year—

- (i) such individual’s taxpayer identification number, and
- (ii) if the individual is married, the taxpayer identification number of such individual’s spouse.

## **(2) Earned income**

**(A)** The term “earned income” means—

- (i) wages, salaries, tips, and other employee compensation, but only if such amounts are includible in gross income for the taxable year, plus
- (ii) the amount of the taxpayer’s net earnings from self-employment for the taxable year (within the meaning of section 1402(a)), but such net earnings shall be determined with regard to the deduction allowed to the taxpayer by section 164(f).

**(B)** For purposes of subparagraph (A)—

- (i) the earned income of an individual shall be computed without regard to any community property laws,
- (ii) no amount received as a pension or annuity shall be taken into account,
- (iii) no amount to which section 871(a) applies (relating to income of nonresident alien individuals not connected with United States business) shall be taken into account,

(iv) no amount received for services provided by an individual while the individual is an inmate at a penal institution shall be taken into account,

(v) no amount described in subparagraph (A) received for service performed in work activities as defined in paragraph (4) or (7) of section 407(d) of the Social Security Act to which the taxpayer is assigned under any State program under part A of title IV of such Act shall be taken into account, but only to the extent such amount is subsidized under such State program, and

(vi) a taxpayer may elect to treat amounts excluded from gross income by reason of section 112 as earned income.

### **(3) Qualifying child**

**(A) In general** The term “qualifying child” means a qualifying child of the taxpayer (as defined in section 152(c), determined without regard to paragraph (1)(D) thereof and section 152(e)).

**(B) Married individual** The term “qualifying child” shall not include an individual who is married as of the close of the taxpayer’s taxable year unless the taxpayer is entitled to a deduction under section 151 for such taxable year with respect to such individual (or would be so entitled but for section 152(e)).

**(C) Place of abode** For purposes of subparagraph (A), the requirements of section 152(c)(1)(B) shall be met only if the principal place of abode is in the United States.

#### **(D) Identification requirements**

**(i) In general** A qualifying child shall not be taken into account under subsection (b) unless the taxpayer includes the name, age, and TIN of the qualifying child on the return of tax for the taxable year.

**(ii) Other methods** The Secretary may prescribe other methods for providing the information described in clause (i).

**(4) Treatment of military personnel stationed outside the United States** For purposes of paragraphs (1)(A)(ii)(I) and (3)(C), the principal place of abode of a member of the Armed Forces of the United States shall be treated as in the United States during any period during which such member is stationed outside the United States while serving on extended active duty with the Armed Forces of the United States. For purposes of the preceding sentence, the term “extended active duty” means any period of active duty pursuant to a call or order to such duty for a period in excess of 90 days or for an indefinite period.

### **(i) Denial of credit for individuals having excessive investment income**

**(1) In general** No credit shall be allowed under subsection (a) for the taxable year if the aggregate amount of disqualified income of the taxpayer for the taxable year exceeds \$10,000.

**(2) Disqualified income** For purposes of paragraph (1), the term “disqualified income” means

—  
**(A)** interest or dividends to the extent includible in gross income for the taxable year,

(B) interest received or accrued during the taxable year which is exempt from tax imposed by this chapter,

(C) the excess (if any) of—

(i) gross income from rents or royalties not derived in the ordinary course of a trade or business, over

(ii) the sum of—

(I) the deductions (other than interest) which are clearly and directly allocable to such gross income, plus

(II) interest deductions properly allocable to such gross income,

(D) the capital gain net income (as defined in section 1222) of the taxpayer for such taxable year, and

(E) the excess (if any) of—

(i) the aggregate income from all passive activities for the taxable year (determined without regard to any amount included in earned income under subsection (c)(2) or described in a preceding subparagraph), over

(ii) the aggregate losses from all passive activities for the taxable year (as so determined).

For purposes of subparagraph (E), the term “passive activity” has the meaning given such term by section 469.

## **§61. GROSS INCOME DEFINED**

### **(a) General definition**

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, fringe benefits, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Annuities;

(9) Income from life insurance and endowment contracts;

- (10) Pensions;
- (11) Income from discharge of indebtedness;
- (12) Distributive share of partnership gross income;
- (13) Income in respect of a decedent; and
- (14) Income from an interest in an estate or trust.

**(b) Cross references**

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

## **§62. ADJUSTED GROSS INCOME DEFINED**

**(a) General rule**

For purposes of this subtitle, the term “adjusted gross income” means, in the case of an individual, gross income minus the following deductions:

**(1) Trade and business deductions** The deductions allowed by this chapter (other than by part VII of this subchapter) which are attributable to a trade or business carried on by the taxpayer, if such trade or business does not consist of the performance of services by the taxpayer as an employee.

**(2) Certain trade and business deductions of employees**

**(A) Reimbursed expenses of employees** The deductions allowed by part VI (section 161 and following) which consist of expenses paid or incurred by the taxpayer, in connection with the performance by him of services as an employee, under a reimbursement or other expense allowance arrangement with his employer. The fact that the reimbursement may be provided by a third party shall not be determinative of whether or not the preceding sentence applies.

**(B) Certain expenses of performing artists** The deductions allowed by section 162 which consist of expenses paid or incurred by a qualified performing artist in connection with the performances by him of services in the performing arts as an employee.

**(C) Certain expenses of officials** The deductions allowed by section 162 which consist of expenses paid or incurred with respect to services performed by an official as an employee of a State or a political subdivision thereof in a position compensated in whole or in part on a fee basis.

**(D) Certain expenses of elementary and secondary school teachers** The deductions allowed by section 162 which consist of expenses, not in excess of \$250, paid or incurred by an eligible educator—

- (i)** by reason of the participation of the educator in professional development courses related to the curriculum in which the educator provides instruction or to the students for



which the educator provides instruction, and

(ii) in connection with books, supplies (other than nonathletic supplies for courses of instruction in health or physical education), computer equipment (including related software and services) and other equipment, and supplementary materials used by the eligible educator in the classroom.

**(E) Certain expenses of members of reserve components of the Armed Forces of the United States** The deductions allowed by section 162 which consist of expenses, determined at a rate not in excess of the rates for travel expenses (including per diem in lieu of subsistence) authorized for employees of agencies under subchapter I of chapter 57 of title 5, United States Code, paid or incurred by the taxpayer in connection with the performance of services by such taxpayer as a member of a reserve component of the Armed Forces of the United States for any period during which such individual is more than 100 miles away from home in connection with such services.

**(3) Losses from sale or exchange of property** The deductions allowed by part VI (sec. 161 and following) as losses from the sale or exchange of property.

**(4) Deductions attributable to rents and royalties** The deductions allowed by part VI (sec. 161 and following), by section 212 (relating to expenses for production of income), and by section 611 (relating to depletion) which are attributable to property held for the production of rents or royalties.

**(5) Certain deductions of life tenants and income beneficiaries of property** In the case of a life tenant of property, or an income beneficiary of property held in trust, or an heir, legatee, or devisee of an estate, the deduction for depreciation allowed by section 167 and the deduction allowed by section 611.

**(6) Pension, profit-sharing, and annuity plans of self-employed individuals** In the case of an individual who is an employee within the meaning of section 401(c)(1), the deduction allowed by section 404.

**(7) Retirement savings** The deduction allowed by section 219 (relating to deduction of certain retirement savings).

**[(8) Repealed. Pub. L. 104–188, title I, §1401(b)(4), Aug. 20, 1996, 110 Stat. 1788]**

**(9) Penalties forfeited because of premature withdrawal of funds from time savings accounts or deposits** The deductions allowed by section 165 for losses incurred in any transaction entered into for profit, though not connected with a trade or business, to the extent that such losses include amounts forfeited to a bank, mutual savings bank, savings and loan association, building and loan association, cooperative bank or homestead association as a penalty for premature withdrawal of funds from a time savings account, certificate of deposit, or similar class of deposit.

**[(10) Repealed. Pub. L. 115–97, title I, §11051(b)(2)(A), Dec. 22, 2017, 131 Stat. 2089]**

**(11) Reforestation expenses** The deduction allowed by section 194.

**(12) Certain required repayments of supplemental unemployment compensation benefits** The deduction allowed by section 165 for the repayment to a trust described in paragraph (9) or (17) of section 501(c) of supplemental unemployment compensation benefits received from such

trust if such repayment is required because of the receipt of trade readjustment allowances under section 231 or 232 of the Trade Act of 1974 (19 U.S.C. 2291 and 2292).

**(13) Jury duty pay remitted to employer** Any deduction allowable under this chapter by reason of an individual remitting any portion of any jury pay to such individual's employer in exchange for payment by the employer of compensation for the period such individual was performing jury duty. For purposes of the preceding sentence, the term "jury pay" means any payment received by the individual for the discharge of jury duty.

**[(14) Repealed. Pub. L. 113–295, div. A, title II, §221(a)(34)(C), Dec. 19, 2014, 128 Stat. 4042]**

**(15) Moving expenses** The deduction allowed by section 217.

**(16) Archer MSAs** The deduction allowed by section 220.

**(17) Interest on education loans** The deduction allowed by section 221.

**[(18) Repealed. Pub. L. 116–260, div. EE, title I, §104(b)(2)(A), Dec. 27, 2020, 134 Stat. 3041]**

**(19) Health savings accounts** The deduction allowed by section 223.

**(20) Costs involving discrimination suits, etc.** Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any action involving a claim of unlawful discrimination (as defined in subsection (e)) or a claim of a violation of subchapter III of chapter 37 of title 31, United States Code, or a claim made under section 1862(b)(3)(A) of the Social Security Act (42 U.S.C. 1395y(b)(3)(A)). The preceding sentence shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of a judgment or settlement (whether by suit or agreement and whether as lump sum or periodic payments) resulting from such claim.

**(21) Attorneys' fees relating to awards to whistleblowers**

**(A) In general** Any deduction allowable under this chapter for attorney fees and court costs paid by, or on behalf of, the taxpayer in connection with any award under—

**(i)** section 7623(b), or

**(ii)** in the case of taxable years beginning after December 31, 2017, any action brought under—

**(I)** section 21F of the Securities Exchange Act of 1934 (15 U.S.C. 78u–6),

**(II)** a State false claims act, including a State false claims act with qui tam provisions, or

**(III)** section 23 of the Commodity Exchange Act (7 U.S.C. 26).

**(B) May not exceed award** Subparagraph (A) shall not apply to any deduction in excess of the amount includible in the taxpayer's gross income for the taxable year on account of such award.

Nothing in this section shall permit the same item to be deducted more than once. Any deduction allowed by section 199A shall not be treated as a deduction described in any of the preceding

paragraphs of this subsection.

**(b) Qualified performing artist**

**(1) In general** For purposes of subsection (a)(2)(B), the term “qualified performing artist” means, with respect to any taxable year, any individual if—

(A) such individual performed services in the performing arts as an employee during the taxable year for at least 2 employers,

(B) the aggregate amount allowable as a deduction under section 162 in connection with the performance of such services exceeds 10 percent of such individual’s gross income attributable to the performance of such services, and

(C) the adjusted gross income of such individual for the taxable year (determined without regard to subsection (a)(2)(B)) does not exceed \$16,000.

**(2) Nominal employer not taken into account** An individual shall not be treated as performing services in the performing arts as an employee for any employer during any taxable year unless the amount received by such individual from such employer for the performance of such services during the taxable year equals or exceeds \$200.

**(3) Special rules for married couples**

**(A) In general** Except in the case of a husband and wife who lived apart at all times during the taxable year, if the taxpayer is married at the close of the taxable year, subsection (a)(2)(B) shall apply only if the taxpayer and his spouse file a joint return for the taxable year.

**(B) Application of paragraph (1)** In the case of a joint return—

(i) paragraph (1) (other than subparagraph (C) thereof) shall be applied separately with respect to each spouse, but

(ii) paragraph (1)(C) shall be applied with respect to their combined adjusted gross income.

**(C) Determination of marital status** For purposes of this subsection, marital status shall be determined under section 7703(a).

**(D) Joint return** For purposes of this subsection, the term “joint return” means the joint return of a husband and wife made under section 6013.

**(c) Certain arrangements not treated as reimbursement arrangements**

For purposes of subsection (a)(2)(A), an arrangement shall in no event be treated as a reimbursement or other expense allowance arrangement if—

(1) such arrangement does not require the employee to substantiate the expenses covered by the arrangement to the person providing the reimbursement, or

(2) such arrangement provides the employee the right to retain any amount in excess of the substantiated expenses covered under the arrangement.

The substantiation requirements of the preceding sentence shall not apply to any expense to the

extent that substantiation is not required under section 274(d) for such expense by reason of the regulations prescribed under the 2nd sentence thereof.

**(d) Definition; special rules**

**(1) Eligible educator**

**(A) In general** For purposes of subsection (a)(2)(D), the term “eligible educator” means, with respect to any taxable year, an individual who is a kindergarten through grade 12 teacher, instructor, counselor, principal, or aide in a school for at least 900 hours during a school year.

**(B) School** The term “school” means any school which provides elementary education or secondary education (kindergarten through grade 12), as determined under State law.

**(2) Coordination with exclusions** A deduction shall be allowed under subsection (a)(2)(D) for expenses only to the extent the amount of such expenses exceeds the amount excludable under section 135, 529(c)(1), or 530(d)(2) for the taxable year.

**(3) Inflation adjustment** In the case of any taxable year beginning after 2015, the \$250 amount in subsection (a)(2)(D) shall be increased by an amount equal to—

**(A)** such dollar amount, multiplied by

**(B)** the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting “calendar year 2014” for “calendar year 2016” in subparagraph (A)(ii) thereof.

Any increase determined under the preceding sentence shall be rounded to the nearest multiple of \$50.

**(e) Unlawful discrimination defined**

For purposes of subsection (a)(20), the term “unlawful discrimination” means an act that is unlawful under any of the following:

**(1)** Section 302 of the Civil Rights Act of 1991 (42 U.S.C. 2000e–16b).

**(2)** Section 201, 202, 203, 204, 205, 206, 207, or 208 of the Congressional Accountability Act of 1995 (2 U.S.C. 1311, 1312, 1313, 1314, 1315, 1316, or 1317).<sup>1</sup>

**(3)** The National Labor Relations Act (29 U.S.C. 151 et seq.).

**(4)** The Fair Labor Standards Act of 1938 (29 U.S.C. 201 et seq.).

**(5)** Section 4 or 15 of the Age Discrimination in Employment Act of 1967 (29 U.S.C. 623 or 633a).

**(6)** Section 501 or 504 of the Rehabilitation Act of 1973 (29 U.S.C. 791 or 794).

**(7)** Section 510 of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1140).

**(8)** Title IX of the Education Amendments of 1972 (20 U.S.C. 1681 et seq.).

**(9)** The Employee Polygraph Protection Act of 1988 (29 U.S.C. 2001 et seq.).

- (10) The Worker Adjustment and Retraining Notification Act (29 U.S.C. 2102 et seq.).
- (11) Section 105 of the Family and Medical Leave Act of 1993 (29 U.S.C. 2615).
- (12) Chapter 43 of title 38, United States Code (relating to employment and reemployment rights of members of the uniformed services).
- (13) Section 1977, 1979, or 1980 of the Revised Statutes (42 U.S.C. 1981, 1983, or 1985).
- (14) Section 703, 704, or 717 of the Civil Rights Act of 1964 (42 U.S.C. 2000e–2, 2000e–3, or 2000e–16).
- (15) Section 804, 805, 806, 808, or 818 of the Fair Housing Act (42 U.S.C. 3604, 3605, 3606, 3608, or 3617).
- (16) Section 102, 202, 302, or 503 of the Americans with Disabilities Act of 1990 (42 U.S.C. 12112, 12132, 12182, or 12203).
- (17) Any provision of Federal law (popularly known as whistleblower protection provisions) prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted under Federal law.
- (18) Any provision of Federal, State, or local law, or common law claims permitted under Federal, State, or local law—
  - (i) providing for the enforcement of civil rights, or
  - (ii) regulating any aspect of the employment relationship, including claims for wages, compensation, or benefits, or prohibiting the discharge of an employee, the discrimination against an employee, or any other form of retaliation or reprisal against an employee for asserting rights or taking other actions permitted by law.

## **§63. TAXABLE INCOME DEFINED**

### **(a) In general**

Except as provided in subsection (b), for purposes of this subtitle, the term “taxable income” means gross income minus the deductions allowed by this chapter (other than the standard deduction).

### **(b) Individuals who do not itemize their deductions**

In the case of an individual who does not elect to itemize his deductions for the taxable year, for purposes of this subtitle, the term “taxable income” means adjusted gross income, minus—

- (1) the standard deduction,
- (2) the deduction for personal exemptions provided in section 151,
- (3) any deduction provided in section 199A, and

(4) the deduction provided in section 170(p).

**(c) Standard deduction**

For purposes of this subtitle—

**(1) In general** Except as otherwise provided in this subsection, the term “standard deduction” means the sum of—

- (A) the basic standard deduction, and
- (B) the additional standard deduction.

**(2) Basic standard deduction** For purposes of paragraph (1), the basic standard deduction is—

(A) 200 percent of the dollar amount in effect under subparagraph (C) for the taxable year in the case of—

- (i) a joint return, or
- (ii) a surviving spouse (as defined in section 2(a)),

(B) \$4,400 in the case of a head of household (as defined in section 2(b)), or

(C) \$3,000 in any other case.

**(3) Additional standard deduction for aged and blind** For purposes of paragraph (1), the additional standard deduction is the sum of each additional amount to which the taxpayer is entitled under subsection (f).

**(4) Adjustments for inflation** In the case of any taxable year beginning in a calendar year after 1988, each dollar amount contained in paragraph (2)(B), (2)(C), or (5) or subsection (f) shall be increased by an amount equal to—

(A) such dollar amount, multiplied by

(B) the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting for “calendar year 2016” in subparagraph (A) (ii) thereof—

(i) “calendar year 1987” in the case of the dollar amounts contained in paragraph (2)(B), (2)(C), or (5)(A) or subsection (f), and

(ii) “calendar year 1997” in the case of the dollar amount contained in paragraph (5)(B).

**(5) Limitation on basic standard deduction in the case of certain dependents** In the case of an individual with respect to whom a deduction under section 151 is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual’s taxable year begins, the basic standard deduction applicable to such individual for such individual’s taxable year shall not exceed the greater of—

(A) \$500, or

(B) the sum of \$250 and such individual’s earned income.

**(6) Certain individuals, etc., not eligible for standard deduction** In the case of—

- (A) a married individual filing a separate return where either spouse itemizes deductions,
  - (B) a nonresident alien individual,
  - (C) an individual making a return under section 443(a)(1) for a period of less than 12 months on account of a change in his annual accounting period, or
  - (D) an estate or trust, common trust fund, or partnership,
- the standard deduction shall be zero.

**(7) Special rules for taxable years 2018 through 2025** In the case of a taxable year beginning after December 31, 2017, and before January 1, 2026—

**(A) Increase in standard deduction** Paragraph (2) shall be applied—

- (i) by substituting “\$18,000” for “\$4,400” in subparagraph (B), and
- (ii) by substituting “\$12,000” for “\$3,000” in subparagraph (C).

**(B) Adjustment for inflation**

**(i) In general** Paragraph (4) shall not apply to the dollar amounts contained in paragraphs (2)(B) and (2)(C).

**(ii) Adjustment of increased amounts** In the case of a taxable year beginning after 2018, the \$18,000 and \$12,000 amounts in subparagraph (A) shall each be increased by an amount equal to—

**(I)** such dollar amount, multiplied by

**(II)** the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, determined by substituting “2017” for “2016” in subparagraph (A)(ii) thereof.

If any increase under this clause is not a multiple of \$50, such increase shall be rounded to the next lowest multiple of \$50.

**(d) Itemized deductions**

For purposes of this subtitle, the term “itemized deductions” means the deductions allowable under this chapter other than—

- (1) the deductions allowable in arriving at adjusted gross income, and
- (2) any deduction referred to in any paragraph of subsection (b).

**(e) Election to itemize**

**(1) In general** Unless an individual makes an election under this subsection for the taxable year, no itemized deduction shall be allowed for the taxable year. For purposes of this subtitle, the determination of whether a deduction is allowable under this chapter shall be made without regard to the preceding sentence.

**(2) Time and manner of election** Any election under this subsection shall be made on the taxpayer’s return, and the Secretary shall prescribe the manner of signifying such election on

the return.

**(3) Change of election** Under regulations prescribed by the Secretary, a change of election with respect to itemized deductions for any taxable year may be made after the filing of the return for such year. If the spouse of the taxpayer filed a separate return for any taxable year corresponding to the taxable year of the taxpayer, the change shall not be allowed unless, in accordance with such regulations—

(A) the spouse makes a change of election with respect to itemized deductions, for the taxable year covered in such separate return, consistent with the change of treatment sought by the taxpayer, and

(B) the taxpayer and his spouse consent in writing to the assessment (within such period as may be agreed on with the Secretary) of any deficiency, to the extent attributable to such change of election, even though at the time of the filing of such consent the assessment of such deficiency would otherwise be prevented by the operation of any law or rule of law. This paragraph shall not apply if the tax liability of the taxpayer's spouse for the taxable year corresponding to the taxable year of the taxpayer has been compromised under section 7122.

**(f) Aged or blind additional amounts**

**(1) Additional amounts for the aged** The taxpayer shall be entitled to an additional amount of \$600—

(A) for himself if he has attained age 65 before the close of his taxable year, and

(B) for the spouse of the taxpayer if the spouse has attained age 65 before the close of the taxable year and an additional exemption is allowable to the taxpayer for such spouse under section 151(b).

**(2) Additional amount for blind** The taxpayer shall be entitled to an additional amount of \$600—

(A) for himself if he is blind at the close of the taxable year, and

(B) for the spouse of the taxpayer if the spouse is blind as of the close of the taxable year and an additional exemption is allowable to the taxpayer for such spouse under section 151(b).

For purposes of subparagraph (B), if the spouse dies during the taxable year the determination of whether such spouse is blind shall be made as of the time of such death.

**(3) Higher amount for certain unmarried individuals** In the case of an individual who is not married and is not a surviving spouse, paragraphs (1) and (2) shall be applied by substituting "\$750" for "\$600".

**(4) Blindness defined** For purposes of this subsection, an individual is blind only if his central visual acuity does not exceed 20/200 in the better eye with correcting lenses, or if his visual acuity is greater than 20/200 but is accompanied by a limitation in the fields of vision such that the widest diameter of the visual field subtends an angle no greater than 20 degrees.

**(g) Marital status**



For purposes of this section, marital status shall be determined under section 7703.

## **§67. 2-PERCENT FLOOR ON MISCELLANEOUS ITEMIZED DEDUCTIONS**

### **(a) General rule**

In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.

### **(b) Miscellaneous itemized deductions**

For purposes of this section, the term “miscellaneous itemized deductions” means the itemized deductions other than—

- (1) the deduction under section 163 (relating to interest),
- (2) the deduction under section 164 (relating to taxes),
- (3) the deduction under section 165(a) for casualty or theft losses described in paragraph (2) or (3) of section 165(c) or for losses described in section 165(d),
- (4) the deductions under section 170 (relating to charitable, etc., contributions and gifts) and section 642(c) (relating to deduction for amounts paid or permanently set aside for a charitable purpose),
- (5) the deduction under section 213 (relating to medical, dental, etc., expenses),
- (6) any deduction allowable for impairment-related work expenses,
- (7) the deduction under section 691(c) (relating to deduction for estate tax in case of income in respect of the decedent),
- (8) any deduction allowable in connection with personal property used in a short sale,
- (9) the deduction under section 1341 (relating to computation of tax where taxpayer restores substantial amount held under claim of right),
- (10) the deduction under section 72(b)(3) (relating to deduction where annuity payments cease before investment recovered),
- (11) the deduction under section 171 (relating to deduction for amortizable bond premium), and
- (12) the deduction under section 216 (relating to deductions in connection with cooperative housing corporations).

### **(c) Disallowance of indirect deduction through pass-thru entity**

(1) **In general** The Secretary shall prescribe regulations which prohibit the indirect deduction through pass-thru entities of amounts which are not allowable as a deduction if paid or incurred

directly by an individual and which contain such reporting requirements as may be necessary to carry out the purposes of this subsection.

**(2) Treatment of publicly offered regulated investment companies**

**(A) In general** Paragraph (1) shall not apply with respect to any publicly offered regulated investment company.

**(B) Publicly offered regulated investment companies** For purposes of this subsection—

**(i) In general** The term “publicly offered regulated investment company” means a regulated investment company the shares of which are—

**(I)** continuously offered pursuant to a public offering (within the meaning of section 4 of the Securities Act of 1933, as amended (15 U.S.C. 77a to 77aa)),

**(II)** regularly traded on an established securities market, or

**(III)** held by or for no fewer than 500 persons at all times during the taxable year.

**(ii) Secretary may reduce 500 person requirement** The Secretary may by regulation decrease the minimum shareholder requirement of clause (i)(III) in the case of regulated investment companies which experience a loss of shareholders through net redemptions of their shares.

**(3) Treatment of certain other entities** Paragraph (1) shall not apply—

**(A)** with respect to cooperatives and real estate investment trusts, and

**(B)** except as provided in regulations, with respect to estates and trusts.

**(d) Impairment-related work expenses**

For purposes of this section, the term “impairment-related work expenses” means expenses—

**(1)** of a handicapped individual (as defined in section 190(b)(3)) for attendant care services at the individual’s place of employment and other expenses in connection with such place of employment which are necessary for such individual to be able to work, and

**(2)** with respect to which a deduction is allowable under section 162 (determined without regard to this section).

**(e) Determination of adjusted gross income in case of estates and trusts**

For purposes of this section, the adjusted gross income of an estate or trust shall be computed in the same manner as in the case of an individual, except that—

**(1)** the deductions for costs which are paid or incurred in connection with the administration of the estate or trust and which would not have been incurred if the property were not held in such trust or estate, and

**(2)** the deductions allowable under sections 642(b), 651, and 661, shall be treated as allowable in arriving at adjusted gross income. Under regulations, appropriate adjustments shall be made in the application of part I of subchapter J of this chapter to take into account the provisions of this section.

**(f) Coordination with other limitation**

This section shall be applied before the application of the dollar limitation of the second sentence of section 162(a) (relating to trade or business expenses).

**(g) Suspension for taxable years 2018 through 2025**

Notwithstanding subsection (a), no miscellaneous itemized deduction shall be allowed for any taxable year beginning after December 31, 2017, and before January 1, 2026.

**§83. PROPERTY TRANSFERRED IN CONNECTION WITH PERFORMANCE OF SERVICES**

**(a) General rule**

If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property, shall be included in the gross income of the person who performed such services in the first taxable year in which the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever is applicable. The preceding sentence shall not apply if such person sells or otherwise disposes of such property in an arm's length transaction before his rights in such property become transferable or not subject to a substantial risk of forfeiture.

**(b) Election to include in gross income in year of transfer**

(1) **In general** Any person who performs services in connection with which property is transferred to any person may elect to include in his gross income for the taxable year in which such property is transferred, the excess of—

(A) the fair market value of such property at the time of transfer (determined without regard to any restriction other than a restriction which by its terms will never lapse), over

(B) the amount (if any) paid for such property.

If such election is made, subsection (a) shall not apply with respect to the transfer of such property, and if such property is subsequently forfeited, no deduction shall be allowed in respect of such forfeiture.

(2) **Election** An election under paragraph (1) with respect to any transfer of property shall be made in such manner as the Secretary prescribes and shall be made not later than 30 days after the date of such transfer. Such election may not be revoked except with the consent of the

Secretary.

**(c) Special rules**

For purposes of this section—

**(1) Substantial risk of forfeiture** The rights of a person in property are subject to a substantial risk of forfeiture if such person's rights to full enjoyment of such property are conditioned upon the future performance of substantial services by any individual.

**(2) Transferability of property** The rights of a person in property are transferable only if the rights in such property of any transferee are not subject to a substantial risk of forfeiture.

**(3) Sales which may give rise to suit under section 16(b) of the Securities Exchange Act of 1934** So long as the sale of property at a profit could subject a person to suit under section 16(b) of the Securities Exchange Act of 1934, such person's rights in such property are—

**(A)** subject to a substantial risk of forfeiture, and

**(B)** not transferable.

**(4)** For purposes of determining an individual's basis in property transferred in connection with the performance of services, rules similar to the rules of section 72(w) shall apply.

**(e) Applicability of section**

This section shall not apply to—

**(1)** a transaction to which section 421 applies,

**(2)** a transfer to or from a trust described in section 401(a) or a transfer under an annuity plan which meets the requirements of section 404(a)(2),

**(3)** the transfer of an option without a readily ascertainable fair market value,

**(4)** the transfer of property pursuant to the exercise of an option with a readily ascertainable fair market value at the date of grant, or

**(5)** group-term life insurance to which section 79 applies.

**(h) Deduction by employer**

In the case of a transfer of property to which this section applies or a cancellation of a restriction described in subsection (d), there shall be allowed as a deduction under section 162, to the person for whom were performed the services in connection with which such property was transferred, an amount equal to the amount included under subsection (a), (b), or (d)(2) in the gross income of the person who performed such services. Such deduction shall be allowed for the taxable year of such person in which or with which ends the taxable year in which such amount is included in the gross income of the person who performed such services.

## **§102. GIFTS AND INHERITANCES**

**(a) General rule**

Gross income does not include the value of property acquired by gift, bequest, devise, or inheritance.

**(b) Income**

Subsection (a) shall not exclude from gross income—

(1) the income from any property referred to in subsection (a); or

(2) where the gift, bequest, devise, or inheritance is of income from property, the amount of such income.

Where, under the terms of the gift, bequest, devise, or inheritance, the payment, crediting, or distribution thereof is to be made at intervals, then, to the extent that it is paid or credited or to be distributed out of income from property, it shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property. Any amount included in the gross income of a beneficiary under subchapter J shall be treated for purposes of paragraph (2) as a gift, bequest, devise, or inheritance of income from property.

**(c) Employee gifts**

(1) **In general** Subsection (a) shall not exclude from gross income any amount transferred by or for an employer to, or for the benefit of, an employee.

(2) **Cross references** For provisions excluding certain employee achievement awards from gross income, see section 74(c). For provisions excluding certain de minimis fringes from gross income, see section 132(e).

## **§103. INTEREST ON STATE AND LOCAL BONDS**

**(a) Exclusion**

Except as provided in subsection (b), gross income does not include interest on any State or local bond.

**(c) Definitions**

For purposes of this section and part IV—

(1) **State or local bond** The term “State or local bond” means an obligation of a State or political subdivision thereof.

(2) **State** The term “State” includes the District of Columbia and any possession of the United States.

## **§104. COMPENSATION FOR INJURIES OR SICKNESS**

**(a) In general**

Except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc., expenses) for any prior taxable year, gross income does not include—

- (1) amounts received under workmen's compensation acts as compensation for personal injuries or sickness;
- (2) the amount of any damages (other than punitive damages) received (whether by suit or agreement and whether as lump sums or as periodic payments) on account of personal physical injuries or physical sickness;
- (3) amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer);
- (4) amounts received as a pension, annuity, or similar allowance for personal injuries or sickness resulting from active service in the armed forces of any country or in the Coast and Geodetic Survey or the Public Health Service, or as a disability annuity payable under the provisions of section 808 of the Foreign Service Act of 1980;
- (5) amounts received by an individual as disability income attributable to injuries incurred as a direct result of a terroristic or military action (as defined in section 692(c)(2)); and
- (6) amounts received pursuant to—
  - (A) section 1201 of the Omnibus Crime Control and Safe Streets Act of 1968 (42 U.S.C. 3796);<sup>1</sup> or
  - (B) a program established under the laws of any State which provides monetary compensation for surviving dependents of a public safety officer who has died as the direct and proximate result of a personal injury sustained in the line of duty, except that subparagraph (B) shall not apply to any amounts that would have been payable if death of the public safety officer had occurred other than as the direct and proximate result of a personal injury sustained in the line of duty.

For purposes of paragraph (3), in the case of an individual who is, or has been, an employee within the meaning of section 401(c)(1) (relating to self-employed individuals), contributions made on behalf of such individual while he was such an employee to a trust described in section 401(a) which is exempt from tax under section 501(a), or under a plan described in section 403(a), shall, to the extent allowed as deductions under section 404, be treated as contributions by the employer which were not includible in the gross income of the employee. For purposes of paragraph (2), emotional distress shall not be treated as a physical injury or physical sickness. The preceding sentence shall not apply to an amount of damages not in excess of the amount paid for medical care (described in subparagraph (A) or (B) of section 213(d)(1)) attributable to emotional distress.

## §108. INCOME FROM DISCHARGE OF INDEBTEDNESS

### (a) Exclusion from gross income

(1) **In general** Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if—

- (A) the discharge occurs in a title 11 case,
- (B) the discharge occurs when the taxpayer is insolvent,
- (C) the indebtedness discharged is qualified farm indebtedness,
- (D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, or
- (E) the indebtedness discharged is qualified principal residence indebtedness which is discharged—
  - (i) before January 1, 2026, or
  - (ii) subject to an arrangement that is entered into and evidenced in writing before January 1, 2026.

### (2) Coordination of exclusions

(A) **Title 11 exclusion takes precedence** Subparagraphs (B), (C), (D), and (E) of paragraph (1) shall not apply to a discharge which occurs in a title 11 case.

(B) **Insolvency exclusion takes precedence over qualified farm exclusion and qualified real property business exclusion** Subparagraphs (C) and (D) of paragraph (1) shall not apply to a discharge to the extent the taxpayer is insolvent.

(C) **Principal residence exclusion takes precedence over insolvency exclusion unless elected otherwise** Paragraph (1)(B) shall not apply to a discharge to which paragraph (1)(E) applies unless the taxpayer elects to apply paragraph (1)(B) in lieu of paragraph (1)(E).

(3) **Insolvency exclusion limited to amount of insolvency** In the case of a discharge to which paragraph (1)(B) applies, the amount excluded under paragraph (1)(B) shall not exceed the amount by which the taxpayer is insolvent.

### (b) Reduction of tax attributes

(1) **In general** The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) **Tax attributes affected; order of reduction** Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) **NOL** Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) **General business credit** Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable as a credit under section 38 (relating to general business credit).

(C) **Minimum tax credit** The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) **Capital loss carryovers** Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

**(E) Basis reduction**

(i) **In general** The basis of the property of the taxpayer.

(ii) **Cross reference** For provisions for making the reduction described in clause (i), see section 1017.

(F) **Passive activity loss and credit carryovers** Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.

(G) **Foreign tax credit carryovers** Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

**(3) Amount of reduction**

(A) **In general** Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

(B) **Credit carryover reduction** The reductions described in subparagraphs (B), (C), and (G) shall be 33 $\frac{1}{3}$  cents for each dollar excluded by subsection (a). The reduction described in subparagraph (F) in any passive activity credit carryover shall be 33 $\frac{1}{3}$  cents for each dollar excluded by subsection (a).

**(4) Ordering rules**

(A) **Reductions made after determination of tax for year** The reductions described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.

(B) **Reductions under subparagraph (A) or (D) of paragraph (2)** The reductions described in subparagraph (A) or (D) of paragraph (2) (as the case may be) shall be made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.

(C) **Reductions under subparagraphs (B) and (G) of paragraph (2)** The reductions described in subparagraphs (B) and (G) of paragraph (2) shall be made in the order in which carryovers are taken into account under this chapter for the taxable year of the discharge.

**(5) Election to apply reduction first against depreciable property**

(A) **In general** The taxpayer may elect to apply any portion of the reduction referred to in



paragraph (1) to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.

**(B) Limitation** The amount to which an election under subparagraph (A) applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.

**(C) Other tax attributes not reduced** Paragraph (2) shall not apply to any amount to which an election under this paragraph applies.

**(d) Meaning of terms; special rules relating to certain provisions**

**(1) Indebtedness of taxpayer** For purposes of this section, the term “indebtedness of the taxpayer” means any indebtedness—

**(A)** for which the taxpayer is liable, or

**(B)** subject to which the taxpayer holds property.

**(2) Title 11 case** For purposes of this section, the term “title 11 case” means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

**(3) Insolvent** For purposes of this section, the term “insolvent” means the excess of liabilities over the fair market value of assets. With respect to any discharge, whether or not the taxpayer is insolvent, and the amount by which the taxpayer is insolvent, shall be determined on the basis of the taxpayer’s assets and liabilities immediately before the discharge.

**[(4) Repealed. Pub. L. 99–514, title VIII, §822(b)(3)(A), Oct. 22, 1986, 100 Stat. 2373]**

**(5) Depreciable property** The term “depreciable property” has the same meaning as when used in section 1017.

**(6) Certain provisions to be applied at partner level** In the case of a partnership, subsections (a), (b), (c), and (g) shall be applied at the partner level.

**(7) Special rules for S corporation**

**(A) Certain provisions to be applied at corporate level** In the case of an S corporation, subsections (a), (b), (c), and (g) shall be applied at the corporate level, including by not taking into account under section 1366(a) any amount excluded under subsection (a) of this section.

**(B) Reduction in carryover of disallowed losses and deductions** In the case of an S corporation, for purposes of subparagraph (A) of subsection (b)(2), any loss or deduction which is disallowed for the taxable year of the discharge under section 1366(d)(1) shall be treated as a net operating loss for such taxable year. The preceding sentence shall not apply to any discharge to the extent that subsection (a)(1)(D) applies to such discharge.

**(C) Coordination with basis adjustments under section 1367(b)(2)** For purposes of subsection (e)(6), a shareholder’s adjusted basis in indebtedness of an S corporation shall be determined without regard to any adjustments made under section 1367(b)(2).

**(8) Reductions of tax attributes in title 11 cases of individuals to be made by estate** In any case under chapter 7 or 11 of title 11 of the United States Code to which section 1398 applies, for purposes of paragraphs (1) and (5) of subsection (b) the estate (and not the individual) shall be treated as the taxpayer. The preceding sentence shall not apply for purposes of applying section 1017 to property transferred by the estate to the individual.

**(9) Time for making election, etc.**

**(A) Time** An election under paragraph (5) of subsection (b) or under paragraph (3)(C) of subsection (c) shall be made on the taxpayer's return for the taxable year in which the discharge occurs or at such other time as may be permitted in regulations prescribed by the Secretary.

**(B) Revocation only with consent** An election referred to in subparagraph (A), once made, may be revoked only with the consent of the Secretary.

**(C) Manner** An election referred to in subparagraph (A) shall be made in such manner as the Secretary may by regulations prescribe.

**(10) Cross reference** For provision that no reduction is to be made in the basis of exempt property of an individual debtor, see section 1017(c)(1).

**(e) General rules for discharge of indebtedness (including discharges not in title 11 cases or insolvency)**

For purposes of this title—

**(1) No other insolvency exception** Except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness.

**(2) Income not realized to extent of lost deductions** No income shall be realized from the discharge of indebtedness to the extent that payment of the liability would have given rise to a deduction.

**(3) Adjustments for unamortized premium and discount** The amount taken into account with respect to any discharge shall be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.

**(4) Acquisition of indebtedness by person related to debtor**

**(A) Treated as acquisition by debtor** For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in section 267(b) or 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor. Such regulations shall provide for such adjustments in the treatment of any subsequent transactions involving the indebtedness as may be appropriate by reason of the application of the preceding sentence.

**(B) Members of family** For purposes of this paragraph, sections 267(b) and 707(b)(1) shall be applied as if section 267(c)(4) provided that the family of an individual consists of the

individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren.

**(C) Entities under common control treated as related** For purposes of this paragraph, two entities which are treated as a single employer under subsection (b) or (c) of section 414 shall be treated as bearing a relationship to each other which is described in section 267(b).

**(5) Purchase-money debt reduction for solvent debtor treated as price reduction** If—

(A) the debt of a purchaser of property to the seller of such property which arose out of the purchase of such property is reduced,

(B) such reduction does not occur—

(i) in a title 11 case, or

(ii) when the purchaser is insolvent, and

(C) but for this paragraph, such reduction would be treated as income to the purchaser from the discharge of indebtedness,  
then such reduction shall be treated as a purchase price adjustment.

**(6) Indebtedness contributed to capital** Except as provided in regulations, for purposes of determining income of the debtor from discharge of indebtedness, if a debtor corporation acquires its indebtedness from a shareholder as a contribution to capital—

(A) section 118 shall not apply, but

(B) such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.

**(7) Recapture of gain on subsequent sale of stock**

**(A) In general** If a creditor acquires stock of a debtor corporation in satisfaction of such corporation's indebtedness, for purposes of section 1245—

(i) such stock (and any other property the basis of which is determined in whole or in part by reference to the adjusted basis of such stock) shall be treated as section 1245 property,

(ii) the aggregate amount allowed to the creditor—

(I) as deductions under subsection (a) or (b) of section 166 (by reason of the worthlessness or partial worthlessness of the indebtedness), or

(II) as an ordinary loss on the exchange,  
shall be treated as an amount allowed as a deduction for depreciation, and

(iii) an exchange of such stock qualifying under section 354(a), 355(a), or 356(a) shall be treated as an exchange to which section 1245(b)(3) applies.

The amount determined under clause (ii) shall be reduced by the amount (if any) included in the creditor's gross income on the exchange.

**(B) Special rule for cash basis taxpayers** In the case of any creditor who computes his taxable income under the cash receipts and disbursements method, proper adjustment shall be made in the amount taken into account under clause (ii) of subparagraph (A) for any

amount which was not included in the creditor's gross income but which would have been included in such gross income if such indebtedness had been satisfied in full.

**(C) Stock of parent corporation** For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.

**(D) Treatment of successor corporation** For purposes of this paragraph, the term "debtor corporation" includes a successor corporation.

**(E) Partnership rule** Under regulations prescribed by the Secretary, rules similar to the rules of the foregoing subparagraphs of this paragraph shall apply with respect to the indebtedness of a partnership.

**(8) Indebtedness satisfied by corporate stock or partnership interest** For purposes of determining income of a debtor from discharge of indebtedness, if—

**(A)** a debtor corporation transfers stock, or

**(B)** a debtor partnership transfers a capital or profits interest in such partnership, to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

**(9) Discharge of indebtedness income not taken into account in determining whether entity meets REIT qualifications** Any amount included in gross income by reason of the discharge of indebtedness shall not be taken into account for purposes of paragraphs (2) and (3) of section 856(c).

**(10) Indebtedness satisfied by issuance of debt instrument**

**(A) In general** For purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument.

**(B) Issue price** For purposes of subparagraph (A), the issue price of any debt instrument shall be determined under sections 1273 and 1274. For purposes of the preceding sentence, section 1273(b)(4) shall be applied by reducing the stated redemption price of any instrument by the portion of such stated redemption price which is treated as interest for purposes of this chapter.

#### **(f) Student loans**

**(1) In general** In the case of an individual, gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of any student loan if such discharge was pursuant to a provision of such loan under which all or part of the indebtedness of the individual would be discharged if the

individual worked for a certain period of time in certain professions for any of a broad class of employers.

**(2) Student loan** For purposes of this subsection, the term “student loan” means any loan to an individual to assist the individual in attending an educational organization described in section 170(b)(1)(A)(ii) made by—

(A) the United States, or an instrumentality or agency thereof,

(B) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof,

(C) a public benefit corporation—

(i) which is exempt from taxation under section 501(c)(3),

(ii) which has assumed control over a State, county, or municipal hospital, and

(iii) whose employees have been deemed to be public employees under State law, or

(D) any educational organization described in section 170(b)(1)(A)(ii) if such loan is made

(i) pursuant to an agreement with any entity described in subparagraph (A), (B), or (C) under which the funds from which the loan was made were provided to such educational organization, or

(ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a).

The term “student loan” includes any loan made by an educational organization described in section 170(b)(1)(A)(ii) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (D)(ii).

**(3) Exception for discharges on account of services performed for certain lenders** Paragraph (1) shall not apply to the discharge of a loan made by an organization described in paragraph (2)(D) if the discharge is on account of services performed for either such organization.

**(4) Payments under national health service corps loan repayment program and certain state loan repayment programs** In the case of an individual, gross income shall not include any amount received under section 338B(g) of the Public Health Service Act, under a State program described in section 338I of such Act, or under any other State loan repayment or loan forgiveness program that is intended to provide for the increased availability of health care services in underserved or health professional shortage areas (as determined by such State).

**(5) Special rule for discharges in 2021 through 2025** Gross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) after December 31, 2020, and before January 1, 2026, of—

(A) any loan provided expressly for postsecondary educational expenses, regardless of

whether provided through the educational institution or directly to the borrower, if such loan was made, insured, or guaranteed by—

- (i) the United States, or an instrumentality or agency thereof,
  - (ii) a State, territory, or possession of the United States, or the District of Columbia, or any political subdivision thereof, or
  - (iii) an eligible educational institution (as defined in section 25A),
- (B) any private education loan (as defined in section 140(a)(7)1 of the Truth in Lending Act),
- (C) any loan made by any educational organization described in section 170(b)(1)(A)(ii) if such loan is made—
- (i) pursuant to an agreement with any entity described in subparagraph (A) or any private education<sup>2</sup> lender (as defined in section 140(a) of the Truth in Lending Act) under which the funds from which the loan was made were provided to such educational organization, or
  - (ii) pursuant to a program of such educational organization which is designed to encourage its students to serve in occupations with unmet needs or in areas with unmet needs and under which the services provided by the students (or former students) are for or under the direction of a governmental unit or an organization described in section 501(c)(3) and exempt from tax under section 501(a), or
- (D) any loan made by an educational organization described in section 170(b)(1)(A)(ii) or by an organization exempt from tax under section 501(a) to refinance a loan to an individual to assist the individual in attending any such educational organization but only if the refinancing loan is pursuant to a program of the refinancing organization which is designed as described in subparagraph (C)(ii).

The preceding sentence shall not apply to the discharge of a loan made by an organization described in subparagraph (C) or made by a private education<sup>2</sup> lender (as defined in section 140(a)(7) of the Truth in Lending Act) if the discharge is on account of services performed for either such organization or for such private education lender.

#### **(h) Special rules relating to qualified principal residence indebtedness**

**(1) Basis reduction** The amount excluded from gross income by reason of subsection (a)(1)(E) shall be applied to reduce (but not below zero) the basis of the principal residence of the taxpayer.

**(2) Qualified principal residence indebtedness** For purposes of this section, the term “qualified principal residence indebtedness” means acquisition indebtedness (within the meaning of section 163(h)(3)(B), applied by substituting “\$750,000 (\$375,000” for “\$1,000,000 (\$500,000” in clause (ii) thereof and determined without regard to the substitution described in section 163(h)(3)(F)(i)(II)) with respect to the principal residence of the taxpayer.

**(3) Exception for certain discharges not related to taxpayer’s financial condition** Subsection (a)(1)(E) shall not apply to the discharge of a loan if the discharge is on account of services

performed for the lender or any other factor not directly related to a decline in the value of the residence or to the financial condition of the taxpayer.

**(4) Ordering rule** If any loan is discharged, in whole or in part, and only a portion of such loan is qualified principal residence indebtedness, subsection (a)(1)(E) shall apply only to so much of the amount discharged as exceeds the amount of the loan (as determined immediately before such discharge) which is not qualified principal residence indebtedness.

**(5) Principal residence** For purposes of this subsection, the term “principal residence” has the same meaning as when used in section 121.

## §121. EXCLUSION OF GAIN FROM SALE OF PRINCIPAL RESIDENCE

### (a) Exclusion

Gross income shall not include gain from the sale or exchange of property if, during the 5-year period ending on the date of the sale or exchange, such property has been owned and used by the taxpayer as the taxpayer’s principal residence for periods aggregating 2 years or more.

### (b) Limitations

**(1) In general** The amount of gain excluded from gross income under subsection (a) with respect to any sale or exchange shall not exceed \$250,000.

**(2) Special rules for joint returns** In the case of a husband and wife who make a joint return for the taxable year of the sale or exchange of the property—

**(A) \$500,000 Limitation for certain joint returns** Paragraph (1) shall be applied by substituting “\$500,000” for “\$250,000” if—

**(i)** either spouse meets the ownership requirements of subsection (a) with respect to such property;

**(ii)** both spouses meet the use requirements of subsection (a) with respect to such property; and

**(iii)** neither spouse is ineligible for the benefits of subsection (a) with respect to such property by reason of paragraph (3).

**(B) Other joint returns** If such spouses do not meet the requirements of subparagraph (A), the limitation under paragraph (1) shall be the sum of the limitations under paragraph (1) to which each spouse would be entitled if such spouses had not been married. For purposes of the preceding sentence, each spouse shall be treated as owning the property during the period that either spouse owned the property.

**(3) Application to only 1 sale or exchange every 2 years** Subsection (a) shall not apply to any sale or exchange by the taxpayer if, during the 2-year period ending on the date of such sale or exchange, there was any other sale or exchange by the taxpayer to which subsection (a) applied.

**(4) Special rule for certain sales by surviving spouses** In the case of a sale or exchange of property by an unmarried individual whose spouse is deceased on the date of such sale, paragraph (1) shall be applied by substituting “\$500,000” for “\$250,000” if such sale occurs not later than 2 years after the date of death of such spouse and the requirements of paragraph (2)(A) were met immediately before such date of death.

**(5) Exclusion of gain allocated to nonqualified use**

**(A) In general** Subsection (a) shall not apply to so much of the gain from the sale or exchange of property as is allocated to periods of nonqualified use.

**(B) Gain allocated to periods of nonqualified use** For purposes of subparagraph (A), gain shall be allocated to periods of nonqualified use based on the ratio which—

(i) the aggregate periods of nonqualified use during the period such property was owned by the taxpayer, bears to

(ii) the period such property was owned by the taxpayer.

**(C) Period of nonqualified use** For purposes of this paragraph—

**(i) In general** The term “period of nonqualified use” means any period (other than the portion of any period preceding January 1, 2009) during which the property is not used as the principal residence of the taxpayer or the taxpayer’s spouse or former spouse.

**(ii) Exceptions** The term “period of nonqualified use” does not include—

**(I)** any portion of the 5-year period described in subsection (a) which is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer’s spouse,

**(II)** any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer’s spouse is serving on qualified official extended duty (as defined in subsection (d)(9)(C)) described in clause (i), (ii), or (iii) of subsection (d)(9)(A), and

**(III)** any other period of temporary absence (not to exceed an aggregate period of 2 years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the Secretary.

**(D) Coordination with recognition of gain attributable to depreciation** For purposes of this paragraph—

(i) subparagraph (A) shall be applied after the application of subsection (d)(6), and

(ii) subparagraph (B) shall be applied without regard to any gain to which subsection (d)(6) applies.

**(c) Exclusion for taxpayers failing to meet certain requirements**

**(1) In general** In the case of a sale or exchange to which this subsection applies, the ownership and use requirements of subsection (a), and subsection (b)(3), shall not apply; but the dollar limitation under paragraph (1) or (2) of subsection (b), whichever is applicable, shall be equal to—



(A) the amount which bears the same ratio to such limitation (determined without regard to this paragraph) as

(B)

(i) the shorter of—

(I) the aggregate periods, during the 5-year period ending on the date of such sale or exchange, such property has been owned and used by the taxpayer as the taxpayer's principal residence; or

(II) the period after the date of the most recent prior sale or exchange by the taxpayer to which subsection (a) applied and before the date of such sale or exchange, bears to

(ii) 2 years.

**(2) Sales and exchanges to which subsection applies** This subsection shall apply to any sale or exchange if—

(A) subsection (a) would not (but for this subsection) apply to such sale or exchange by reason of—

(i) a failure to meet the ownership and use requirements of subsection (a), or

(ii) subsection (b)(3), and

(B) such sale or exchange is by reason of a change in place of employment, health, or, to the extent provided in regulations, unforeseen circumstances.

**(f) Election to have section not apply**

This section shall not apply to any sale or exchange with respect to which the taxpayer elects not to have this section apply.

## **§132. CERTAIN FRINGE BENEFITS**

**(a) Exclusion from gross income**

Gross income shall not include any fringe benefit which qualifies as a—

- (1) no-additional-cost service,
- (2) qualified employee discount,
- (3) working condition fringe,
- (4) de minimis fringe,
- (5) qualified transportation fringe,
- (6) qualified moving expense reimbursement,
- (7) qualified retirement planning services, or
- (8) qualified military base realignment and closure fringe.

**(b) No-additional-cost service defined**

For purposes of this section, the term “no-additional-cost service” means any service provided by an employer to an employee for use by such employee if—

- (1) such service is offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services, and
- (2) the employer incurs no substantial additional cost (including forgone revenue) in providing such service to the employee (determined without regard to any amount paid by the employee for such service).

**(c) Qualified employee discount defined**

For purposes of this section—

(1) **Qualified employee discount** The term “qualified employee discount” means any employee discount with respect to qualified property or services to the extent such discount does not exceed—

(A) in the case of property, the gross profit percentage of the price at which the property is being offered by the employer to customers, or

(B) in the case of services, 20 percent of the price at which the services are being offered by the employer to customers.

**(2) Gross profit percentage**

(A) **In general** The term “gross profit percentage” means the percent which—

(i) the excess of the aggregate sales price of property sold by the employer to customers over the aggregate cost of such property to the employer, is of

(ii) the aggregate sale price of such property.

(B) **Determination of gross profit percentage** Gross profit percentage shall be determined on the basis of—

(i) all property offered to customers in the ordinary course of the line of business of the employer in which the employee is performing services (or a reasonable classification of property selected by the employer), and

(ii) the employer’s experience during a representative period.

**(3) Employee discount defined** The term “employee discount” means the amount by which—

(A) the price at which the property or services are provided by the employer to an employee for use by such employee, is less than

(B) the price at which such property or services are being offered by the employer to customers.

(4) **Qualified property or services** The term “qualified property or services” means any property (other than real property and other than personal property of a kind held for investment) or services which are offered for sale to customers in the ordinary course of the

line of business of the employer in which the employee is performing services.

**(d) Working condition fringe defined**

For purposes of this section, the term “working condition fringe” means any property or services provided to an employee of the employer to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under section 162 or 167.

**(e) De minimis fringe defined**

For purposes of this section—

**(1) In general** The term “de minimis fringe” means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer’s employees) so small as to make accounting for it unreasonable or administratively impracticable.

**(2) Treatment of certain eating facilities** The operation by an employer of any eating facility for employees shall be treated as a de minimis fringe if—

(A) such facility is located on or near the business premises of the employer, and

(B) revenue derived from such facility normally equals or exceeds the direct operating costs of such facility.

The preceding sentence shall apply with respect to any highly compensated employee only if access to the facility is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees. For purposes of subparagraph (B), an employee entitled under section 119 to exclude the value of a meal provided at such facility shall be treated as having paid an amount for such meal equal to the direct operating costs of the facility attributable to such meal.

**(f) Qualified transportation fringe**

**(1) In general** For purposes of this section, the term “qualified transportation fringe” means any of the following provided by an employer to an employee:

(A) Transportation in a commuter highway vehicle if such transportation is in connection with travel between the employee’s residence and place of employment.

(B) Any transit pass.

(C) Qualified parking.

(D) Any qualified bicycle commuting reimbursement.

**(2) Limitation on exclusion** The amount of the fringe benefits which are provided by an employer to any employee and which may be excluded from gross income under subsection (a) (5) shall not exceed—

(A) \$175 per month in the case of the aggregate of the benefits described in subparagraphs

(A) and (B) of paragraph (1),

(B) \$175 per month in the case of qualified parking, and

(C) the applicable annual limitation in the case of any qualified bicycle commuting reimbursement.

**(3) Cash reimbursements** For purposes of this subsection, the term “qualified transportation fringe” includes a cash reimbursement by an employer to an employee for a benefit described in paragraph (1). The preceding sentence shall apply to a cash reimbursement for any transit pass only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

**(4) No constructive receipt** No amount shall be included in the gross income of an employee solely because the employee may choose between any qualified transportation fringe (other than a qualified bicycle commuting reimbursement) and compensation which would otherwise be includible in gross income of such employee.

**(5) Definitions** For purposes of this subsection—

**(A) Transit pass** The term “transit pass” means any pass, token, farecard, voucher, or similar item entitling a person to transportation (or transportation at a reduced price) if such transportation is—

(i) on mass transit facilities (whether or not publicly owned), or

(ii) provided by any person in the business of transporting persons for compensation or hire if such transportation is provided in a vehicle meeting the requirements of subparagraph (B)(i).

**(B) Commuter highway vehicle** The term “commuter highway vehicle” means any highway vehicle—

(i) the seating capacity of which is at least 6 adults (not including the driver), and

(ii) at least 80 percent of the mileage use of which can reasonably be expected to be—

(I) for purposes of transporting employees in connection with travel between their residences and their place of employment, and

(II) on trips during which the number of employees transported for such purposes is at least ½ of the adult seating capacity of such vehicle (not including the driver).

**(C) Qualified parking** The term “qualified parking” means parking provided to an employee on or near the business premises of the employer or on or near a location from which the employee commutes to work by transportation described in subparagraph (A), in a commuter highway vehicle, or by carpool. Such term shall not include any parking on or near property used by the employee for residential purposes.

**(D) Transportation provided by employer** Transportation referred to in paragraph (1)(A) shall be considered to be provided by an employer if such transportation is furnished in a commuter highway vehicle operated by or for the employer.

**(E) Employee** For purposes of this subsection, the term “employee” does not include an individual who is an employee within the meaning of section 401(c)(1).

**(F) Definitions related to bicycle commuting reimbursement**

**(i) Qualified bicycle commuting reimbursement** The term “qualified bicycle commuting reimbursement” means, with respect to any calendar year, any employer reimbursement during the 15-month period beginning with the first day of such calendar year for reasonable expenses incurred by the employee during such calendar year for the purchase of a bicycle and bicycle improvements, repair, and storage, if such bicycle is regularly used for travel between the employee’s residence and place of employment.

**(ii) Applicable annual limitation** The term “applicable annual limitation” means, with respect to any employee for any calendar year, the product of \$20 multiplied by the number of qualified bicycle commuting months during such year.

**(iii) Qualified bicycle commuting month** The term “qualified bicycle commuting month” means, with respect to any employee, any month during which such employee—

**(I)** regularly uses the bicycle for a substantial portion of the travel between the employee’s residence and place of employment, and

**(II)** does not receive any benefit described in subparagraph (A), (B), or (C) of paragraph (1).

**(6) Inflation adjustment**

**(A) In general** In the case of any taxable year beginning in a calendar year after 1999, the dollar amounts contained in subparagraphs (A) and (B) of paragraph (2) shall be increased by an amount equal to—

**(i)** such dollar amount, multiplied by

**(ii)** the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting “calendar year 1998” for “calendar year 2016” in subparagraph (A)(ii) thereof.

**(B) Rounding** If any increase determined under subparagraph (A) is not a multiple of \$5, such increase shall be rounded to the next lowest multiple of \$5.

**(7) Coordination with other provisions** For purposes of this section, the terms “working condition fringe” and “de minimis fringe” shall not include any qualified transportation fringe (determined without regard to paragraph (2)).

**(8) Suspension of qualified bicycle commuting reimbursement exclusion** Paragraph (1)(D) shall not apply to any taxable year beginning after December 31, 2017, and before January 1, 2026.

**(h) Certain individuals treated as employees for purposes of subsections (a)(1) and (2)**

For purposes of paragraphs (1) and (2) of subsection (a)—

**(1) Retired and disabled employees and surviving spouse of employee treated as employee** With respect to a line of business of an employer, the term “employee” includes—

**(A)** any individual who was formerly employed by such employer in such line of business and who separated from service with such employer in such line of business by reason of

retirement or disability, and

(B) any widow or widower of any individual who died while employed by such employer in such line of business or while an employee within the meaning of subparagraph (A).

**(2) Spouse and dependent children**

(A) **In general** Any use by the spouse or a dependent child of the employee shall be treated as use by the employee.

(B) **Dependent child** For purposes of subparagraph (A), the term “dependent child” means any child (as defined in section 152(f)(1)) of the employee—

(i) who is a dependent of the employee, or

(ii) both of whose parents are deceased and who has not attained age 25.

For purposes of the preceding sentence, any child to whom section 152(e) applies shall be treated as the dependent of both parents.

(3) **Special rule for parents in the case of air transportation** Any use of air transportation by a parent of an employee (determined without regard to paragraph (1)(B)) shall be treated as use by the employee.

**(i) Reciprocal agreements**

For purposes of paragraph (1) of subsection (a), any service provided by an employer to an employee of another employer shall be treated as provided by the employer of such employee if —

(1) such service is provided pursuant to a written agreement between such employers, and

(2) neither of such employers incurs any substantial additional costs (including foregone revenue) in providing such service or pursuant to such agreement.

**(j) Special rules**

(1) **Exclusions under subsection (a)(1) and (2) apply to highly compensated employees only if no discrimination** Paragraphs (1) and (2) of subsection (a) shall apply with respect to any fringe benefit described therein provided with respect to any highly compensated employee only if such fringe benefit is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees.

**(2) Special rule for leased sections of department stores**

(A) **In general** For purposes of paragraph (2) of subsection (a), in the case of a leased section of a department store—

(i) such section shall be treated as part of the line of business of the person operating the department store, and

(ii) employees in the leased section shall be treated as employees of the person operating the department store.

**(B) Leased section of department store** For purposes of subparagraph (A), a leased section of a department store is any part of a department store where over-the-counter sales of property are made under a lease or similar arrangement where it appears to the general public that individuals making such sales are employed by the person operating the department store.

### **(3) Auto salesmen**

**(A) In general** For purposes of subsection (a)(3), qualified automobile demonstration use shall be treated as a working condition fringe.

**(B) Qualified automobile demonstration use** For purposes of subparagraph (A), the term “qualified automobile demonstration use” means any use of an automobile by a full-time automobile salesman in the sales area in which the automobile dealer’s sales office is located if—

- (i) such use is provided primarily to facilitate the salesman’s performance of services for the employer, and
- (ii) there are substantial restrictions on the personal use of such automobile by such salesman.

### **(4) On-premises gyms and other athletic facilities**

**(A) In general** Gross income shall not include the value of any on-premises athletic facility provided by an employer to his employees.

**(B) On-premises athletic facility** For purposes of this paragraph, the term “on-premises athletic facility” means any gym or other athletic facility—

- (i) which is located on the premises of the employer,
- (ii) which is operated by the employer, and
- (iii) substantially all the use of which is by employees of the employer, their spouses, and their dependent children (within the meaning of subsection (h)).

### **(5) Special rule for affiliates of airlines**

**(A) In general** If—

- (i) a qualified affiliate is a member of an affiliated group another member of which operates an airline, and
  - (ii) employees of the qualified affiliate who are directly engaged in providing airline-related services are entitled to no-additional-cost service with respect to air transportation provided by such other member,
- then, for purposes of applying paragraph (1) of subsection (a) to such no-additional-cost service provided to such employees, such qualified affiliate shall be treated as engaged in the same line of business as such other member.

**(B) Qualified affiliate** For purposes of this paragraph, the term “qualified affiliate” means any corporation which is predominantly engaged in airline-related services.

**(C) Airline-related services** For purposes of this paragraph, the term “airline-related

services” means any of the following services provided in connection with air transportation:

- (i) Catering.
- (ii) Baggage handling.
- (iii) Ticketing and reservations.
- (iv) Flight planning and weather analysis.
- (v) Restaurants and gift shops located at an airport.
- (vi) Such other similar services provided to the airline as the Secretary may prescribe.

**(D) Affiliated group** For purposes of this paragraph, the term “affiliated group” has the meaning given such term by section 1504(a).

**(6) Highly compensated employee** For purposes of this section, the term “highly compensated employee” has the meaning given such term by section 414(q).

**(7) Air cargo** For purposes of subsection (b), the transportation of cargo by air and the transportation of passengers by air shall be treated as the same service.

**(8) Application of section to otherwise taxable educational or training benefits** Amounts paid or expenses incurred by the employer for education or training provided to the employee which are not excludable from gross income under section 127 shall be excluded from gross income under this section if (and only if) such amounts or expenses are a working condition fringe.

## §151. ALLOWANCE OF DEDUCTIONS FOR PERSONAL EXEMPTIONS

### (a) Allowance of deductions

In the case of an individual, the exemptions provided by this section shall be allowed as deductions in computing taxable income.

### (b) Taxpayer and spouse

An exemption of the exemption amount for the taxpayer; and an additional exemption of the exemption amount for the spouse of the taxpayer if a joint return is not made by the taxpayer and his spouse, and if the spouse, for the calendar year in which the taxable year of the taxpayer begins, has no gross income and is not the dependent of another taxpayer.

### (c) Additional exemption for dependents

An exemption of the exemption amount for each individual who is a dependent (as defined in section 152) of the taxpayer for the taxable year.

### (d) Exemption amount

For purposes of this section—

- (1) In general** Except as otherwise provided in this subsection, the term “exemption amount”



means \$2,000.

**(2) Exemption amount disallowed in case of certain dependents** In the case of an individual with respect to whom a deduction under this section is allowable to another taxpayer for a taxable year beginning in the calendar year in which the individual's taxable year begins, the exemption amount applicable to such individual for such individual's taxable year shall be zero.

**(3) Phaseout**

**(A) In general** In the case of any taxpayer whose adjusted gross income for the taxable year exceeds the applicable amount in effect under section 68(b), the exemption amount shall be reduced by the applicable percentage.

**(B) Applicable percentage** For purposes of subparagraph (A), the term "applicable percentage" means 2 percentage points for each \$2,500 (or fraction thereof) by which the taxpayer's adjusted gross income for the taxable year exceeds the applicable amount in effect under section 68(b). In the case of a married individual filing a separate return, the preceding sentence shall be applied by substituting "\$1,250" for "\$2,500". In no event shall the applicable percentage exceed 100 percent.

**(C) Coordination with other provisions** The provisions of this paragraph shall not apply for purposes of determining whether a deduction under this section with respect to any individual is allowable to another taxpayer for any taxable year.

**(4) Inflation adjustment** Except as provided in paragraph (5), in the case of any taxable year beginning in a calendar year after 1989, the dollar amount contained in paragraph (1) shall be increased by an amount equal to—

**(A)** such dollar amount, multiplied by

**(B)** the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting "calendar year 1988" for "calendar year 2016" in subparagraph (A)(ii) thereof.

**(5) Special rules for taxable years 2018 through 2025** In the case of a taxable year beginning after December 31, 2017, and before January 1, 2026—

**(A) Exemption amount** The term "exemption amount" means zero.

**(B) References** For purposes of any other provision of this title, the reduction of the exemption amount to zero under subparagraph (A) shall not be taken into account in determining whether a deduction is allowed or allowable, or whether a taxpayer is entitled to a deduction, under this section.

**(e) Identifying information required**

No exemption shall be allowed under this section with respect to any individual unless the TIN of such individual is included on the return claiming the exemption.

## **§152. DEPENDENT DEFINED**

**(a) In general**

For purposes of this subtitle, the term “dependent” means—

- (1) a qualifying child, or
- (2) a qualifying relative.

**(b) Exceptions**

For purposes of this section—

**(1) Dependents ineligible** If an individual is a dependent of a taxpayer for any taxable year of such taxpayer beginning in a calendar year, such individual shall be treated as having no dependents for any taxable year of such individual beginning in such calendar year.

**(2) Married dependents** An individual shall not be treated as a dependent of a taxpayer under subsection (a) if such individual has made a joint return with the individual’s spouse under section 6013 for the taxable year beginning in the calendar year in which the taxable year of the taxpayer begins.

**(3) Citizens or nationals of other countries**

**(A) In general** The term “dependent” does not include an individual who is not a citizen or national of the United States unless such individual is a resident of the United States or a country contiguous to the United States.

**(B) Exception for adopted child** Subparagraph (A) shall not exclude any child of a taxpayer (within the meaning of subsection (f)(1)(B)) from the definition of “dependent” if—

- (i) for the taxable year of the taxpayer, the child has the same principal place of abode as the taxpayer and is a member of the taxpayer’s household, and
- (ii) the taxpayer is a citizen or national of the United States.

**(c) Qualifying child**

For purposes of this section—

**(1) In general** The term “qualifying child” means, with respect to any taxpayer for any taxable year, an individual—

- (A) who bears a relationship to the taxpayer described in paragraph (2),
- (B) who has the same principal place of abode as the taxpayer for more than one-half of such taxable year,
- (C) who meets the age requirements of paragraph (3),
- (D) who has not provided over one-half of such individual’s own support for the calendar year in which the taxable year of the taxpayer begins, and
- (E) who has not filed a joint return (other than only for a claim of refund) with the individual’s spouse under section 6013 for the taxable year beginning in the calendar year in

which the taxable year of the taxpayer begins.

**(2) Relationship** For purposes of paragraph (1)(A), an individual bears a relationship to the taxpayer described in this paragraph if such individual is—

(A) a child of the taxpayer or a descendant of such a child, or

(B) a brother, sister, stepbrother, or stepsister of the taxpayer or a descendant of any such relative.

**(3) Age requirements**

**(A) In general** For purposes of paragraph (1)(C), an individual meets the requirements of this paragraph if such individual is younger than the taxpayer claiming such individual as a qualifying child and—

(i) has not attained the age of 19 as of the close of the calendar year in which the taxable year of the taxpayer begins, or

(ii) is a student who has not attained the age of 24 as of the close of such calendar year.

**(B) Special rule for disabled** In the case of an individual who is permanently and totally disabled (as defined in section 22(e)(3)) at any time during such calendar year, the requirements of subparagraph (A) shall be treated as met with respect to such individual.

**(4) Special rule relating to 2 or more who can claim the same qualifying child**

**(A) In general** Except as provided in subparagraphs (B) and (C), if (but for this paragraph) an individual may be claimed as a qualifying child by 2 or more taxpayers for a taxable year beginning in the same calendar year, such individual shall be treated as the qualifying child of the taxpayer who is—

(i) a parent of the individual, or

(ii) if clause (i) does not apply, the taxpayer with the highest adjusted gross income for such taxable year.

**(B) More than 1 parent claiming qualifying child** If the parents claiming any qualifying child do not file a joint return together, such child shall be treated as the qualifying child of —

(i) the parent with whom the child resided for the longest period of time during the taxable year, or

(ii) if the child resides with both parents for the same amount of time during such taxable year, the parent with the highest adjusted gross income.

**(C) No parent claiming qualifying child** If the parents of an individual may claim such individual as a qualifying child but no parent so claims the individual, such individual may be claimed as the qualifying child of another taxpayer but only if the adjusted gross income of such taxpayer is higher than the highest adjusted gross income of any parent of the individual.

**(d) Qualifying relative**

For purposes of this section—

**(1) In general** The term “qualifying relative” means, with respect to any taxpayer for any taxable year, an individual—

(A) who bears a relationship to the taxpayer described in paragraph (2),

(B) whose gross income for the calendar year in which such taxable year begins is less than the exemption amount (as defined in section 151(d)),

(C) with respect to whom the taxpayer provides over one-half of the individual’s support for the calendar year in which such taxable year begins, and

(D) who is not a qualifying child of such taxpayer or of any other taxpayer for any taxable year beginning in the calendar year in which such taxable year begins.

**(2) Relationship** For purposes of paragraph (1)(A), an individual bears a relationship to the taxpayer described in this paragraph if the individual is any of the following with respect to the taxpayer:

(A) A child or a descendant of a child.

(B) A brother, sister, stepbrother, or stepsister.

(C) The father or mother, or an ancestor of either.

(D) A stepfather or stepmother.

(E) A son or daughter of a brother or sister of the taxpayer.

(F) A brother or sister of the father or mother of the taxpayer.

(G) A son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law.

(H) An individual (other than an individual who at any time during the taxable year was the spouse, determined without regard to section 7703, of the taxpayer) who, for the taxable year of the taxpayer, has the same principal place of abode as the taxpayer and is a member of the taxpayer’s household.

**(3) Special rule relating to multiple support agreements** For purposes of paragraph (1)(C), over one-half of the support of an individual for a calendar year shall be treated as received from the taxpayer if—

(A) no one person contributed over one-half of such support,

(B) over one-half of such support was received from 2 or more persons each of whom, but for the fact that any such person alone did not contribute over one-half of such support, would have been entitled to claim such individual as a dependent for a taxable year beginning in such calendar year,

(C) the taxpayer contributed over 10 percent of such support, and

(D) each person described in subparagraph (B) (other than the taxpayer) who contributed over 10 percent of such support files a written declaration (in such manner and form as the Secretary may by regulations prescribe) that such person will not claim such individual as a

dependent for any taxable year beginning in such calendar year.

#### **(4) Special rule relating to income of handicapped dependents**

**(A) In general** For purposes of paragraph (1)(B), the gross income of an individual who is permanently and totally disabled (as defined in section 22(e)(3)) at any time during the taxable year shall not include income attributable to services performed by the individual at a sheltered workshop if—

- (i) the availability of medical care at such workshop is the principal reason for the individual's presence there, and
- (ii) the income arises solely from activities at such workshop which are incident to such medical care.

**(B) Sheltered workshop defined** For purposes of subparagraph (A), the term “sheltered workshop” means a school—

- (i) which provides special instruction or training designed to alleviate the disability of the individual, and
- (ii) which is operated by an organization described in section 501(c)(3) and exempt from tax under section 501(a), or by a State, a possession of the United States, any political subdivision of any of the foregoing, the United States, or the District of Columbia.

#### **(5) Special rules for support**

**(A) In general** For purposes of this subsection—

- (i) payments to a spouse of alimony or separate maintenance payments shall not be treated as a payment by the payor spouse for the support of any dependent, and
- (ii) in the case of the remarriage of a parent, support of a child received from the parent's spouse shall be treated as received from the parent.

**(B) Alimony or separate maintenance payment** For purposes of subparagraph (A), the term “alimony or separate maintenance payment” means any payment in cash if—

- (i) such payment is received by (or on behalf of) a spouse under a divorce or separation instrument (as defined in section 121(d)(3)(C)),
- (ii) in the case of an individual legally separated from the individual's spouse under a decree of divorce or of separate maintenance, the payee spouse and the payor spouse are not members of the same household at the time such payment is made, and
- (iii) there is no liability to make any such payment for any period after the death of the payee spouse and there is no liability to make any payment (in cash or property) as a substitute for such payments after the death of the payee spouse.

#### **(f) Other definitions and rules**

For purposes of this section—

##### **(1) Child defined**

**(A) In general** The term “child” means an individual who is—

- (i) a son, daughter, stepson, or stepdaughter of the taxpayer, or
- (ii) an eligible foster child of the taxpayer.

**(B) Adopted child** In determining whether any of the relationships specified in subparagraph (A)(i) or paragraph (4) exists, a legally adopted individual of the taxpayer, or an individual who is lawfully placed with the taxpayer for legal adoption by the taxpayer, shall be treated as a child of such individual by blood.

**(C) Eligible foster child** For purposes of subparagraph (A)(ii), the term “eligible foster child” means an individual who is placed with the taxpayer by an authorized placement agency or by judgment, decree, or other order of any court of competent jurisdiction.

**(2) Student defined** The term “student” means an individual who during each of 5 calendar months during the calendar year in which the taxable year of the taxpayer begins—

**(A)** is a full-time student at an educational organization described in section 170(b)(1)(A)(ii), or

**(B)** is pursuing a full-time course of institutional on-farm training under the supervision of an accredited agent of an educational organization described in section 170(b)(1)(A)(ii) or of a State or political subdivision of a State.

**(3) Determination of household status** An individual shall not be treated as a member of the taxpayer’s household if at any time during the taxable year of the taxpayer the relationship between such individual and the taxpayer is in violation of local law.

**(4) Brother and sister** The terms “brother” and “sister” include a brother or sister by the half blood.

**(5) Special support test in case of students** For purposes of subsections (c)(1)(D) and (d)(1)(C), in the case of an individual who is—

**(A)** a child of the taxpayer, and

**(B)** a student,

amounts received as scholarships for study at an educational organization described in section 170(b)(1)(A)(ii) shall not be taken into account.

**(6) Treatment of missing children**

**(A) In general** Solely for the purposes referred to in subparagraph (B), a child of the taxpayer—

**(i)** who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such child or the taxpayer, and

**(ii)** who had, for the taxable year in which the kidnapping occurred, the same principal place of abode as the taxpayer for more than one-half of the portion of such year before the date of the kidnapping,

shall be treated as meeting the requirement of subsection (c)(1)(B) with respect to a taxpayer for all taxable years ending during the period that the child is kidnapped.

**(B) Purposes** Subparagraph (A) shall apply solely for purposes of determining—

- (i) the deduction under section 151(c),
- (ii) the credit under section 24 (relating to child tax credit),
- (iii) whether an individual is a surviving spouse or a head of a household (as such terms are defined in section 2), and
- (iv) the earned income credit under section 32.

**(C) Comparable treatment of certain qualifying relatives** For purposes of this section, a child of the taxpayer—

- (i) who is presumed by law enforcement authorities to have been kidnapped by someone who is not a member of the family of such child or the taxpayer, and
- (ii) who was (without regard to this paragraph) a qualifying relative of the taxpayer for the portion of the taxable year before the date of the kidnapping, shall be treated as a qualifying relative of the taxpayer for all taxable years ending during the period that the child is kidnapped.

**(D) Termination of treatment** Subparagraphs (A) and (C) shall cease to apply as of the first taxable year of the taxpayer beginning after the calendar year in which there is a determination that the child is dead (or, if earlier, in which the child would have attained age 18).

**(7) Cross references** For provision treating child as dependent of both parents for purposes of certain provisions, see sections 105(b), 132(h)(2)(B), and 213(d)(5).

## §162. TRADE OR BUSINESS EXPENSES

### (a) In general

There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including—

- (1) a reasonable allowance for salaries or other compensation for personal services actually rendered;
- (2) traveling expenses (including amounts expended for meals and lodging other than amounts which are lavish or extravagant under the circumstances) while away from home in the pursuit of a trade or business; and
- (3) rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

For purposes of the preceding sentence, the place of residence of a Member of Congress (including any Delegate and Resident Commissioner) within the State, congressional district, or possession which he represents in Congress shall be considered his home, but amounts expended by such Members within each taxable year for living expenses shall not be deductible for income tax purposes. For purposes of paragraph (2), the taxpayer shall not be treated as being

temporarily away from home during any period of employment if such period exceeds 1 year. The preceding sentence shall not apply to any Federal employee during any period for which such employee is certified by the Attorney General (or the designee thereof) as traveling on behalf of the United States in temporary duty status to investigate or prosecute, or provide support services for the investigation or prosecution of, a Federal crime.

**(c) Illegal bribes, kickbacks, and other payments**

**(1) Illegal payments to government officials or employees** No deduction shall be allowed under subsection (a) for any payment made, directly or indirectly, to an official or employee of any government, or of any agency or instrumentality of any government, if the payment constitutes an illegal bribe or kickback or, if the payment is to an official or employee of a foreign government, the payment is unlawful under the Foreign Corrupt Practices Act of 1977. The burden of proof in respect of the issue, for the purposes of this paragraph, as to whether a payment constitutes an illegal bribe or kickback (or is unlawful under the Foreign Corrupt Practices Act of 1977) shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

**(2) Other illegal payments** No deduction shall be allowed under subsection (a) for any payment (other than a payment described in paragraph (1)) made, directly or indirectly, to any person, if the payment constitutes an illegal bribe, illegal kickback, or other illegal payment under any law of the United States, or under any law of a State (but only if such State law is generally enforced), which subjects the payor to a criminal penalty or the loss of license or privilege to engage in a trade or business. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer. The burden of proof in respect of the issue, for purposes of this paragraph, as to whether a payment constitutes an illegal bribe, illegal kickback, or other illegal payment shall be upon the Secretary to the same extent as he bears the burden of proof under section 7454 (concerning the burden of proof when the issue relates to fraud).

**(3) Kickbacks, rebates, and bribes under medicare and medicaid** No deduction shall be allowed under subsection (a) for any kickback, rebate, or bribe made by any provider of services, supplier, physician, or other person who furnishes items or services for which payment is or may be made under the Social Security Act, or in whole or in part out of Federal funds under a State plan approved under such Act, if such kickback, rebate, or bribe is made in connection with the furnishing of such items or services or the making or receipt of such payments. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer.

**(f) Fines, penalties, and other amounts**

**(1) In general** Except as provided in the following paragraphs of this subsection, no deduction otherwise allowable shall be allowed under this chapter for any amount paid or incurred (whether by suit, agreement, or otherwise) to, or at the direction of, a government or governmental entity in relation to the violation of any law or the investigation or inquiry by such government or entity into the potential violation of any law.

**(2) Exception for amounts constituting restitution or paid to come into compliance with law**



**(A) In general** Paragraph (1) shall not apply to any amount that—

**(i)** the taxpayer establishes—

**(I)** constitutes restitution (including remediation of property) for damage or harm which was or may be caused by the violation of any law or the potential violation of any law, or

**(II)** is paid to come into compliance with any law which was violated or otherwise involved in the investigation or inquiry described in paragraph (1),

**(ii)** is identified as restitution or as an amount paid to come into compliance with such law, as the case may be, in the court order or settlement agreement, and

**(iii)** in the case of any amount of restitution for failure to pay any tax imposed under this title in the same manner as if such amount were such tax, would have been allowed as a deduction under this chapter if it had been timely paid.

The identification under clause (ii) alone shall not be sufficient to make the establishment required under clause (i).

**(B) Limitation** Subparagraph (A) shall not apply to any amount paid or incurred as reimbursement to the government or entity for the costs of any investigation or litigation.

**(3) Exception for amounts paid or incurred as the result of certain court orders** Paragraph (1) shall not apply to any amount paid or incurred by reason of any order of a court in a suit in which no government or governmental entity is a party.

**(4) Exception for taxes due** Paragraph (1) shall not apply to any amount paid or incurred as taxes due.

**(5) Treatment of certain nongovernmental regulatory entities** For purposes of this subsection, the following nongovernmental entities shall be treated as governmental entities:

**(A)** Any nongovernmental entity which exercises self-regulatory powers (including imposing sanctions) in connection with a qualified board or exchange (as defined in section 1256(g)(7)).

**(B)** To the extent provided in regulations, any nongovernmental entity which exercises self-regulatory powers (including imposing sanctions) as part of performing an essential governmental function.

#### **(g) Treble damage payments under the antitrust laws**

If in a criminal proceeding a taxpayer is convicted of a violation of the antitrust laws, or his plea of guilty or nolo contendere to an indictment or information charging such a violation is entered or accepted in such a proceeding, no deduction shall be allowed under subsection (a) for two-thirds of any amount paid or incurred—

**(1)** on any judgment for damages entered against the taxpayer under section 4 of the Act entitled “An Act to supplement existing laws against unlawful restraints and monopolies, and for other purposes”, approved October 15, 1914 (commonly known as the Clayton Act), on account of such violation or any related violation of the antitrust laws which occurred prior to the date of the final judgment of such conviction, or

(2) in settlement of any action brought under such section 4 on account of such violation or related violation.

## §163. INTEREST

### (a) General rule

There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

### (h) Disallowance of deduction for personal interest

(1) **In general** In the case of a taxpayer other than a corporation, no deduction shall be allowed under this chapter for personal interest paid or accrued during the taxable year.

(2) **Personal interest** For purposes of this subsection, the term “personal interest” means any interest allowable as a deduction under this chapter other than—

(A) interest paid or accrued on indebtedness properly allocable to a trade or business (other than the trade or business of performing services as an employee),

(B) any investment interest (within the meaning of subsection (d)),

(C) any interest which is taken into account under section 469 in computing income or loss from a passive activity of the taxpayer,

(D) any qualified residence interest (within the meaning of paragraph (3)),

(E) any interest payable under section 6601 on any unpaid portion of the tax imposed by section 2001 for the period during which an extension of time for payment of such tax is in effect under section 6163, and

(F) any interest allowable as a deduction under section 221 (relating to interest on educational loans).

(3) **Qualified residence interest** For purposes of this subsection—

(A) **In general** The term “qualified residence interest” means any interest which is paid or accrued during the taxable year on—

(i) acquisition indebtedness with respect to any qualified residence of the taxpayer, or

(ii) home equity indebtedness with respect to any qualified residence of the taxpayer. For purposes of the preceding sentence, the determination of whether any property is a qualified residence of the taxpayer shall be made as of the time the interest is accrued.

(B) **Acquisition indebtedness**

(i) **In general** The term “acquisition indebtedness” means any indebtedness which—

(I) is incurred in acquiring, constructing, or substantially improving any qualified residence of the taxpayer, and

(II) is secured by such residence.

Such term also includes any indebtedness secured by such residence resulting from the refinancing of indebtedness meeting the requirements of the preceding sentence (or this sentence); but only to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

**(ii) \$1,000,000 limitation** The aggregate amount treated as acquisition indebtedness for any period shall not exceed \$1,000,000 (\$500,000 in the case of a married individual filing a separate return).

**(C) Home equity indebtedness**

**(i) In general** The term “home equity indebtedness” means any indebtedness (other than acquisition indebtedness) secured by a qualified residence to the extent the aggregate amount of such indebtedness does not exceed—

(I) the fair market value of such qualified residence, reduced by

(II) the amount of acquisition indebtedness with respect to such residence.

**(ii) Limitation** The aggregate amount treated as home equity indebtedness for any period shall not exceed \$100,000 (\$50,000 in the case of a separate return by a married individual).

**(D) Treatment of indebtedness incurred on or before October 13, 1987**

**(i) In general** In the case of any pre-October 13, 1987, indebtedness—

(I) such indebtedness shall be treated as acquisition indebtedness, and

(II) the limitation of subparagraph (B)(ii) shall not apply.

**(ii) Reduction in \$1,000,000 limitation** The limitation of subparagraph (B)(ii) shall be reduced (but not below zero) by the aggregate amount of outstanding pre-October 13, 1987, indebtedness.

**(iii) Pre-October 13, 1987, indebtedness** The term “pre-October 13, 1987, indebtedness” means—

(I) any indebtedness which was incurred on or before October 13, 1987, and which was secured by a qualified residence on October 13, 1987, and at all times thereafter before the interest is paid or accrued, or

(II) any indebtedness which is secured by the qualified residence and was incurred after October 13, 1987, to refinance indebtedness described in subclause (I) (or refinanced indebtedness meeting the requirements of this subclause) to the extent (immediately after the refinancing) the principal amount of the indebtedness resulting from the refinancing does not exceed the principal amount of the refinanced indebtedness (immediately before the refinancing).

**(iv) Limitation on period of refinancing** Subclause (II) of clause (iii) shall not apply to any indebtedness after—

(I) the expiration of the term of the indebtedness described in clause (iii)(I), or

(II) if the principal of the indebtedness described in clause (iii)(I) is not amortized over its term, the expiration of the term of the 1st refinancing of such indebtedness (or

if earlier, the date which is 30 years after the date of such 1st refinancing).

**(E) Mortgage insurance premiums treated as interest**

**(i) In general** Premiums paid or accrued for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness with respect to a qualified residence of the taxpayer shall be treated for purposes of this section as interest which is qualified residence interest.

**(ii) Phaseout** The amount otherwise treated as interest under clause (i) shall be reduced (but not below zero) by 10 percent of such amount for each \$1,000 (\$500 in the case of a married individual filing a separate return) (or fraction thereof) that the taxpayer's adjusted gross income for the taxable year exceeds \$100,000 (\$50,000 in the case of a married individual filing a separate return).

**(iii) Limitation** Clause (i) shall not apply with respect to any mortgage insurance contracts issued before January 1, 2007.

**(iv) Termination** Clause (i) shall not apply to amounts—

**(I)** paid or accrued after December 31, 2021, or

**(II)** properly allocable to any period after such date.

**(F) Special rules for taxable years 2018 through 2025**

**(i) In general** In the case of taxable years beginning after December 31, 2017, and before January 1, 2026—

**(I) Disallowance of home equity indebtedness interest** Subparagraph (A)(ii) shall not apply.

**(II) Limitation on acquisition indebtedness** Subparagraph (B)(ii) shall be applied by substituting “\$750,000 (\$375,000)” for “\$1,000,000 (\$500,000”).

**(III) Treatment of indebtedness incurred on or before December 15, 2017** Subclause (II) shall not apply to any indebtedness incurred on or before December 15, 2017, and, in applying such subclause to any indebtedness incurred after such date, the limitation under such subclause shall be reduced (but not below zero) by the amount of any indebtedness incurred on or before December 15, 2017, which is treated as acquisition indebtedness for purposes of this subsection for the taxable year.

**(IV) Binding contract exception** In the case of a taxpayer who enters into a written binding contract before December 15, 2017, to close on the purchase of a principal residence before January 1, 2018, and who purchases such residence before April 1, 2018, subclause (III) shall be applied by substituting “April 1, 2018” for “December 15, 2017”.

**(ii) Treatment of limitation in taxable years after December 31, 2025** In the case of taxable years beginning after December 31, 2025, the limitation under subparagraph (B) (ii) shall be applied to the aggregate amount of indebtedness of the taxpayer described in subparagraph (B)(i) without regard to the taxable year in which the indebtedness was incurred.

**(iii) Treatment of refinancings of indebtedness**

**(I) In general** In the case of any indebtedness which is incurred to refinance

indebtedness, such refinanced indebtedness shall be treated for purposes of clause (i) (III) as incurred on the date that the original indebtedness was incurred to the extent the amount of the indebtedness resulting from such refinancing does not exceed the amount of the refinanced indebtedness.

**(II) Limitation on period of refinancing** Subclause (I) shall not apply to any indebtedness after the expiration of the term of the original indebtedness or, if the principal of such original indebtedness is not amortized over its term, the expiration of the term of the 1st refinancing of such indebtedness (or if earlier, the date which is 30 years after the date of such 1st refinancing).

**(iv) Coordination with exclusion of income from discharge of indebtedness** Section 108(h)(2) shall be applied without regard to this subparagraph.

**(4) Other definitions and special rules** For purposes of this subsection—

**(A) Qualified residence**

**(i) In general** The term “qualified residence” means—

**(I)** the principal residence (within the meaning of section 121) of the taxpayer, and

**(II)** 1 other residence of the taxpayer which is selected by the taxpayer for purposes of this subsection for the taxable year and which is used by the taxpayer as a residence (within the meaning of section 280A(d)(1)).

**(ii) Married individuals filing separate returns** If a married couple does not file a joint return for the taxable year—

**(I)** such couple shall be treated as 1 taxpayer for purposes of clause (i), and

**(II)** each individual shall be entitled to take into account 1 residence unless both individuals consent in writing to 1 individual taking into account the principal residence and 1 other residence.

**(iii) Residence not rented** For purposes of clause (i)(II), notwithstanding section 280A(d)(1), if the taxpayer does not rent a dwelling unit at any time during a taxable year, such unit may be treated as a residence for such taxable year.

**(B) Special rule for cooperative housing corporations** Any indebtedness secured by stock held by the taxpayer as a tenant-stockholder (as defined in section 216) in a cooperative housing corporation (as so defined) shall be treated as secured by the house or apartment which the taxpayer is entitled to occupy as such a tenant-stockholder. If stock described in the preceding sentence may not be used to secure indebtedness, indebtedness shall be treated as so secured if the taxpayer establishes to the satisfaction of the Secretary that such indebtedness was incurred to acquire such stock.

**(C) Unenforceable security interests** Indebtedness shall not fail to be treated as secured by any property solely because, under any applicable State or local homestead or other debtor protection law in effect on August 16, 1986, the security interest is ineffective or the enforceability of the security interest is restricted.

**(D) Special rules for estates and trusts** For purposes of determining whether any interest paid or accrued by an estate or trust is qualified residence interest, any residence held by such estate or trust shall be treated as a qualified residence of such estate or trust if such

estate or trust establishes that such residence is a qualified residence of a beneficiary who has a present interest in such estate or trust or an interest in the residuary of such estate or trust.

**(E) Qualified mortgage insurance** The term “qualified mortgage insurance” means—

- (i) mortgage insurance provided by the Department of Veterans Affairs, the Federal Housing Administration, or the Rural Housing Service, and
- (ii) private mortgage insurance (as defined by section 2 of the Homeowners Protection Act of 1998 (12 U.S.C. 4901), as in effect on the date of the enactment of this subparagraph).

**(F) Special rules for prepaid qualified mortgage insurance** Any amount paid by the taxpayer for qualified mortgage insurance that is properly allocable to any mortgage the payment of which extends to periods that are after the close of the taxable year in which such amount is paid shall be chargeable to capital account and shall be treated as paid in such periods to which so allocated. No deduction shall be allowed for the unamortized balance of such account if such mortgage is satisfied before the end of its term. The preceding sentences shall not apply to amounts paid for qualified mortgage insurance provided by the Department of Veterans Affairs or the Rural Housing Service.

## §164. TAXES

### (a) General rule

Except as otherwise provided in this section, the following taxes shall be allowed as a deduction for the taxable year within which paid or accrued:

- (1) State and local, and foreign, real property taxes.
- (2) State and local personal property taxes.
- (3) State and local, and foreign, income, war profits, and excess profits taxes.
- (4) The GST tax imposed on income distributions.

In addition, there shall be allowed as a deduction State and local, and foreign, taxes not described in the preceding sentence which are paid or accrued within the taxable year in carrying on a trade or business or an activity described in section 212 (relating to expenses for production of income). Notwithstanding the preceding sentence, any tax (not described in the first sentence of this subsection) which is paid or accrued by the taxpayer in connection with an acquisition or disposition of property shall be treated as part of the cost of the acquired property or, in the case of a disposition, as a reduction in the amount realized on the disposition.

### (b) Definitions and special rules

For purposes of this section—

- (1) **Personal property taxes** The term “personal property tax” means an ad valorem tax which is imposed on an annual basis in respect of personal property.
- (2) **State or local taxes** A State or local tax includes only a tax imposed by a State, a

possession of the United States, or a political subdivision of any of the foregoing, or by the District of Columbia.

**(3) Foreign taxes** A foreign tax includes only a tax imposed by the authority of a foreign country.

**(4) Special rules for GST tax**

**(A) In general** The GST tax imposed on income distributions is—

- (i)** the tax imposed by section 2601, and
- (ii)** any State tax described in section 2604 (as in effect before its repeal), but only to the extent such tax is imposed on a transfer which is included in the gross income of the distributee and to which section 666 does not apply.

**(B) Special rule for tax paid before due date** Any tax referred to in subparagraph (A) imposed with respect to a transfer occurring during the taxable year of the distributee (or, in the case of a taxable termination, the trust) which is paid not later than the time prescribed by law (including extensions) for filing the return with respect to such transfer shall be treated as having been paid on the last day of the taxable year in which the transfer was made.

**(5) General sales taxes** For purposes of subsection (a)—

**(A) Election to deduct State and local sales taxes in lieu of State and local income taxes** At the election of the taxpayer for the taxable year, subsection (a) shall be applied—

- (i)** without regard to the reference to State and local income taxes, and
- (ii)** as if State and local general sales taxes were referred to in a paragraph thereof.

**(B) Definition of general sales tax** The term “general sales tax” means a tax imposed at one rate with respect to the sale at retail of a broad range of classes of items.

**(C) Special rules for food, etc.** In the case of items of food, clothing, medical supplies, and motor vehicles—

- (i)** the fact that the tax does not apply with respect to some or all of such items shall not be taken into account in determining whether the tax applies with respect to a broad range of classes of items, and
- (ii)** the fact that the rate of tax applicable with respect to some or all of such items is lower than the general rate of tax shall not be taken into account in determining whether the tax is imposed at one rate.

**(D) Items taxed at different rates** Except in the case of a lower rate of tax applicable with respect to an item described in subparagraph (C), no deduction shall be allowed under this paragraph for any general sales tax imposed with respect to an item at a rate other than the general rate of tax.

**(E) Compensating use taxes** A compensating use tax with respect to an item shall be treated as a general sales tax. For purposes of the preceding sentence, the term “compensating use tax” means, with respect to any item, a tax which—

- (i)** is imposed on the use, storage, or consumption of such item, and

(ii) is complementary to a general sales tax, but only if a deduction is allowable under this paragraph with respect to items sold at retail in the taxing jurisdiction which are similar to such item.

**(F) Special rule for motor vehicles** In the case of motor vehicles, if the rate of tax exceeds the general rate, such excess shall be disregarded and the general rate shall be treated as the rate of tax.

**(G) Separately stated general sales taxes** If the amount of any general sales tax is separately stated, then, to the extent that the amount so stated is paid by the consumer (other than in connection with the consumer's trade or business) to the seller, such amount shall be treated as a tax imposed on, and paid by, such consumer.

**(H) Amount of deduction may be determined under tables**

**(i) In general** At the election of the taxpayer for the taxable year, the amount of the deduction allowed under this paragraph for such year shall be—

(I) the amount determined under this paragraph (without regard to this subparagraph) with respect to motor vehicles, boats, and other items specified by the Secretary, and

(II) the amount determined under tables prescribed by the Secretary with respect to items to which subclause (I) does not apply.

**(ii) Requirements for tables** The tables prescribed under clause (i)—

(I) shall reflect the provisions of this paragraph,

(II) shall be based on the average consumption by taxpayers on a State-by-State basis (as determined by the Secretary) of items to which clause (i)(I) does not apply, taking into account filing status, number of dependents, adjusted gross income, and rates of State and local general sales taxation, and

(III) need only be determined with respect to adjusted gross incomes up to the applicable amount (as determined under section 68(b)).

**(6) Limitation on individual deductions for taxable years 2018 through 2025** In the case of an individual and a taxable year beginning after December 31, 2017, and before January 1, 2026

(A) foreign real property taxes shall not be taken into account under subsection (a)(1), and

(B) the aggregate amount of taxes taken into account under paragraphs (1), (2), and (3) of subsection (a) and paragraph (5) of this subsection for any taxable year shall not exceed \$10,000 (\$5,000 in the case of a married individual filing a separate return).

The preceding sentence shall not apply to any foreign taxes described in subsection (a)(3) or to any taxes described in paragraph (1) and (2) of subsection (a) which are paid or accrued in carrying on a trade or business or an activity described in section 212. For purposes of subparagraph (B), an amount paid in a taxable year beginning before January 1, 2018, with respect to a State or local income tax imposed for a taxable year beginning after December 31, 2017, shall be treated as paid on the last day of the taxable year for which such tax is so imposed.



## §165. LOSSES

### (a) General rule

There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

### (c) Limitation on losses of individuals

In the case of an individual, the deduction under subsection (a) shall be limited to—

- (1) losses incurred in a trade or business;
- (2) losses incurred in any transaction entered into for profit, though not connected with a trade or business; and
- (3) except as provided in subsection (h), losses of property not connected with a trade or business or a transaction entered into for profit, if such losses arise from fire, storm, shipwreck, or other casualty, or from theft.

### (d) Wagering losses

Losses from wagering transactions shall be allowed only to the extent of the gains from such transactions. For purposes of the preceding sentence, in the case of taxable years beginning after December 31, 2017, and before January 1, 2026, the term “losses from wagering transactions” includes any deduction otherwise allowable under this chapter incurred in carrying on any wagering transaction.

## §166. BAD DEBTS

### (a) General rule

(1) **Wholly worthless debts** There shall be allowed as a deduction any debt which becomes worthless within the taxable year.

(2) **Partially worthless debts** When satisfied that a debt is recoverable only in part, the Secretary may allow such debt, in an amount not in excess of the part charged off within the taxable year, as a deduction.

### (b) Amount of deduction

For purposes of subsection (a), the basis for determining the amount of the deduction for any bad debt shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

[(c) Repealed. Pub. L. 99–514, title VIII, §805(a), Oct. 22, 1986, 100 Stat. 2361]

#### **(d) Nonbusiness debts**

**(1) General rule** In the case of a taxpayer other than a corporation—

(A) subsection (a) shall not apply to any nonbusiness debt; and

(B) where any nonbusiness debt becomes worthless within the taxable year, the loss resulting therefrom shall be considered a loss from the sale or exchange, during the taxable year, of a capital asset held for not more than 1 year.

**(2) Nonbusiness debt defined** For purposes of paragraph (1), the term “nonbusiness debt” means a debt other than—

(A) a debt created or acquired (as the case may be) in connection with a trade or business of the taxpayer; or

(B) a debt the loss from the worthlessness of which is incurred in the taxpayer’s trade or business.

#### **(e) Worthless securities**

This section shall not apply to a debt which is evidenced by a security as defined in section 165(g)(2)(C).

#### **(f) Cross references**

(1) For disallowance of deduction for worthlessness of debts owed by political parties and similar organizations, see section 271.

(2) For special rule for banks with respect to worthless securities, see section 582.

### **§167. DEPRECIATION**

#### **(a) General rule**

There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

#### **(b) Cross reference**

For determination of depreciation deduction in case of property to which section 168 applies, see section 168.

#### **(c) Basis for depreciation**

(1) **In general** The basis on which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 1011, for the purpose of determining the gain on the sale or other disposition of such property.

(2) **Special rule for property subject to lease** If any property is acquired subject to a lease—

(A) no portion of the adjusted basis shall be allocated to the leasehold interest, and

(B) the entire adjusted basis shall be taken into account in determining the depreciation deduction (if any) with respect to the property subject to the lease.

## §168. ACCELERATED COST RECOVERY SYSTEM

### (a) General rule

Except as otherwise provided in this section, the depreciation deduction provided by section 167(a) for any tangible property shall be determined by using—

(1) the applicable depreciation method,

(2) the applicable recovery period, and

(3) the applicable convention.

### (b) Applicable depreciation method

For purposes of this section—

(1) **In general** Except as provided in paragraphs (2) and (3), the applicable depreciation method is—

(A) the 200 percent declining balance method,

(B) switching to the straight line method for the 1st taxable year for which using the straight line method with respect to the adjusted basis as of the beginning of such year will yield a larger allowance.

(2) **150 percent declining balance method in certain cases** Paragraph (1) shall be applied by substituting “150 percent” for “200 percent” in the case of—

(A) any 15-year or 20-year property not referred to in paragraph (3),

(B) any property (other than property described in paragraph (3)) which is a qualified smart electric meter or qualified smart electric grid system, or

(C) any property (other than property described in paragraph (3)) with respect to which the taxpayer elects under paragraph (5) to have the provisions of this paragraph apply.

(3) **Property to which straight line method applies** The applicable depreciation method shall be the straight line method in the case of the following property:

(A) Nonresidential real property.

(B) Residential rental property.

(C) Any railroad grading or tunnel bore.

(D) Property with respect to which the taxpayer elects under paragraph (5) to have the provisions of this paragraph apply.

(E) Property described in subsection (e)(3)(D)(ii).

(F) Water utility property described in subsection (e)(5).

(G) Qualified improvement property described in subsection (e)(6).

**(4) Salvage value treated as zero** Salvage value shall be treated as zero.

**(5) Election** An election under paragraph (2)(D)1 or (3)(D) may be made with respect to 1 or more classes of property for any taxable year and once made with respect to any class shall apply to all property in such class placed in service during such taxable year. Such an election, once made, shall be irrevocable.

### **(c) Applicable recovery period**

For purposes of this section, the applicable recovery period shall be determined in accordance with the following table:

<b>In the case of:</b>	<b>The applicable recovery period is:</b>
3-year property	3 years
5-year property	5 years
7-year property	7 years
10-year property	10 years
15-year property	15 years
20-year property	20 years
Water utility property	25 years
Residential rental property	27.5 years
Nonresidential real property	39 years.
Any railroad grading or tunnel bore	50 years.

### **(d) Applicable convention**

For purposes of this section—

**(1) In general** Except as otherwise provided in this subsection, the applicable convention is the half-year convention.

**(2) Real property** In the case of—

- (A) nonresidential real property,
  - (B) residential rental property, and
  - (C) any railroad grading or tunnel bore,
- the applicable convention is the mid-month convention.

**(3) Special rule where substantial property placed in service during last 3 months of taxable year**

**(A) In general** Except as provided in regulations, if during any taxable year—

- (i) the aggregate bases of property to which this section applies placed in service during the last 3 months of the taxable year, exceed
  - (ii) 40 percent of the aggregate bases of property to which this section applies placed in service during such taxable year,
- the applicable convention for all property to which this section applies placed in service during such taxable year shall be the mid-quarter convention.

**(B) Certain property not taken into account** For purposes of subparagraph (A), there shall not be taken into account—

- (i) any nonresidential real property, residential rental property, and railroad grading or tunnel bore, and
- (ii) any other property placed in service and disposed of during the same taxable year.

**(4) Definitions**

**(A) Half-year convention** The half-year convention is a convention which treats all property placed in service during any taxable year (or disposed of during any taxable year) as placed in service (or disposed of) on the mid-point of such taxable year.

**(B) Mid-month convention** The mid-month convention is a convention which treats all property placed in service during any month (or disposed of during any month) as placed in service (or disposed of) on the mid-point of such month.

**(C) Mid-quarter convention** The mid-quarter convention is a convention which treats all property placed in service during any quarter of a taxable year (or disposed of during any quarter of a taxable year) as placed in service (or disposed of) on the mid-point of such quarter.

**(e) Classification of property**

For purposes of this section—

**(1) In general** Except as otherwise provided in this subsection, property shall be classified under the following table:

Property shall be treated as:	If such property has a class life (in years) of:
3-year property	4 or less
5-year property	More than 4 but less than 10
7-year property	10 or more but less than 16

7-year property 10 or more but less than 16  
10-year property 16 or more but less than 20  
15-year property 20 or more but less than 25  
20-year property 25 or more.

## **(2) Residential rental or nonresidential real property**

### **(A) Residential rental property**

**(i) Residential rental property** The term “residential rental property” means any building or structure if 80 percent or more of the gross rental income from such building or structure for the taxable year is rental income from dwelling units.

**(ii) Definitions** For purposes of clause (i)—

**(I)** the term “dwelling unit” means a house or apartment used to provide living accommodations in a building or structure, but does not include a unit in a hotel, motel, or other establishment more than one-half of the units in which are used on a transient basis, and

**(II)** if any portion of the building or structure is occupied by the taxpayer, the gross rental income from such building or structure shall include the rental value of the portion so occupied.

**(B) Nonresidential real property** The term “nonresidential real property” means section 1250 property which is not—

**(i)** residential rental property, or

**(ii)** property with a class life of less than 27.5 years.

## **(3) Classification of certain property**

**(A) 3-year property** The term “3-year property” includes—

**(i)** any race horse—

**(I)** which is placed in service before January 1, 2022, and

**(II)** which is placed in service after December 31, 2021, and which is more than 2 years old at the time such horse is placed in service by such purchaser,

**(ii)** any horse other than a race horse which is more than 12 years old at the time it is placed in service, and

**(iii)** any qualified rent-to-own property.

**(B) 5-year property** The term “5-year property” includes—

**(i)** any automobile or light general purpose truck,

**(ii)** any semi-conductor manufacturing equipment,

**(iii)** any computer-based telephone central office switching equipment,

**(iv)** any qualified technological equipment,

**(v)** any section 1245 property used in connection with research and experimentation,

**(vi)** any property which—

(I) is described in subparagraph (A) of section 48(a)(3) (or would be so described if “solar or wind energy” were substituted for “solar energy” in clause (i) thereof and the last sentence of such section did not apply to such subparagraph),

(II) is described in paragraph (15) of section 48(I) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990) and has a power production capacity of not greater than 80 megawatts, or

(III) is described in section 48(I)(3)(A)(ix) (as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990), and

(vii) any machinery or equipment (other than any grain bin, cotton ginning asset, fence, or other land improvement) which is used in a farming business (as defined in section 263A(e)(4)), the original use of which commences with the taxpayer after December 31, 2017.

Nothing in any provision of law shall be construed to treat property as not being described in subclause (I) or (II) of clause (vi) by reason of being public utility property.

**(C) 7-year property** The term “7-year property” includes—

(i) any railroad track,

(ii) any motorsports entertainment complex,

(iii) any Alaska natural gas pipeline,

(iv) any natural gas gathering line the original use of which commences with the taxpayer after April 11, 2005, and

(v) any property which—

(I) does not have a class life, and

(II) is not otherwise classified under paragraph (2) or this paragraph.

**(D) 10-year property** The term “10-year property” includes—

(i) any single purpose agricultural or horticultural structure (within the meaning of subsection (i)(13)),

(ii) any tree or vine bearing fruit or nuts,

(iii) any qualified smart electric meter, and

(iv) any qualified smart electric grid system.

**(E) 15-year property** The term “15-year property” includes—

(i) any municipal wastewater treatment plant,

(ii) any telephone distribution plant and comparable equipment used for 2-way exchange of voice and data communications,

(iii) any section 1250 property which is a retail motor fuels outlet (whether or not food or other convenience items are sold at the outlet),

(iv) initial clearing and grading land improvements with respect to gas utility property,

(v) any section 1245 property (as defined in section 1245(a)(3)) used in the transmission at 69 or more kilovolts of electricity for sale and the original use of which commences

with the taxpayer after April 11, 2005,

(vi) any natural gas distribution line the original use of which commences with the taxpayer after April 11, 2005, and which is placed in service before January 1, 2011, and

(vii) any qualified improvement property.

**(F) 20-year property** The term “20-year property” means initial clearing and grading land improvements with respect to any electric utility transmission and distribution plant.

**(4) Railroad grading or tunnel bore** The term “railroad grading or tunnel bore” means all improvements resulting from excavations (including tunneling), construction of embankments, clearings, diversions of roads and streams, sodding of slopes, and from similar work necessary to provide, construct, reconstruct, alter, protect, improve, replace, or restore a roadbed or right-of-way for railroad track.

**(5) Water utility property** The term “water utility property” means property—

(A) which is an integral part of the gathering, treatment, or commercial distribution of water, and which, without regard to this paragraph, would be 20-year property, and

(B) any municipal sewer.

**(6) Qualified improvement property**

**(A) In general** The term “qualified improvement property” means any improvement made by the taxpayer to an interior portion of a building which is nonresidential real property if such improvement is placed in service after the date such building was first placed in service.

**(B) Certain improvements not included** Such term shall not include any improvement for which the expenditure is attributable to—

(i) the enlargement of the building,

(ii) any elevator or escalator, or

(iii) the internal structural framework of the building.

## **(i) Definitions and special rules**

For purposes of this section—

**(1) Class life** Except as provided in this section, the term “class life” means the class life (if any) which would be applicable with respect to any property as of January 1, 1986, under subsection (m) of section 167 (determined without regard to paragraph (4) and as if the taxpayer had made an election under such subsection). The Secretary, through an office established in the Treasury, shall monitor and analyze actual experience with respect to all depreciable assets. The reference in this paragraph to subsection (m) of section 167 shall be treated as a reference to such subsection as in effect on the day before the date of the enactment of the Revenue Reconciliation Act of 1990.

**(2) Qualified technological equipment**

**(A) In general** The term “qualified technological equipment” means—

(i) any computer or peripheral equipment,



- (ii) any high technology telephone station equipment installed on the customer's premises, and
- (iii) any high technology medical equipment.

**(B) Computer or peripheral equipment defined** For purposes of this paragraph—

**(i) In general** The term “computer or peripheral equipment” means—

- (I) any computer, and
- (II) any related peripheral equipment.

**(ii) Computer** The term “computer” means a programmable electronically activated device which—

- (I) is capable of accepting information, applying prescribed processes to the information, and supplying the results of these processes with or without human intervention, and
- (II) consists of a central processing unit containing extensive storage, logic, arithmetic, and control capabilities.

**(iii) Related peripheral equipment** The term “related peripheral equipment” means any auxiliary machine (whether on-line or off-line) which is designed to be placed under the control of the central processing unit of a computer.

**(iv) Exceptions** The term “computer or peripheral equipment” shall not include—

- (I) any equipment which is an integral part of other property which is not a computer,
- (II) typewriters, calculators, adding and accounting machines, copiers, duplicating equipment, and similar equipment, and
- (III) equipment of a kind used primarily for amusement or entertainment of the user.

**(C) High technology medical equipment** For purposes of this paragraph, the term “high technology medical equipment” means any electronic, electromechanical, or computer-based high technology equipment used in the screening, monitoring, observation, diagnosis, or treatment of patients in a laboratory, medical, or hospital environment.

**(3) Lease term**

**(A) In general** In determining a lease term—

- (i) there shall be taken into account options to renew,
- (ii) the term of a lease shall include the term of any service contract or similar arrangement (whether or not treated as a lease under section 7701(e))—
  - (I) which is part of the same transaction (or series of related transactions) which includes the lease, and
  - (II) which is with respect to the property subject to the lease or substantially similar property, and
- (iii) 2 or more successive leases which are part of the same transaction (or a series of related transactions) with respect to the same or substantially similar property shall be

treated as 1 lease.

**(B) Special rule for fair rental options on nonresidential real property or residential rental property** For purposes of clause (i) of subparagraph (A), in the case of nonresidential real property or residential rental property, there shall not be taken into account any option to renew at fair market value, determined at the time of renewal.

**(4) General asset accounts** Under regulations, a taxpayer may maintain 1 or more general asset accounts for any property to which this section applies. Except as provided in regulations, all proceeds realized on any disposition of property in a general asset account shall be included in income as ordinary income.

**(5) Changes in use** The Secretary shall, by regulations, provide for the method of determining the deduction allowable under section 167(a) with respect to any tangible property for any taxable year (and the succeeding taxable years) during which such property changes status under this section but continues to be held by the same person.

**(6) Treatments of additions or improvements to property** In the case of any addition to (or improvement of) any property—

(A) any deduction under subsection (a) for such addition or improvement shall be computed in the same manner as the deduction for such property would be computed if such property had been placed in service at the same time as such addition or improvement, and

(B) the applicable recovery period for such addition or improvement shall begin on the later of—

(i) the date on which such addition (or improvement) is placed in service, or

(ii) the date on which the property with respect to which such addition (or improvement) was made is placed in service.

**(7) Treatment of certain transferees**

**(A) In general** In the case of any property transferred in a transaction described in subparagraph (B), the transferee shall be treated as the transferor for purposes of computing the depreciation deduction determined under this section with respect to so much of the basis in the hands of the transferee as does not exceed the adjusted basis in the hands of the transferor. In any case where this section as in effect before the amendments made by section 201 of the Tax Reform Act of 1986 applied to the property in the hands of the transferor, the reference in the preceding sentence to this section shall be treated as a reference to this section as so in effect.

**(B) Transactions covered** The transactions described in this subparagraph are—

(i) any transaction described in section 332, 351, 361, 721, or 731, and

(ii) any transaction between members of the same affiliated group during any taxable year for which a consolidated return is made by such group.

**(C) Property reacquired by the taxpayer** Under regulations, property which is disposed of and then reacquired by the taxpayer shall be treated for purposes of computing the deduction allowable under subsection (a) as if such property had not been disposed of.

## **(8) Treatment of leasehold improvements**

**(A) In general** In the case of any building erected (or improvements made) on leased property, if such building or improvement is property to which this section applies, the depreciation deduction shall be determined under the provisions of this section.

**(B) Treatment of lessor improvements which are abandoned at termination of lease** An improvement—

(i) which is made by the lessor of leased property for the lessee of such property, and

(ii) which is irrevocably disposed of or abandoned by the lessor at the termination of the lease by such lessee,  
shall be treated for purposes of determining gain or loss under this title as disposed of by the lessor when so disposed of or abandoned.

**(C) Cross reference** For treatment of qualified long-term real property constructed or improved in connection with cash or rent reduction from lessor to lessee, see section 110(b).

## **(9) Normalization rules**

**(A) In general** In order to use a normalization method of accounting with respect to any public utility property for purposes of subsection (f)(2)—

(i) the taxpayer must, in computing its tax expense for purposes of establishing its cost of service for ratemaking purposes and reflecting operating results in its regulated books of account, use a method of depreciation with respect to such property that is the same as, and a depreciation period for such property that is no shorter than, the method and period used to compute its depreciation expense for such purposes; and

(ii) if the amount allowable as a deduction under this section with respect to such property (respecting all elections made by the taxpayer under this section) differs from the amount that would be allowable as a deduction under section 167 using the method (including the period, first and last year convention, and salvage value) used to compute regulated tax expense under clause (i), the taxpayer must make adjustments to a reserve to reflect the deferral of taxes resulting from such difference.

### **(B) Use of inconsistent estimates and projections, etc.**

**(i) In general** One way in which the requirements of subparagraph (A) are not met is if the taxpayer, for ratemaking purposes, uses a procedure or adjustment which is inconsistent with the requirements of subparagraph (A).

**(ii) Use of inconsistent estimates and projections** The procedures and adjustments which are to be treated as inconsistent for purposes of clause (i) shall include any procedure or adjustment for ratemaking purposes which uses an estimate or projection of the taxpayer's tax expense, depreciation expense, or reserve for deferred taxes under subparagraph (A) (ii) unless such estimate or projection is also used, for ratemaking purposes, with respect to the other 2 such items and with respect to the rate base.

**(iii) Regulatory authority** The Secretary may by regulations prescribe procedures and adjustments (in addition to those specified in clause (ii)) which are to be treated as inconsistent for purposes of clause (i).

**(C) Public utility property which does not meet normalization rules** In the case of any public utility property to which this section does not apply by reason of subsection (f)(2), the allowance for depreciation under section 167(a) shall be an amount computed using the method and period referred to in subparagraph (A)(i).

**(10) Public utility property** The term “public utility property” means property used predominantly in the trade or business of the furnishing or sale of—

(A) electrical energy, water, or sewage disposal services,

(B) gas or steam through a local distribution system,

(C) telephone services, or other communication services if furnished or sold by the Communications Satellite Corporation for purposes authorized by the Communications Satellite Act of 1962 (47 U.S.C. 701), or

(D) transportation of gas or steam by pipeline,  
if the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by any agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

**(11) Research and experimentation** The term “research and experimentation” has the same meaning as the term research and experimental has under section 174.

**(12) Section 1245 and 1250 property** The terms “section 1245 property” and “section 1250 property” have the meanings given such terms by sections 1245(a)(3) and 1250(c), respectively.

**(13) Single purpose agricultural or horticultural structure**

**(A) In general** The term “single purpose agricultural or horticultural structure” means—

(i) a single purpose livestock structure, and

(ii) a single purpose horticultural structure.

**(B) Definitions** For purposes of this paragraph—

**(i) Single purpose livestock structure** The term “single purpose livestock structure” means any enclosure or structure specifically designed, constructed, and used—

(I) for housing, raising, and feeding a particular type of livestock and their produce, and

(II) for housing the equipment (including any replacements) necessary for the housing, raising, and feeding referred to in subclause (I).

**(ii) Single purpose horticultural structure** The term “single purpose horticultural structure” means—

(I) a greenhouse specifically designed, constructed, and used for the commercial production of plants, and

(II) a structure specifically designed, constructed, and used for the commercial production of mushrooms.

(iii) **Structures which include work space** An enclosure or structure which provides work space shall be treated as a single purpose agricultural or horticultural structure only if such work space is solely for—

(I) the stocking, caring for, or collecting of livestock or plants (as the case may be) or their produce,

(II) the maintenance of the enclosure or structure, and

(III) the maintenance or replacement of the equipment or stock enclosed or housed therein.

(iv) **Livestock** The term “livestock” includes poultry.

#### (14) **Qualified rent-to-own property**

(A) **In general** The term “qualified rent-to-own property” means property held by a rent-to-own dealer for purposes of being subject to a rent-to-own contract.

(B) **Rent-to-own dealer** The term “rent-to-own dealer” means a person that, in the ordinary course of business, regularly enters into rent-to-own contracts with customers for the use of consumer property, if a substantial portion of those contracts terminate and the property is returned to such person before the receipt of all payments required to transfer ownership of the property from such person to the customer.

(C) **Consumer property** The term “consumer property” means tangible personal property of a type generally used within the home for personal use.

(D) **Rent-to-own contract** The term “rent-to-own contract” means any lease for the use of consumer property between a rent-to-own dealer and a customer who is an individual which

—  
(i) is titled “Rent-to-Own Agreement” or “Lease Agreement with Ownership Option,” or uses other similar language,

(ii) provides for level (or decreasing where no payment is less than 40 percent of the largest payment), regular periodic payments (for a payment period which is a week or month),

(iii) provides that legal title to such property remains with the rent-to-own dealer until the customer makes all the payments described in clause (ii) or early purchase payments required under the contract to acquire legal title to the item of property,

(iv) provides a beginning date and a maximum period of time for which the contract may be in effect that does not exceed 156 weeks or 36 months from such beginning date (including renewals or options to extend),

(v) provides for payments within the 156-week or 36-month period that, in the aggregate, generally exceed the normal retail price of the consumer property plus interest,

(vi) provides for payments under the contract that, in the aggregate, do not exceed \$10,000 per item of consumer property,

(vii) provides that the customer does not have any legal obligation to make all the payments referred to in clause (ii) set forth under the contract, and that at the end of each payment period the customer may either continue to use the consumer property by making

the payment for the next payment period or return such property to the rent-to-own dealer in good working order, in which case the customer does not incur any further obligations under the contract and is not entitled to a return of any payments previously made under the contract, and

(viii) provides that the customer has no right to sell, sublease, mortgage, pawn, pledge, encumber, or otherwise dispose of the consumer property until all the payments stated in the contract have been made.

**(15) Motorsports entertainment complex**

**(A) In general** The term “motorsports entertainment complex” means a racing track facility which—

(i) is permanently situated on land, and

(ii) during the 36-month period following the first day of the month in which the asset is placed in service, hosts 1 or more racing events for automobiles (of any type), trucks, or motorcycles which are open to the public for the price of admission.

**(B) Ancillary and support facilities** Such term shall include, if owned by the taxpayer who owns the complex and provided for the benefit of patrons of the complex—

(i) ancillary facilities and land improvements in support of the complex’s activities (including parking lots, sidewalks, waterways, bridges, fences, and landscaping),

(ii) support facilities (including food and beverage retailing, souvenir vending, and other nonlodging accommodations), and

(iii) appurtenances associated with such facilities and related attractions and amusements (including ticket booths, race track surfaces, suites and hospitality facilities, grandstands and viewing structures, props, walls, facilities that support the delivery of entertainment services, other special purpose structures, facades, shop interiors, and buildings).

**(C) Exception** Such term shall not include any transportation equipment, administrative services assets, warehouses, administrative buildings, hotels, or motels.

**(D) Termination** Such term shall not include any property placed in service after December 31, 2025.

**(16) Alaska natural gas pipeline** The term “Alaska natural gas pipeline” means the natural gas pipeline system located in the State of Alaska which—

(A) has a capacity of more than 500,000,000,000 Btu of natural gas per day, and

(B) is—

(i) placed in service after December 31, 2013, or

(ii) treated as placed in service on January 1, 2014, if the taxpayer who places such system in service before January 1, 2014, elects such treatment.

Such term includes the pipe, trunk lines, related equipment, and appurtenances used to carry natural gas, but does not include any gas processing plant.

**(17) Natural gas gathering line** The term “natural gas gathering line” means—

(A) the pipe, equipment, and appurtenances determined to be a gathering line by the Federal Energy Regulatory Commission, and

(B) the pipe, equipment, and appurtenances used to deliver natural gas from the wellhead or a commonpoint to the point at which such gas first reaches—

(i) a gas processing plant,

(ii) an interconnection with a transmission pipeline for which a certificate as an interstate transmission pipeline has been issued by the Federal Energy Regulatory Commission,

(iii) an interconnection with an intrastate transmission pipeline, or

(iv) a direct interconnection with a local distribution company, a gas storage facility, or an industrial consumer.

#### **(18) Qualified smart electric meters**

(A) **In general** The term “qualified smart electric meter” means any smart electric meter which—

(i) is placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services, and

(ii) does not have a class life (determined without regard to subsection (e)) of less than 16 years.

(B) **Smart electric meter** For purposes of subparagraph (A), the term “smart electric meter” means any time-based meter and related communication equipment which is capable of being used by the taxpayer as part of a system that—

(i) measures and records electricity usage data on a time-differentiated basis in at least 24 separate time segments per day,

(ii) provides for the exchange of information between supplier or provider and the customer’s electric meter in support of time-based rates or other forms of demand response,

(iii) provides data to such supplier or provider so that the supplier or provider can provide energy usage information to customers electronically, and

(iv) provides net metering.

#### **(19) Qualified smart electric grid systems**

(A) **In general** The term “qualified smart electric grid system” means any smart grid property which—

(i) is used as part of a system for electric distribution grid communications, monitoring, and management placed in service by a taxpayer who is a supplier of electric energy or a provider of electric energy services, and

(ii) does not have a class life (determined without regard to subsection (e)) of less than 16 years.

(B) **Smart grid property** For the purposes of subparagraph (A), the term “smart grid

property” means electronics and related equipment that is capable of—

- (i) sensing, collecting, and monitoring data of or from all portions of a utility’s electric distribution grid,
- (ii) providing real-time, two-way communications to monitor or manage such grid, and
- (iii) providing real time analysis of and event prediction based upon collected data that can be used to improve electric distribution system reliability, quality, and performance.

**(k) Special allowance for certain property**

**(1) Additional allowance** In the case of any qualified property—

(A) the depreciation deduction provided by section 167(a) for the taxable year in which such property is placed in service shall include an allowance equal to the applicable percentage of the adjusted basis of the qualified property, and

(B) the adjusted basis of the qualified property shall be reduced by the amount of such deduction before computing the amount otherwise allowable as a depreciation deduction under this chapter for such taxable year and any subsequent taxable year.

**(2) Qualified property** For purposes of this subsection—

**(A) In general** The term “qualified property” means property—

(i)

(I) to which this section applies which has a recovery period of 20 years or less,

(II) which is computer software (as defined in section 167(f)(1)(B)) for which a deduction is allowable under section 167(a) without regard to this subsection,

(III) which is water utility property, or

(IV) which is a qualified film or television production (as defined in subsection (d) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection, or

(V) which is a qualified live theatrical production (as defined in subsection (e) of section 181) for which a deduction would have been allowable under section 181 without regard to subsections (a)(2) and (g) of such section or this subsection,

(ii) the original use of which begins with the taxpayer or the acquisition of which by the taxpayer meets the requirements of clause (ii) of subparagraph (E), and

(iii) which is placed in service by the taxpayer before January 1, 2027.

**(B) Certain property having longer production periods treated as qualified property**

**(i) In general** The term “qualified property” includes any property if such property—

(I) meets the requirements of clauses (i) and (ii) of subparagraph (A),

(II) is placed in service by the taxpayer before January 1, 2028,

(III) is acquired by the taxpayer (or acquired pursuant to a written binding contract entered into) before January 1, 2027,



(IV) has a recovery period of at least 10 years or is transportation property,

(V) is subject to section 263A, and

(VI) meets the requirements of clause (iii) of section 263A(f)(1)(B) (determined as if such clause also applies to property which has a long useful life (within the meaning of section 263A(f))).

**(ii) Only pre-January 1, 2027 basis eligible for additional allowance** In the case of property which is qualified property solely by reason of clause (i), paragraph (1) shall apply only to the extent of the adjusted basis thereof attributable to manufacture, construction, or production before January 1, 2027.

**(iii) Transportation property** For purposes of this subparagraph, the term “transportation property” means tangible personal property used in the trade or business of transporting persons or property.

**(iv) Application of subparagraph** This subparagraph shall not apply to any property which is described in subparagraph (C).

**(C) Certain aircraft** The term “qualified property” includes property—

(i) which meets the requirements of subparagraph (A)(ii) and subclauses (II) and (III) of subparagraph (B)(i),

(ii) which is an aircraft which is not a transportation property (as defined in subparagraph (B)(iii)) other than for agricultural or firefighting purposes,

(iii) which is purchased and on which such purchaser, at the time of the contract for purchase, has made a nonrefundable deposit of the lesser of—

(I) 10 percent of the cost, or

(II) \$100,000, and

(iv) which has—

(I) an estimated production period exceeding 4 months, and

(II) a cost exceeding \$200,000.

**(D) Exception for alternative depreciation property** The term “qualified property” shall not include any property to which the alternative depreciation system under subsection (g) applies, determined—

(i) without regard to paragraph (7) of subsection (g) (relating to election to have system apply), and

(ii) after application of section 280F(b) (relating to listed property with limited business use).

**(E) Special rules**

**(i) Self-constructed property** In the case of a taxpayer manufacturing, constructing, or producing property for the taxpayer’s own use, the requirements of subclause (III) of subparagraph (B)(i) shall be treated as met if the taxpayer begins manufacturing, constructing, or producing the property before January 1, 2027.

**(ii) Acquisition requirements** An acquisition of property meets the requirements of this clause if—

(I) such property was not used by the taxpayer at any time prior to such acquisition, and

(II) the acquisition of such property meets the requirements of paragraphs (2)(A), (2)(B), (2)(C), and (3) of section 179(d).

**(iii) Syndication** For purposes of subparagraph (A)(ii), if—

(I) property is used by a lessor of such property and such use is the lessor's first use of such property,

(II) such property is sold by such lessor or any subsequent purchaser within 3 months after the date such property was originally placed in service (or, in the case of multiple units of property subject to the same lease, within 3 months after the date the final unit is placed in service, so long as the period between the time the first unit is placed in service and the time the last unit is placed in service does not exceed 12 months), and

(III) the user of such property after the last sale during such 3-month period remains the same as when such property was originally placed in service, such property shall be treated as originally placed in service not earlier than the date of such last sale.

**(F) Coordination with section 280F** For purposes of section 280F—

**(i) Automobiles** In the case of a passenger automobile (as defined in section 280F(d)(5)) which is qualified property, the Secretary shall increase the limitation under section 280F(a)(1)(A)(i) by \$8,000.

**(ii) Listed property** The deduction allowable under paragraph (1) shall be taken into account in computing any recapture amount under section 280F(b)(2).

**(iii) Phase down** In the case of a passenger automobile acquired by the taxpayer before September 28, 2017, and placed in service by the taxpayer after September 27, 2017, clause (i) shall be applied by substituting for "\$8,000"—

(I) in the case of an automobile placed in service during 2018, \$6,400, and

(II) in the case of an automobile placed in service during 2019, \$4,800.

**(G) Deduction allowed in computing minimum tax** For purposes of determining alternative minimum taxable income under section 55, the deduction under section 167 for qualified property shall be determined without regard to any adjustment under section 56.

**(H) Production placed in service** For purposes of subparagraph (A)—

(i) a qualified film or television production shall be considered to be placed in service at the time of initial release or broadcast, and

(ii) a qualified live theatrical production shall be considered to be placed in service at the time of the initial live staged performance.

[ (3) Repealed. Pub. L. 115–97, title I, §13204(a)(4)(B)(ii), Dec. 22, 2017, 131 Stat. 2111 ]

[ (4) Repealed. Pub. L. 115–97, title I, §12001(b)(13), Dec. 22, 2017, 131 Stat. 2094]

**(5) Special rules for certain plants bearing fruits and nuts**

**(A) In general** In the case of any specified plant which is planted before January 1, 2027, or is grafted before such date to a plant that has already been planted, by the taxpayer in the ordinary course of the taxpayer’s farming business (as defined in section 263A(e)(4)) during a taxable year for which the taxpayer has elected the application of this paragraph—

(i) a depreciation deduction equal to the applicable percentage of the adjusted basis of such specified plant shall be allowed under section 167(a) for the taxable year in which such specified plant is so planted or grafted, and

(ii) the adjusted basis of such specified plant shall be reduced by the amount of such deduction.

**(B) Specified plant** For purposes of this paragraph, the term “specified plant” means—

(i) any tree or vine which bears fruits or nuts, and

(ii) any other plant which will have more than one crop or yield of fruits or nuts and which generally has a pre-productive period of more than 2 years from the time of planting or grafting to the time at which such plant begins bearing a marketable crop or yield of fruits or nuts.

Such term shall not include any property which is planted or grafted outside of the United States.

**(C) Election revocable only with consent** An election under this paragraph may be revoked only with the consent of the Secretary.

**(D) Additional depreciation may be claimed only once** If this paragraph applies to any specified plant, such specified plant shall not be treated as qualified property in the taxable year in which placed in service.

**(E) Deduction allowed in computing minimum tax** Rules similar to the rules of paragraph (2)(G) shall apply for purposes of this paragraph.

**(6) Applicable percentage** For purposes of this subsection—

**(A) In general** Except as otherwise provided in this paragraph, the term “applicable percentage” means—

(i) in the case of property placed in service after September 27, 2017, and before January 1, 2023, 100 percent,

(ii) in the case of property placed in service after December 31, 2022, and before January 1, 2024, 80 percent,

(iii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 60 percent,

(iv) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 40 percent, and

(v) in the case of property placed in service after December 31, 2025, and before

January 1, 2027, 20 percent.

**(B) Rule for property with longer production periods** In the case of property described in subparagraph (B) or (C) of paragraph (2), the term “applicable percentage” means—

(i) in the case of property placed in service after September 27, 2017, and before January 1, 2024, 100 percent,

(ii) in the case of property placed in service after December 31, 2023, and before January 1, 2025, 80 percent,

(iii) in the case of property placed in service after December 31, 2024, and before January 1, 2026, 60 percent,

(iv) in the case of property placed in service after December 31, 2025, and before January 1, 2027, 40 percent, and

(v) in the case of property placed in service after December 31, 2026, and before January 1, 2028, 20 percent.

**(C) Rule for plants bearing fruits and nuts** In the case of a specified plant described in paragraph (5), the term “applicable percentage” means—

(i) in the case of a plant which is planted or grafted after September 27, 2017, and before January 1, 2023, 100 percent,

(ii) in the case of a plant which is planted or grafted after December 31, 2022, and before January 1, 2024, 80 percent,

(iii) in the case of a plant which is planted or grafted after December 31, 2023, and before January 1, 2025, 60 percent,

(iv) in the case of a plant which is planted or grafted after December 31, 2024, and before January 1, 2026, 40 percent, and

(v) in the case of a plant which is planted or grafted after December 31, 2025, and before January 1, 2027, 20 percent.

**(7) Election out** If a taxpayer makes an election under this paragraph with respect to any class of property for any taxable year, paragraphs (1) and (2)(F) shall not apply to any qualified property in such class placed in service during such taxable year. An election under this paragraph may be revoked only with the consent of the Secretary.

**(8) Phase down** In the case of qualified property acquired by the taxpayer before September 28, 2017, and placed in service by the taxpayer after September 27, 2017, paragraph (6) shall be applied by substituting for each percentage therein—

(A) “50 percent” in the case of—

(i) property placed in service before January 1, 2018, and

(ii) property described in subparagraph (B) or (C) of paragraph (2) which is placed in service in 2018,

(B) “40 percent” in the case of—

(i) property placed in service in 2018 (other than property described in subparagraph

(B) or (C) of paragraph (2)), and

(ii) property described in subparagraph (B) or (C) of paragraph (2) which is placed in service in 2019,

(C) “30 percent” in the case of—

(i) property placed in service in 2019 (other than property described in subparagraph (B) or (C) of paragraph (2)), and

(ii) property described in subparagraph (B) or (C) of paragraph (2) which is placed in service in 2020, and

(D) “0 percent” in the case of—

(i) property placed in service after 2019 (other than property described in subparagraph (B) or (C) of paragraph (2)), and

(ii) property described in subparagraph (B) or (C) of paragraph (2) which is placed in service after 2020.

**(9) Exception for certain property** The term “qualified property” shall not include—

(A) any property which is primarily used in a trade or business described in clause (iv) of section 163(j)(7)(A), or

(B) any property used in a trade or business that has had floor plan financing indebtedness (as defined in paragraph (9) of section 163(j)), if the floor plan financing interest related to such indebtedness was taken into account under paragraph (1)(C) of such section.

**(10) Special rule for property placed in service during certain periods**

(A) **In general** In the case of qualified property placed in service by the taxpayer during the first taxable year ending after September 27, 2017, if the taxpayer elects to have this paragraph apply for such taxable year, paragraphs (1)(A) and (5)(A)(i) shall be applied by substituting “50 percent” for “the applicable percentage”.

(B) **Form of election** Any election under this paragraph shall be made at such time and in such form and manner as the Secretary may prescribe.

## **§170. CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS**

**(a) Allowance of deduction**

(1) **General rule** There shall be allowed as a deduction any charitable contribution (as defined in subsection (c)) payment of which is made within the taxable year. A charitable contribution shall be allowable as a deduction only if verified under regulations prescribed by the Secretary.

(2) **Corporations on accrual basis** In the case of a corporation reporting its taxable income on the accrual basis, if—

(A) the board of directors authorizes a charitable contribution during any taxable year, and

(B) payment of such contribution is made after the close of such taxable year and on or before the 15th day of the fourth month following the close of such taxable year, then the taxpayer may elect to treat such contribution as paid during such taxable year. The election may be made only at the time of the filing of the return for such taxable year, and shall be signified in such manner as the Secretary shall by regulations prescribe.

**(3) Future interests in tangible personal property** For purposes of this section, payment of a charitable contribution which consists of a future interest in tangible personal property shall be treated as made only when all intervening interests in, and rights to the actual possession or enjoyment of, the property have expired or are held by persons other than the taxpayer or those standing in a relationship to the taxpayer described in section 267(b) or 707(b). For purposes of the preceding sentence, a fixture which is intended to be severed from the real property shall be treated as tangible personal property.

### **(c) Charitable contribution defined**

For purposes of this section, the term “charitable contribution” means a contribution or gift to or for the use of—

(1) A State, a possession of the United States, or any political subdivision of any of the foregoing, or the United States or the District of Columbia, but only if the contribution or gift is made for exclusively public purposes.

(2) A corporation, trust, or community chest, fund, or foundation—

(A) created or organized in the United States or in any possession thereof, or under the law of the United States, any State, the District of Columbia, or any possession of the United States;

(B) organized and operated exclusively for religious, charitable, scientific, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals;

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual; and

(D) which is not disqualified for tax exemption under section 501(c)(3) by reason of attempting to influence legislation, and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

A contribution or gift by a corporation to a trust, chest, fund, or foundation shall be deductible by reason of this paragraph only if it is to be used within the United States or any of its possessions exclusively for purposes specified in subparagraph (B). Rules similar to the rules of section 501(j) shall apply for purposes of this paragraph.

(3) A post or organization of war veterans, or an auxiliary unit or society of, or trust or foundation for, any such post or organization—

(A) organized in the United States or any of its possessions, and

(B) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(4) In the case of a contribution or gift by an individual, a domestic fraternal society, order, or association, operating under the lodge system, but only if such contribution or gift is to be used exclusively for religious, charitable, scientific, literary, or educational purposes, or for the prevention of cruelty to children or animals.

(5) A cemetery company owned and operated exclusively for the benefit of its members, or any corporation chartered solely for burial purposes as a cemetery corporation and not permitted by its charter to engage in any business not necessarily incident to that purpose, if such company or corporation is not operated for profit and no part of the net earnings of such company or corporation inures to the benefit of any private shareholder or individual.

For purposes of this section, the term “charitable contribution” also means an amount treated under subsection (g) as paid for the use of an organization described in paragraph (2), (3), or (4).

**(e) Certain contributions of ordinary income and capital gain property**

**(1) General rule** The amount of any charitable contribution of property otherwise taken into account under this section shall be reduced by the sum of—

(A) the amount of gain which would not have been long-term capital gain (determined without regard to section 1221(b)(3)) if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such contribution), and

(B) in the case of a charitable contribution—

(i) of tangible personal property—

(I) if the use by the donee is unrelated to the purpose or function constituting the basis for its exemption under section 501 (or, in the case of a governmental unit, to any purpose or function described in subsection (c)), or

(II) which is applicable property (as defined in paragraph (7)(C), but without regard to clause (ii) thereof) which is sold, exchanged, or otherwise disposed of by the donee before the last day of the taxable year in which the contribution was made and with respect to which the donee has not made a certification in accordance with paragraph (7)(D),

(ii) to or for the use of a private foundation (as defined in section 509(a)), other than a private foundation described in subsection (b)(1)(F),

(iii) of any patent, copyright (other than a copyright described in section 1221(a)(3) or 1231(b)(1)(C)), trademark, trade name, trade secret, know-how, software (other than software described in section 197(e)(3)(A)(i)), or similar property, or applications or registrations of such property, or

(iv) of any taxidermy property which is contributed by the person who prepared, stuffed, or mounted the property or by any person who paid or incurred the cost of such preparation, stuffing, or mounting,

the amount of gain which would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of such

contribution).

For purposes of applying this paragraph (other than in the case of gain to which section 617(d) (1), 1245(a), 1250(a), 1252(a), or 1254(a) applies), property which is property used in the trade or business (as defined in section 1231(b)) shall be treated as a capital asset. For purposes of applying this paragraph in the case of a charitable contribution of stock in an S corporation, rules similar to the rules of section 751 shall apply in determining whether gain on such stock would have been long-term capital gain if such stock were sold by the taxpayer.

**(2) Allocation of basis** For purposes of paragraph (1), in the case of a charitable contribution of less than the taxpayer's entire interest in the property contributed, the taxpayer's adjusted basis in such property shall be allocated between the interest contributed and any interest not contributed in accordance with regulations prescribed by the Secretary.

**(3) Special rule for certain contributions of inventory and other property**

**(A) Qualified contributions** For purposes of this paragraph, a qualified contribution shall mean a charitable contribution of property described in paragraph (1) or (2) of section 1221(a), by a corporation (other than a corporation which is an S corporation) to an organization which is described in section 501(c)(3) and is exempt under section 501(a) (other than a private foundation, as defined in section 509(a), which is not an operating foundation, as defined in section 4942(j)(3)), but only if—

- (i)** the use of the property by the donee is related to the purpose or function constituting the basis for its exemption under section 501 and the property is to be used by the donee solely for the care of the ill, the needy, or infants;
- (ii)** the property is not transferred by the donee in exchange for money, other property, or services;
- (iii)** the taxpayer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of clauses (i) and (ii); and
- (iv)** in the case where the property is subject to regulation under the Federal Food, Drug, and Cosmetic Act, as amended, such property must fully satisfy the applicable requirements of such Act and regulations promulgated thereunder on the date of transfer and for one hundred and eighty days prior thereto.

**(B) Amount of reduction** The reduction under paragraph (1)(A) for any qualified contribution (as defined in subparagraph (A)) shall be no greater than the sum of—

- (i)** one-half of the amount computed under paragraph (1)(A) (computed without regard to this paragraph), and
- (ii)** the amount (if any) by which the charitable contribution deduction under this section for any qualified contribution (computed by taking into account the amount determined in clause (i), but without regard to this clause) exceeds twice the basis of such property.

**(C) Special rule for contributions of food inventory**

**(i) General rule** In the case of a charitable contribution of food from any trade or business of the taxpayer, this paragraph shall be applied—



- (I) without regard to whether the contribution is made by a C corporation, and
- (II) only to food that is apparently wholesome food.

**(ii) Limitation** The aggregate amount of such contributions for any taxable year which may be taken into account under this section shall not exceed—

(I) in the case of any taxpayer other than a C corporation, 15 percent of the taxpayer's aggregate net income for such taxable year from all trades or businesses from which such contributions were made for such year, computed without regard to this section, and

(II) in the case of a C corporation, 15 percent of taxable income (as defined in subsection (b)(2)(D)).

**(iii) Rules related to limitation**

(I) **Carryover** If such aggregate amount exceeds the limitation imposed under clause (ii), such excess shall be treated (in a manner consistent with the rules of subsection (d)) as a charitable contribution described in clause (i) in each of the 5 succeeding taxable years in order of time.

(II) **Coordination with overall corporate limitation** In the case of any charitable contribution which is allowable after the application of clause (ii)(II), subsection (b)(2)(A) shall not apply to such contribution, but the limitation imposed by such subsection shall be reduced (but not below zero) by the aggregate amount of such contributions. For purposes of subsection (b)(2)(B), such contributions shall be treated as allowable under subsection (b)(2)(A).

**(iv) Determination of basis for certain taxpayers** If a taxpayer—

(I) does not account for inventories under section 471, and

(II) is not required to capitalize indirect costs under section 263A, the taxpayer may elect, solely for purposes of subparagraph (B), to treat the basis of any apparently wholesome food as being equal to 25 percent of the fair market value of such food.

**(v) Determination of fair market value** In the case of any such contribution of apparently wholesome food which cannot or will not be sold solely by reason of internal standards of the taxpayer, lack of market, or similar circumstances, or by reason of being produced by the taxpayer exclusively for the purposes of transferring the food to an organization described in subparagraph (A), the fair market value of such contribution shall be determined—

(I) without regard to such internal standards, such lack of market, such circumstances, or such exclusive purpose, and

(II) by taking into account the price at which the same or substantially the same food items (as to both type and quality) are sold by the taxpayer at the time of the contribution (or, if not so sold at such time, in the recent past).

**(vi) Apparently wholesome food** For purposes of this subparagraph, the term “apparently wholesome food” has the meaning given to such term by section 22(b)(2) of the Bill Emerson Good Samaritan Food Donation Act (42 U.S.C. 1791(b)(2)), as in effect on the date of the enactment of this subparagraph.

(D) This paragraph shall not apply to so much of the amount of the gain described in paragraph (1)(A) which would be long-term capital gain but for the application of sections 617, 1245, 1250, or 1252.

**(4) Special rule for contributions of scientific property used for research**

(A) **Limit on reduction** In the case of a qualified research contribution, the reduction under paragraph (1)(A) shall be no greater than the amount determined under paragraph (3)(B).

(B) **Qualified research contributions** For purposes of this paragraph, the term “qualified research contribution” means a charitable contribution by a corporation of tangible personal property described in paragraph (1) of section 1221(a), but only if—

- (i) the contribution is to an organization described in subparagraph (A) or subparagraph (B) of section 41(e)(6),
- (ii) the property is constructed or assembled by the taxpayer,
- (iii) the contribution is made not later than 2 years after the date the construction or assembly of the property is substantially completed,
- (iv) the original use of the property is by the donee,
- (v) the property is scientific equipment or apparatus substantially all of the use of which by the donee is for research or experimentation (within the meaning of section 174), or for research training, in the United States in physical or biological sciences,
- (vi) the property is not transferred by the donee in exchange for money, other property, or services, and
- (vii) the taxpayer receives from the donee a written statement representing that its use and disposition of the property will be in accordance with the provisions of clauses (v) and (vi).

(C) **Construction of property by taxpayer** For purposes of this paragraph, property shall be treated as constructed by the taxpayer only if the cost of the parts used in the construction of such property (other than parts manufactured by the taxpayer or a related person) do not exceed 50 percent of the taxpayer’s basis in such property.

(D) **Corporation** For purposes of this paragraph, the term “corporation” shall not include—

- (i) an S corporation,
- (ii) a personal holding company (as defined in section 542), and
- (iii) a service organization (as defined in section 414(m)(3)).

**(5) Special rule for contributions of stock for which market quotations are readily available**

(A) **In general** Subparagraph (B)(ii) of paragraph (1) shall not apply to any contribution of qualified appreciated stock.

(B) **Qualified appreciated stock** Except as provided in subparagraph (C), for purposes of this paragraph, the term “qualified appreciated stock” means any stock of a corporation—

- (i) for which (as of the date of the contribution) market quotations are readily available on an established securities market, and

(ii) which is capital gain property (as defined in subsection (b)(1)(C)(iv)).

**(C) Donor may not contribute more than 10 percent of stock of corporation**

(i) **In general** In the case of any donor, the term “qualified appreciated stock” shall not include any stock of a corporation contributed by the donor in a contribution to which paragraph (1)(B)(ii) applies (determined without regard to this paragraph) to the extent that the amount of the stock so contributed (when increased by the aggregate amount of all prior such contributions by the donor of stock in such corporation) exceeds 10 percent (in value) of all of the outstanding stock of such corporation.

(ii) **Special rule** For purposes of clause (i), an individual shall be treated as making all contributions made by any member of his family (as defined in section 267(c)(4)).

[(6) Repealed. Pub. L. 113–295, div. A, title II, §221(a)(28)(B), Dec. 19, 2014, 128 Stat. 4041]

**(7) Recapture of deduction on certain dispositions of exempt use property**

(A) **In general** In the case of an applicable disposition of applicable property, there shall be included in the income of the donor of such property for the taxable year of such donor in which the applicable disposition occurs an amount equal to the excess (if any) of—

(i) the amount of the deduction allowed to the donor under this section with respect to such property, over

(ii) the donor’s basis in such property at the time such property was contributed.

(B) **Applicable disposition** For purposes of this paragraph, the term “applicable disposition” means any sale, exchange, or other disposition by the donee of applicable property—

(i) after the last day of the taxable year of the donor in which such property was contributed, and

(ii) before the last day of the 3-year period beginning on the date of the contribution of such property,  
unless the donee makes a certification in accordance with subparagraph (D).

(C) **Applicable property** For purposes of this paragraph, the term “applicable property” means charitable deduction property (as defined in section 6050L(a)(2)(A))—

(i) which is tangible personal property the use of which is identified by the donee as related to the purpose or function constituting the basis of the donee’s exemption under section 501, and

(ii) for which a deduction in excess of the donor’s basis is allowed.

(D) **Certification** A certification meets the requirements of this subparagraph if it is a written statement which is signed under penalty of perjury by an officer of the donee organization and—

(i) which—

(I) certifies that the use of the property by the donee was substantial and related to the purpose or function constituting the basis for the donee’s exemption under section

501, and

(II) describes how the property was used and how such use furthered such purpose or function, or

(ii) which—

(I) states the intended use of the property by the donee at the time of the contribution, and

(II) certifies that such intended use has become impossible or infeasible to implement.

**(f) Disallowance of deduction in certain cases and special rules**

**(1) In general** No deduction shall be allowed under this section for a contribution to or for the use of an organization or trust described in section 508(d) or 4948(c)(4) subject to the conditions specified in such sections.

**(2) Contributions of property placed in trust**

**(A) Remainder interest** In the case of property transferred in trust, no deduction shall be allowed under this section for the value of a contribution of a remainder interest unless the trust is a charitable remainder annuity trust or a charitable remainder unitrust (described in section 664), or a pooled income fund (described in section 642(c)(5)).

**(B) Income interests, etc.** No deduction shall be allowed under this section for the value of any interest in property (other than a remainder interest) transferred in trust unless the interest is in the form of a guaranteed annuity or the trust instrument specifies that the interest is a fixed percentage distributed yearly of the fair market value of the trust property (to be determined yearly) and the grantor is treated as the owner of such interest for purposes of applying section 671. If the donor ceases to be treated as the owner of such an interest for purposes of applying section 671, at the time the donor ceases to be so treated, the donor shall for purposes of this chapter be considered as having received an amount of income equal to the amount of any deduction he received under this section for the contribution reduced by the discounted value of all amounts of income earned by the trust and taxable to him before the time at which he ceases to be treated as the owner of the interest. Such amounts of income shall be discounted to the date of the contribution. The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this subparagraph.

**(C) Denial of deduction in case of payments by certain trusts** In any case in which a deduction is allowed under this section for the value of an interest in property described in subparagraph (B), transferred in trust, no deduction shall be allowed under this section to the grantor or any other person for the amount of any contribution made by the trust with respect to such interest.

**(D) Exception** This paragraph shall not apply in a case in which the value of all interests in property transferred in trust are deductible under subsection (a).

**(3) Denial of deduction in case of certain contributions of partial interests in property**

**(A) In general** In the case of a contribution (not made by a transfer in trust) of an interest in property which consists of less than the taxpayer's entire interest in such property, a deduction shall be allowed under this section only to the extent that the value of the interest contributed would be allowable as a deduction under this section if such interest had been transferred in trust. For purposes of this subparagraph, a contribution by a taxpayer of the right to use property shall be treated as a contribution of less than the taxpayer's entire interest in such property.

**(B) Exceptions** Subparagraph (A) shall not apply to—

- (i) a contribution of a remainder interest in a personal residence or farm,
- (ii) a contribution of an undivided portion of the taxpayer's entire interest in property, and
- (iii) a qualified conservation contribution.

**(4) Valuation of remainder interest in real property** For purposes of this section, in determining the value of a remainder interest in real property, depreciation (computed on the straight line method) and depletion of such property shall be taken into account, and such value shall be discounted at a rate of 6 percent per annum, except that the Secretary may prescribe a different rate.

**(5) Reduction for certain interest** If, in connection with any charitable contribution, a liability is assumed by the recipient or by any other person, or if a charitable contribution is of property which is subject to a liability, then, to the extent necessary to avoid the duplication of amounts, the amount taken into account for purposes of this section as the amount of the charitable contribution—

(A) shall be reduced for interest (i) which has been paid (or is to be paid) by the taxpayer, (ii) which is attributable to the liability, and (iii) which is attributable to any period after the making of the contribution, and

(B) in the case of a bond, shall be further reduced for interest (i) which has been paid (or is to be paid) by the taxpayer on indebtedness incurred or continued to purchase or carry such bond, and (ii) which is attributable to any period before the making of the contribution. The reduction pursuant to subparagraph (B) shall not exceed the interest (including interest equivalent) on the bond which is attributable to any period before the making of the contribution and which is not (under the taxpayer's method of accounting) includible in the gross income of the taxpayer for any taxable year. For purposes of this paragraph, the term "bond" means any bond, debenture, note, or certificate or other evidence of indebtedness.

**(6) Deductions for out-of-pocket expenditures** No deduction shall be allowed under this section for an out-of-pocket expenditure made by any person on behalf of an organization described in subsection (c) (other than an organization described in section 501(h)(5) (relating to churches, etc.)) if the expenditure is made for the purpose of influencing legislation (within the meaning of section 501(c)(3)).

**(7) Reforms to comply with paragraph (2)**

**(A) In general** A deduction shall be allowed under subsection (a) in respect of any qualified reformation (within the meaning of section 2055(e)(3)(B)).

**(B) Rules similar to section 2055(e)(3) to apply** For purposes of this paragraph, rules similar to the rules of section 2055(e)(3) shall apply.

**(8) Substantiation requirement for certain contributions**

**(A) General rule** No deduction shall be allowed under subsection (a) for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgment of the contribution by the donee organization that meets the requirements of subparagraph (B).

**(B) Content of acknowledgement** An acknowledgement meets the requirements of this subparagraph if it includes the following information:

- (i)** The amount of cash and a description (but not value) of any property other than cash contributed.
- (ii)** Whether the donee organization provided any goods or services in consideration, in whole or in part, for any property described in clause (i).
- (iii)** A description and good faith estimate of the value of any goods or services referred to in clause (ii) or, if such goods or services consist solely of intangible religious benefits, a statement to that effect.

For purposes of this subparagraph, the term “intangible religious benefit” means any intangible religious benefit which is provided by an organization organized exclusively for religious purposes and which generally is not sold in a commercial transaction outside the donative context.

**(C) Contemporaneous** For purposes of subparagraph (A), an acknowledgment shall be considered to be contemporaneous if the taxpayer obtains the acknowledgment on or before the earlier of—

- (i)** the date on which the taxpayer files a return for the taxable year in which the contribution was made, or
- (ii)** the due date (including extensions) for filing such return.

**(D) Regulations** The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph, including regulations that may provide that some or all of the requirements of this paragraph do not apply in appropriate cases.

**(9) Denial of deduction where contribution for lobbying activities** No deduction shall be allowed under this section for a contribution to an organization which conducts activities to which section 162(e)(1) applies on matters of direct financial interest to the donor’s trade or business, if a principal purpose of the contribution was to avoid Federal income tax by securing a deduction for such activities under this section which would be disallowed by reason of section 162(e) if the donor had conducted such activities directly. No deduction shall be allowed under section 162(a) for any amount for which a deduction is disallowed under the preceding sentence.

**(10) Split-dollar life insurance, annuity, and endowment contracts**

**(A) In general** Nothing in this section or in section 545(b)(2), 642(c), 2055, 2106(a)(2), or

2522 shall be construed to allow a deduction, and no deduction shall be allowed, for any transfer to or for the use of an organization described in subsection (c) if in connection with such transfer—

- (i) the organization directly or indirectly pays, or has previously paid, any premium on any personal benefit contract with respect to the transferor, or

- (ii) there is an understanding or expectation that any person will directly or indirectly pay any premium on any personal benefit contract with respect to the transferor.

**(B) Personal benefit contract** For purposes of subparagraph (A), the term “personal benefit contract” means, with respect to the transferor, any life insurance, annuity, or endowment contract if any direct or indirect beneficiary under such contract is the transferor, any member of the transferor’s family, or any other person (other than an organization described in subsection (c)) designated by the transferor.

**(C) Application to charitable remainder trusts** In the case of a transfer to a trust referred to in subparagraph (E), references in subparagraphs (A) and (F) to an organization described in subsection (c) shall be treated as a reference to such trust.

**(D) Exception for certain annuity contracts** If, in connection with a transfer to or for the use of an organization described in subsection (c), such organization incurs an obligation to pay a charitable gift annuity (as defined in section 501(m)) and such organization purchases any annuity contract to fund such obligation, persons receiving payments under the charitable gift annuity shall not be treated for purposes of subparagraph (B) as indirect beneficiaries under such contract if—

- (i) such organization possesses all of the incidents of ownership under such contract,

- (ii) such organization is entitled to all the payments under such contract, and

- (iii) the timing and amount of payments under such contract are substantially the same as the timing and amount of payments to each such person under such obligation (as such obligation is in effect at the time of such transfer).

**(E) Exception for certain contracts held by charitable remainder trusts** A person shall not be treated for purposes of subparagraph (B) as an indirect beneficiary under any life insurance, annuity, or endowment contract held by a charitable remainder annuity trust or a charitable remainder unitrust (as defined in section 664(d)) solely by reason of being entitled to any payment referred to in paragraph (1)(A) or (2)(A) of section 664(d) if—

- (i) such trust possesses all of the incidents of ownership under such contract, and

- (ii) such trust is entitled to all the payments under such contract.

**(F) Excise tax on premiums paid**

- (i) **In general** There is hereby imposed on any organization described in subsection (c) an excise tax equal to the premiums paid by such organization on any life insurance, annuity, or endowment contract if the payment of premiums on such contract is in connection with a transfer for which a deduction is not allowable under subparagraph (A), determined without regard to when such transfer is made.

- (ii) **Payments by other persons** For purposes of clause (i), payments made by any other

person pursuant to an understanding or expectation referred to in subparagraph (A) shall be treated as made by the organization.

**(iii) Reporting** Any organization on which tax is imposed by clause (i) with respect to any premium shall file an annual return which includes—

(I) the amount of such premiums paid during the year and the name and TIN of each beneficiary under the contract to which the premium relates, and

(II) such other information as the Secretary may require.

The penalties applicable to returns required under section 6033 shall apply to returns required under this clause. Returns required under this clause shall be furnished at such time and in such manner as the Secretary shall by forms or regulations require.

**(iv) Certain rules to apply** The tax imposed by this subparagraph shall be treated as imposed by chapter 42 for purposes of this title other than subchapter B of chapter 42.

**(G) Special rule where State requires specification of charitable gift annuitant in contract** In the case of an obligation to pay a charitable gift annuity referred to in subparagraph (D) which is entered into under the laws of a State which requires, in order for the charitable gift annuity to be exempt from insurance regulation by such State, that each beneficiary under the charitable gift annuity be named as a beneficiary under an annuity contract issued by an insurance company authorized to transact business in such State, the requirements of clauses (i) and (ii) of subparagraph (D) shall be treated as met if—

(i) such State law requirement was in effect on February 8, 1999,

(ii) each such beneficiary under the charitable gift annuity is a bona fide resident of such State at the time the obligation to pay a charitable gift annuity is entered into, and

(iii) the only persons entitled to payments under such contract are persons entitled to payments as beneficiaries under such obligation on the date such obligation is entered into.

**(H) Member of family** For purposes of this paragraph, an individual's family consists of the individual's grandparents, the grandparents of such individual's spouse, the lineal descendants of such grandparents, and any spouse of such a lineal descendant.

**(I) Regulations** The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph, including regulations to prevent the avoidance of such purposes.

## **(11) Qualified appraisal and other documentation for certain contributions**

### **(A) In general**

**(i) Denial of deduction** In the case of an individual, partnership, or corporation, no deduction shall be allowed under subsection (a) for any contribution of property for which a deduction of more than \$500 is claimed unless such person meets the requirements of subparagraphs (B), (C), and (D), as the case may be, with respect to such contribution.

### **(ii) Exceptions**

**(I) Readily valued property** Subparagraphs (C) and (D) shall not apply to cash, property described in subsection (e)(1)(B)(iii) or section 1221(a)(1), publicly traded



securities (as defined in section 6050L(a)(2)(B)), and any qualified vehicle described in paragraph (12)(A)(ii) for which an acknowledgement under paragraph (12)(B)(iii) is provided.

**(II) Reasonable cause** Clause (i) shall not apply if it is shown that the failure to meet such requirements is due to reasonable cause and not to willful neglect.

**(B) Property description for contributions of more than \$500** In the case of contributions of property for which a deduction of more than \$500 is claimed, the requirements of this subparagraph are met if the individual, partnership or corporation includes with the return for the taxable year in which the contribution is made a description of such property and such other information as the Secretary may require. The requirements of this subparagraph shall not apply to a C corporation which is not a personal service corporation or a closely held C corporation.

**(C) Qualified appraisal for contributions of more than \$5,000** In the case of contributions of property for which a deduction of more than \$5,000 is claimed, the requirements of this subparagraph are met if the individual, partnership, or corporation obtains a qualified appraisal of such property and attaches to the return for the taxable year in which such contribution is made such information regarding such property and such appraisal as the Secretary may require.

**(D) Substantiation for contributions of more than \$500,000** In the case of contributions of property for which a deduction of more than \$500,000 is claimed, the requirements of this subparagraph are met if the individual, partnership, or corporation attaches to the return for the taxable year a qualified appraisal of such property.

**(E) Qualified appraisal and appraiser** For purposes of this paragraph—

**(i) Qualified appraisal** The term “qualified appraisal” means, with respect to any property, an appraisal of such property which—

**(I)** is treated for purposes of this paragraph as a qualified appraisal under regulations or other guidance prescribed by the Secretary, and

**(II)** is conducted by a qualified appraiser in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed under subclause (I).

**(ii) Qualified appraiser** Except as provided in clause (iii), the term “qualified appraiser” means an individual who—

**(I)** has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements set forth in regulations prescribed by the Secretary,

**(II)** regularly performs appraisals for which the individual receives compensation, and

**(III)** meets such other requirements as may be prescribed by the Secretary in regulations or other guidance.

**(iii) Specific appraisals** An individual shall not be treated as a qualified appraiser with respect to any specific appraisal unless—

(I) the individual demonstrates verifiable education and experience in valuing the type of property subject to the appraisal, and

(II) the individual has not been prohibited from practicing before the Internal Revenue Service by the Secretary under section 330(c)2 of title 31, United States Code, at any time during the 3-year period ending on the date of the appraisal.

**(F) Aggregation of similar items of property** For purposes of determining thresholds under this paragraph, property and all similar items of property donated to 1 or more donees shall be treated as 1 property.

**(G) Special rule for pass-thru entities** In the case of a partnership or S corporation, this paragraph shall be applied at the entity level, except that the deduction shall be denied at the partner or shareholder level.

**(H) Regulations** The Secretary may prescribe such regulations as may be necessary or appropriate to carry out the purposes of this paragraph, including regulations that may provide that some or all of the requirements of this paragraph do not apply in appropriate cases.

## **(12) Contributions of used motor vehicles, boats, and airplanes**

**(A) In general** In the case of a contribution of a qualified vehicle the claimed value of which exceeds \$500—

(i) paragraph (8) shall not apply and no deduction shall be allowed under subsection (a) for such contribution unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization that meets the requirements of subparagraph (B) and includes the acknowledgement with the taxpayer's return of tax which includes the deduction, and

(ii) if the organization sells the vehicle without any significant intervening use or material improvement of such vehicle by the organization, the amount of the deduction allowed under subsection (a) shall not exceed the gross proceeds received from such sale.

**(B) Content of acknowledgement** An acknowledgement meets the requirements of this subparagraph if it includes the following information:

(i) The name and taxpayer identification number of the donor.

(ii) The vehicle identification number or similar number.

(iii) In the case of a qualified vehicle to which subparagraph (A)(ii) applies—

(I) a certification that the vehicle was sold in an arm's length transaction between unrelated parties,

(II) the gross proceeds from the sale, and

(III) a statement that the deductible amount may not exceed the amount of such gross proceeds.

(iv) In the case of a qualified vehicle to which subparagraph (A)(ii) does not apply—

(I) a certification of the intended use or material improvement of the vehicle and the intended duration of such use, and

(II) a certification that the vehicle would not be transferred in exchange for money, other property, or services before completion of such use or improvement.

(v) Whether the donee organization provided any goods or services in consideration, in whole or in part, for the qualified vehicle.

(vi) A description and good faith estimate of the value of any goods or services referred to in clause (v) or, if such goods or services consist solely of intangible religious benefits (as defined in paragraph (8)(B)), a statement to that effect.

**(C) Contemporaneous** For purposes of subparagraph (A), an acknowledgement shall be considered to be contemporaneous if the donee organization provides it within 30 days of—

(i) the sale of the qualified vehicle, or

(ii) in the case of an acknowledgement including a certification described in subparagraph (B)(iv), the contribution of the qualified vehicle.

**(D) Information to Secretary** A donee organization required to provide an acknowledgement under this paragraph shall provide to the Secretary the information contained in the acknowledgement. Such information shall be provided at such time and in such manner as the Secretary may prescribe.

**(E) Qualified vehicle** For purposes of this paragraph, the term “qualified vehicle” means any—

(i) motor vehicle manufactured primarily for use on public streets, roads, and highways,

(ii) boat, or

(iii) airplane.

Such term shall not include any property which is described in section 1221(a)(1).

**(F) Regulations or other guidance** The Secretary shall prescribe such regulations or other guidance as may be necessary to carry out the purposes of this paragraph. The Secretary may prescribe regulations or other guidance which exempts sales by the donee organization which are in direct furtherance of such organization’s charitable purpose from the requirements of subparagraphs (A)(ii) and (B)(iv)(II).

### **(13) Contributions of certain interests in buildings located in registered historic districts**

**(A) In general** No deduction shall be allowed with respect to any contribution described in subparagraph (B) unless the taxpayer includes with the return for the taxable year of the contribution a \$500 filing fee.

**(B) Contribution described** A contribution is described in this subparagraph if such contribution is a qualified conservation contribution (as defined in subsection (h)) which is a restriction with respect to the exterior of a building described in subsection (h)(4)(C)(ii) and for which a deduction is claimed in excess of \$10,000.

**(C) Dedication of fee** Any fee collected under this paragraph shall be used for the enforcement of the provisions of subsection (h).

**(14) Reduction for amounts attributable to rehabilitation credit** In the case of any qualified conservation contribution (as defined in subsection (h)), the amount of the deduction allowed

under this section shall be reduced by an amount which bears the same ratio to the fair market value of the contribution as—

(A) the sum of the credits allowed to the taxpayer under section 47 for the 5 preceding taxable years with respect to any building which is a part of such contribution, bears to

(B) the fair market value of the building on the date of the contribution.

**(15) Special rule for taxidermy property**

(A) **Basis** For purposes of this section and notwithstanding section 1012, in the case of a charitable contribution of taxidermy property which is made by the person who prepared, stuffed, or mounted the property or by any person who paid or incurred the cost of such preparation, stuffing, or mounting, only the cost of the preparing, stuffing, or mounting shall be included in the basis of such property.

(B) **Taxidermy property** For purposes of this section, the term “taxidermy property” means any work of art which—

(i) is the reproduction or preservation of an animal, in whole or in part,

(ii) is prepared, stuffed, or mounted for purposes of recreating one or more characteristics of such animal, and

(iii) contains a part of the body of the dead animal.

**(16) Contributions of clothing and household items**

(A) **In general** In the case of an individual, partnership, or corporation, no deduction shall be allowed under subsection (a) for any contribution of clothing or a household item unless such clothing or household item is in good used condition or better.

(B) **Items of minimal value** Notwithstanding subparagraph (A), the Secretary may by regulation deny a deduction under subsection (a) for any contribution of clothing or a household item which has minimal monetary value.

(C) **Exception for certain property** Subparagraphs (A) and (B) shall not apply to any contribution of a single item of clothing or a household item for which a deduction of more than \$500 is claimed if the taxpayer includes with the taxpayer’s return a qualified appraisal with respect to the property.

(D) **Household items** For purposes of this paragraph—

(i) **In general** The term “household items” includes furniture, furnishings, electronics, appliances, linens, and other similar items.

(ii) **Excluded items** Such term does not include—

(I) food,

(II) paintings, antiques, and other objects of art,

(III) jewelry and gems, and

(IV) collections.

(E) **Special rule for pass-thru entities** In the case of a partnership or S corporation, this paragraph shall be applied at the entity level, except that the deduction shall be denied at the

partner or shareholder level.

**(17) Recordkeeping** No deduction shall be allowed under subsection (a) for any contribution of a cash, check, or other monetary gift unless the donor maintains as a record of such contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution.

**(18) Contributions to donor advised funds** A deduction otherwise allowed under subsection (a) for any contribution to a donor advised fund (as defined in section 4966(d)(2)) shall only be allowed if—

(A) the sponsoring organization (as defined in section 4966(d)(1)) with respect to such donor advised fund is not—

(i) described in paragraph (3), (4), or (5) of subsection (c), or

(ii) a type III supporting organization (as defined in section 4943(f)(5)(A)) which is not a functionally integrated type III supporting organization (as defined in section 4943(f)(5)(B)), and

(B) the taxpayer obtains a contemporaneous written acknowledgment (determined under rules similar to the rules of paragraph (8)(C)) from the sponsoring organization (as so defined) of such donor advised fund that such organization has exclusive legal control over the assets contributed.

**(19) Certain qualified conservation contributions**

**(A) In general** In the case of a qualified conservation contribution to which this paragraph applies, no deduction shall be allowed under subsection (a) for such contribution unless the partnership making such contribution—

(i) includes on its return for the taxable year in which the contribution is made a statement that the partnership made such a contribution, and

(ii) provides such information about the contribution as the Secretary may require.

**(B) Contributions to which this paragraph applies** This paragraph shall apply to any qualified conservation contribution—

(i) the conservation purpose of which is the preservation of any building which is a certified historic structure (as defined in subsection (h)(4)(C)),

(ii) which is made by a partnership (whether directly or as a distributive share of a contribution of another partnership), and

(iii) the amount of which exceeds 2.5 times the sum of each partner's relevant basis (as defined in subsection (h)(7)) in the partnership making the contribution.

**(C) Application to other pass-through entities** Except as may be otherwise provided by the Secretary, the rules of this paragraph shall apply to S corporations and other pass-through entities in the same manner as such rules apply to partnerships.

## §172. NET OPERATING LOSS DEDUCTION

**(a) Deduction allowed**

There shall be allowed as a deduction for the taxable year an amount equal to—

(1) in the case of a taxable year beginning before January 1, 2021, the aggregate of the net operating loss carryovers to such year, plus the net operating loss carrybacks to such year, and

(2) in the case of a taxable year beginning after December 31, 2020, the sum of—

(A) the aggregate amount of net operating losses arising in taxable years beginning before January 1, 2018, carried to such taxable year, plus

(B) the lesser of—

(i) the aggregate amount of net operating losses arising in taxable years beginning after December 31, 2017, carried to such taxable year, or

(ii) 80 percent of the excess (if any) of—

(I) taxable income computed without regard to the deductions under this section and sections 199A and 250, over

(II) the amount determined under subparagraph (A).

For purposes of this subtitle, the term “net operating loss deduction” means the deduction allowed by this subsection.

**(b) Net operating loss carrybacks and carryovers**

**(1) Years to which loss may be carried**

**(A) General rule** A net operating loss for any taxable year—

(i) shall be a net operating loss carryback to the extent provided in subparagraphs (B), (C)(i), and (D), and

(ii) except as provided in subparagraph (C)(ii), shall be a net operating loss carryover—

(I) in the case of a net operating loss arising in a taxable year beginning before January 1, 2018, to each of the 20 taxable years following the taxable year of the loss, and

(II) in the case of a net operating loss arising in a taxable year beginning after December 31, 2017, to each taxable year following the taxable year of the loss.

**(B) Farming losses**

(i) **In general** In the case of any portion of a net operating loss for the taxable year which is a farming loss with respect to the taxpayer, such loss shall be a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss.

(ii) **Farming loss** For purposes of this section, the term “farming loss” means the lesser of—

(I) the amount which would be the net operating loss for the taxable year if only income and deductions attributable to farming businesses (as defined in section 263A(e)(4)) are taken into account, or

(II) the amount of the net operating loss for such taxable year.

(iii) **Coordination with paragraph (2)** For purposes of applying paragraph (2), a farming loss for any taxable year shall be treated as a separate net operating loss for such taxable year to be taken into account after the remaining portion of the net operating loss for such taxable year.

(iv) **Election** Any taxpayer entitled to a 2-year carryback under clause (i) from any loss year may elect not to have such clause apply to such loss year. Such election shall be made in such manner as prescribed by the Secretary and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the net operating loss. Such election, once made for any taxable year, shall be irrevocable for such taxable year.

(C) **Insurance companies** In the case of an insurance company (as defined in section 816(a)) other than a life insurance company, the net operating loss for any taxable year—

(i) shall be a net operating loss carryback to each of the 2 taxable years preceding the taxable year of such loss, and

(ii) shall be a net operating loss carryover to each of the 20 taxable years following the taxable year of the loss.

(D) **Special rule for losses arising in 2018, 2019, and 2020**

(i) **In general** In the case of any net operating loss arising in a taxable year beginning after December 31, 2017, and before January 1, 2021—

(I) such loss shall be a net operating loss carryback to each of the 5 taxable years preceding the taxable year of such loss, and

(II) subparagraphs (B) and (C)(i) shall not apply.

(ii) **Special rules for REITs** For purposes of this subparagraph—

(I) **In general** A net operating loss for a REIT year shall not be a net operating loss carryback to any taxable year preceding the taxable year of such loss.

(II) **Special rule** In the case of any net operating loss for a taxable year which is not a REIT year, such loss shall not be carried to any preceding taxable year which is a REIT year.

(III) **REIT year** For purposes of this subparagraph, the term “REIT year” means any taxable year for which the provisions of part II of subchapter M (relating to real estate investment trusts) apply to the taxpayer.

(iii) **Special rule for life insurance companies** In the case of a life insurance company, if a net operating loss is carried pursuant to clause (i)(I) to a life insurance company taxable year beginning before January 1, 2018, such net operating loss carryback shall be treated in the same manner as an operations loss carryback (within the meaning of section 810 as in effect before its repeal) of such company to such taxable year.

(iv) **Rule relating to carrybacks to years to which section 965 applies** If a net operating loss of a taxpayer is carried pursuant to clause (i)(I) to any taxable year in which an amount is includible in gross income by reason of section 965(a), the taxpayer shall be treated as having made the election under section 965(n) with respect to each such taxable

year.

**(v) Special rules for elections under paragraph (3)**

**(I) Special election to exclude section 965 years** If the 5-year carryback period under clause (i)(I) with respect to any net operating loss of a taxpayer includes 1 or more taxable years in which an amount is includible in gross income by reason of section 965(a), the taxpayer may, in lieu of the election otherwise available under paragraph (3), elect under such paragraph to exclude all such taxable years from such carryback period.

**(II) Time of elections** An election under paragraph (3) (including an election described in subclause (I)) with respect to a net operating loss arising in a taxable year beginning in 2018 or 2019 shall be made by the due date (including extensions of time) for filing the taxpayer's return for the first taxable year ending after the date of the enactment of this subparagraph.

**(2) Amount of carrybacks and carryovers** The entire amount of the net operating loss for any taxable year (hereinafter in this section referred to as the "loss year") shall be carried to the earliest of the taxable years to which (by reason of paragraph (1)) such loss may be carried. The portion of such loss which shall be carried to each of the other taxable years shall be the excess, if any, of the amount of such loss over the sum of the taxable income for each of the prior taxable years to which such loss may be carried. For purposes of the preceding sentence, the taxable income for any such prior taxable year shall—

(A) be computed with the modifications specified in subsection (d) other than paragraphs (1), (4), and (5) thereof, and by determining the amount of the net operating loss deduction without regard to the net operating loss for the loss year or for any taxable year thereafter,

(B) not be considered to be less than zero, and

(C) for taxable years beginning after December 31, 2020, be reduced by 20 percent of the excess (if any) described in subsection (a)(2)(B)(ii) for such taxable year.

**(3) Election to waive carryback** Any taxpayer entitled to a carryback period under paragraph (1) may elect to relinquish the entire carryback period with respect to a net operating loss for any taxable year. Such election shall be made in such manner as may be prescribed by the Secretary, and shall be made by the due date (including extensions of time) for filing the taxpayer's return for the taxable year of the net operating loss for which the election is to be in effect. Such election, once made for any taxable year, shall be irrevocable for such taxable year.

**(c) Net operating loss defined**

For purposes of this section, the term "net operating loss" means the excess of the deductions allowed by this chapter over the gross income. Such excess shall be computed with the modifications specified in subsection (d).

**(d) Modifications**

The modifications referred to in this section are as follows:



**(1) Net operating loss deduction** No net operating loss deduction shall be allowed.

**(2) Capital gains and losses of taxpayers other than corporations** In the case of a taxpayer other than a corporation—

(A) the amount deductible on account of losses from sales or exchanges of capital assets shall not exceed the amount includable on account of gains from sales or exchanges of capital assets; and

(B) the exclusion provided by section 1202 shall not be allowed.

**(3) Deduction for personal exemptions** No deduction shall be allowed under section 151 (relating to personal exemptions). No deduction in lieu of any such deduction shall be allowed.

**(4) Nonbusiness deductions of taxpayers other than corporations** In the case of a taxpayer other than a corporation, the deductions allowable by this chapter which are not attributable to a taxpayer's trade or business shall be allowed only to the extent of the amount of the gross income not derived from such trade or business. For purposes of the preceding sentence—

(A) any gain or loss from the sale or other disposition of—

(i) property, used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or

(ii) real property used in the trade or business,  
shall be treated as attributable to the trade or business;

(B) the modifications specified in paragraphs (1), (2)(B), and (3) shall be taken into account;

(C) any deduction for casualty or theft losses allowable under paragraph (2) or (3) of section 165(c) shall be treated as attributable to the trade or business; and

(D) any deduction allowed under section 404 to the extent attributable to contributions which are made on behalf of an individual who is an employee within the meaning of section 401(c)(1) shall not be treated as attributable to the trade or business of such individual.

**(5) Computation of deduction for dividends received** The deductions allowed by sections 243 (relating to dividends received by corporations) and 245 (relating to dividends received from certain foreign corporations) shall be computed without regard to section 246(b) (relating to limitation on aggregate amount of deductions).

**(6) Modifications related to real estate investment trusts** In the case of any taxable year for which part II of subchapter M (relating to real estate investment trusts) applies to the taxpayer —

(A) the net operating loss for such taxable year shall be computed by taking into account the adjustments described in section 857(b)(2) (other than the deduction for dividends paid described in section 857(b)(2)(B));

(B) where such taxable year is a "prior taxable year" referred to in paragraph (2) of subsection (b), the term "taxable income" in such paragraph shall mean "real estate investment trust taxable income" (as defined in section 857(b)(2)); and

(C) subsection (a)(2)(B)(ii)(I) shall be applied by substituting “real estate investment trust taxable income (as defined in section 857(b)(2) but without regard to the deduction for dividends paid (as defined in section 561))” for “taxable income”.

[(7) Repealed. Pub. L. 115–97, title I, §13305(b)(3), Dec. 22, 2017, 131 Stat. 2126]

**(8) Qualified business income deduction** Any deduction under section 199A shall not be allowed.

**(9) Deduction for foreign-derived intangible income** The deduction under section 250 shall not be allowed.

## §197. AMORTIZATION OF GOODWILL AND CERTAIN OTHER INTANGIBLES

### (a) General rule

A taxpayer shall be entitled to an amortization deduction with respect to any amortizable section 197 intangible. The amount of such deduction shall be determined by amortizing the adjusted basis (for purposes of determining gain) of such intangible ratably over the 15-year period beginning with the month in which such intangible was acquired.

### (b) No other depreciation or amortization deduction allowable

Except as provided in subsection (a), no depreciation or amortization deduction shall be allowable with respect to any amortizable section 197 intangible.

### (c) Amortizable section 197 intangible

For purposes of this section—

**(1) In general** Except as otherwise provided in this section, the term “amortizable section 197 intangible” means any section 197 intangible—

(A) which is acquired by the taxpayer after the date of the enactment of this section, and

(B) which is held in connection with the conduct of a trade or business or an activity described in section 212.

**(2) Exclusion of self-created intangibles, etc.** The term “amortizable section 197 intangible” shall not include any section 197 intangible—

(A) which is not described in subparagraph (D), (E), or (F) of subsection (d)(1), and

(B) which is created by the taxpayer.

This paragraph shall not apply if the intangible is created in connection with a transaction (or series of related transactions) involving the acquisition of assets constituting a trade or business or substantial portion thereof.

**(3) Anti-churning rules** For exclusion of intangibles acquired in certain transactions, see

subsection (f)(9).

**(d) Section 197 intangible**

For purposes of this section—

**(1) In general** Except as otherwise provided in this section, the term “section 197 intangible” means—

- (A) goodwill,
- (B) going concern value,
- (C) any of the following intangible items:
  - (i) workforce in place including its composition and terms and conditions (contractual or otherwise) of its employment,
  - (ii) business books and records, operating systems, or any other information base (including lists or other information with respect to current or prospective customers),
  - (iii) any patent, copyright, formula, process, design, pattern, knowhow, format, or other similar item,
  - (iv) any customer-based intangible,
  - (v) any supplier-based intangible, and
  - (vi) any other similar item,
- (D) any license, permit, or other right granted by a governmental unit or an agency or instrumentality thereof,
- (E) any covenant not to compete (or other arrangement to the extent such arrangement has substantially the same effect as a covenant not to compete) entered into in connection with an acquisition (directly or indirectly) of an interest in a trade or business or substantial portion thereof, and
- (F) any franchise, trademark, or trade name.

**(2) Customer-based intangible**

**(A) In general** The term “customer-based intangible” means—

- (i) composition of market,
- (ii) market share, and
- (iii) any other value resulting from future provision of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with customers.

**(B) Special rule for financial institutions** In the case of a financial institution, the term “customer-based intangible” includes deposit base and similar items.

**(3) Supplier-based intangible** The term “supplier-based intangible” means any value resulting from future acquisitions of goods or services pursuant to relationships (contractual or otherwise) in the ordinary course of business with suppliers of goods or services to be used or

sold by the taxpayer.

## **§212. EXPENSES FOR PRODUCTION OF INCOME**

In the case of an individual, there shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year—

- (1) for the production or collection of income;
- (2) for the management, conservation, or maintenance of property held for the production of income; or
- (3) in connection with the determination, collection, or refund of any tax.

## **§213. MEDICAL, DENTAL, ETC., EXPENSES**

### **(a) Allowance of deduction**

There shall be allowed as a deduction the expenses paid during the taxable year, not compensated for by insurance or otherwise, for medical care of the taxpayer, his spouse, or a dependent (as defined in section 152, determined without regard to subsections (b)(1), (b)(2), and (d)(1)(B) thereof), to the extent that such expenses exceed 7.5 percent of adjusted gross income.

## **§262. PERSONAL, LIVING, AND FAMILY EXPENSES**

### **(a) General rule**

Except as otherwise expressly provided in this chapter, no deduction shall be allowed for personal, living, or family expenses.

## **§263. CAPITAL EXPENDITURES**

### **(a) General rule**

No deduction shall be allowed for—

- (1) Any amount paid out for new buildings or for permanent improvements or betterments made to increase the value of any property or estate. This paragraph shall not apply to—
  - (A) expenditures for the development of mines or deposits deductible under section 616,
  - (B) research and experimental expenditures deductible under section 174,
  - (C) soil and water conservation expenditures deductible under section 175,
  - (D) expenditures by farmers for fertilizer, etc., deductible under section 180,

(E) expenditures for removal of architectural and transportation barriers to the handicapped and elderly which the taxpayer elects to deduct under section 190,

(F) expenditures for tertiary injectants with respect to which a deduction is allowed under section 193,

(G) expenditures for which a deduction is allowed under section 179,

(H) expenditures for which a deduction is allowed under section 179B,

(I) expenditures for which a deduction is allowed under section 179C,

(J) expenditures for which a deduction is allowed under section 179D, or

(K) expenditures for which a deduction is allowed under section 179E.

(2) Any amount expended in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

## **§263A. CAPITALIZATION AND INCLUSION IN INVENTORY COSTS OF CERTAIN EXPENSES**

### **(a) Nondeductibility of certain direct and indirect costs**

(1) **In general** In the case of any property to which this section applies, any costs described in paragraph (2)—

(A) in the case of property which is inventory in the hands of the taxpayer, shall be included in inventory costs, and

(B) in the case of any other property, shall be capitalized.

(2) **Allocable costs** The costs described in this paragraph with respect to any property are—

(A) the direct costs of such property, and

(B) such property's proper share of those indirect costs (including taxes) part or all of which are allocable to such property.

Any cost which (but for this subsection) could not be taken into account in computing taxable income for any taxable year shall not be treated as a cost described in this paragraph.

### **(b) Property to which section applies**

Except as otherwise provided in this section, this section shall apply to—

(1) **Property produced by taxpayer** Real or tangible personal property produced by the taxpayer.

(2) **Property acquired for resale** Real or personal property described in section 1221(a)(1) which is acquired by the taxpayer for resale.

For purposes of paragraph (1), the term “tangible personal property” shall include a film, sound

recording, video tape, book, or similar property.

**(i) Exemption for certain small businesses**

**(1) In general** In the case of any taxpayer (other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3)) which meets the gross receipts test of section 448(c) for any taxable year, this section shall not apply with respect to such taxpayer for such taxable year.

**(2) Application of gross receipts test to individuals, etc.** In the case of any taxpayer which is not a corporation or a partnership, the gross receipts test of section 448(c) shall be applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership.

**(3) Coordination with section 481** Any change in method of accounting made pursuant to this subsection shall be treated for purposes of section 481 as initiated by the taxpayer and made with the consent of the Secretary.

## **§267. LOSSES, EXPENSES, AND INTEREST WITH RESPECT TO TRANSACTIONS BETWEEN RELATED TAXPAYERS**

**(a) In general**

**(1) Deduction for losses disallowed** No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.

**(2) Matching of deduction and payee income item in the case of expenses and interest** If—

**(A)** by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

**(B)** at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b), then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph). For purposes of this paragraph, in the case of a personal service corporation (within the meaning of section 441(i)(2)), such corporation and any employee-owner (within the meaning of section 269A(b)(2), as modified by section 441(i)(2)) shall be treated as persons specified in subsection (b).

**(3) Payments to foreign persons**

**(A) In general** The Secretary shall by regulations apply the matching principle of paragraph

(2) in cases in which the person to whom the payment is to be made is not a United States person.

**(B) Special rule for certain foreign entities**

**(i) In general** Notwithstanding subparagraph (A), in the case of any item payable to a controlled foreign corporation (as defined in section 957) or a passive foreign investment company (as defined in section 1297), a deduction shall be allowable to the payor with respect to such amount for any taxable year before the taxable year in which paid only to the extent that an amount attributable to such item is includible (determined without regard to properly allocable deductions and qualified deficits under section 952(c)(1)(B)) during such prior taxable year in the gross income of a United States person who owns (within the meaning of section 958(a)) stock in such corporation.

**(ii) Secretarial authority** The Secretary may by regulation exempt transactions from the application of clause (i), including any transaction which is entered into by a payor in the ordinary course of a trade or business in which the payor is predominantly engaged and in which the payment of the accrued amounts occurs within 8½ months after accrual or within such other period as the Secretary may prescribe.

**(b) Relationships**

The persons referred to in subsection (a) are:

- (1) Members of a family, as defined in subsection (c)(4);
- (2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;
- (3) Two corporations which are members of the same controlled group (as defined in subsection (f));
- (4) A grantor and a fiduciary of any trust;
- (5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;
- (6) A fiduciary of a trust and a beneficiary of such trust;
- (7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;
- (8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;
- (9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;
- (10) A corporation and a partnership if the same persons own—
  - (A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

### **(c) Constructive ownership of stock**

For purposes of determining, in applying subsection (b), the ownership of stock—

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

## **§280E. EXPENDITURES IN CONNECTION WITH THE ILLEGAL SALE OF DRUGS**

No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.

## **§414. DEFINITIONS AND SPECIAL RULES**

### **(q) Highly compensated employee**



**(1) In general** The term “highly compensated employee” means any employee who—

(A) was a 5-percent owner at any time during the year or the preceding year, or

(B) for the preceding year—

(i) had compensation from the employer in excess of \$80,000, and

(ii) if the employer elects the application of this clause for such preceding year, was in the top-paid group of employees for such preceding year.

The Secretary shall adjust the \$80,000 amount under subparagraph (B) at the same time and in the same manner as under section 415(d), except that the base period shall be the calendar quarter ending September 30, 1996.

**(2) 5-percent owner** An employee shall be treated as a 5-percent owner for any year if at any time during such year such employee was a 5-percent owner (as defined in section 416(i)(1)) of the employer.

**(3) Top-paid group** An employee is in the top-paid group of employees for any year if such employee is in the group consisting of the top 20 percent of the employees when ranked on the basis of compensation paid during such year.

**(4) Compensation** For purposes of this subsection, the term “compensation” has the meaning given such term by section 415(c)(3).

**(5) Excluded employees** For purposes of subsection (r) and for purposes of determining the number of employees in the top-paid group, the following employees shall be excluded—

(A) employees who have not completed 6 months of service,

(B) employees who normally work less than 17½ hours per week,

(C) employees who normally work during not more than 6 months during any year,

(D) employees who have not attained age 21, and

(E) except to the extent provided in regulations, employees who are included in a unit of employees covered by an agreement which the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and the employer.

Except as provided by the Secretary, the employer may elect to apply subparagraph (A), (B), (C), or (D) by substituting a shorter period of service, smaller number of hours or months, or lower age for the period of service, number of hours or months, or age (as the case may be) than that specified in such subparagraph.

**(6) Former employees** A former employee shall be treated as a highly compensated employee if—

(A) such employee was a highly compensated employee when such employee separated from service, or

(B) such employee was a highly compensated employee at any time after attaining age 55.

**(7) Coordination with other provisions** Subsections (b), (c), (m), (n), and (o) shall be applied before the application of this subsection.

**(8) Special rule for nonresident aliens** For purposes of this subsection and subsection (r), employees who are nonresident aliens and who receive no earned income (within the meaning of section 911(d)(2)) from the employer which constitutes income from sources within the United States (within the meaning of section 861(a)(3)) shall not be treated as employees.

**(9) Certain employees not considered highly compensated and excluded employees under pre-ERISA rules for church plans** In the case of a church plan (as defined in subsection (e)), no employee shall be considered an officer, a person whose principal duties consist of supervising the work of other employees, or a highly compensated employee for any year unless such employee is a highly compensated employee under paragraph (1) for such year.

## §421. GENERAL RULES

### (a) Effect of qualifying transfer

If a share of stock is transferred to an individual in a transfer in respect of which the requirements of section 422(a) or 423(a) are met—

- (1) no income shall result at the time of the transfer of such share to the individual upon his exercise of the option with respect to such share;
- (2) no deduction under section 162 (relating to trade or business expenses) shall be allowable at any time to the employer corporation, a parent or subsidiary corporation of such corporation, or a corporation issuing or assuming a stock option in a transaction to which section 424(a) applies, with respect to the share so transferred; and
- (3) no amount other than the price paid under the option shall be considered as received by any of such corporations for the share so transferred.

## §422. INCENTIVE STOCK OPTIONS

### (a) In general

Section 421(a) shall apply with respect to the transfer of a share of stock to an individual pursuant to his exercise of an incentive stock option if—

- (1) no disposition of such share is made by him within 2 years from the date of the granting of the option nor within 1 year after the transfer of such share to him, and
- (2) at all times during the period beginning on the date of the granting of the option and ending on the day 3 months before the date of such exercise, such individual was an employee of either the corporation granting such option, a parent or subsidiary corporation of such corporation, or a corporation or a parent or subsidiary corporation of such corporation issuing or assuming a stock option in a transaction to which section 424(a) applies.

## §446. GENERAL RULE FOR METHODS OF ACCOUNTING

**(a) General rule**

Taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books.

**(b) Exceptions**

If no method of accounting has been regularly used by the taxpayer, or if the method used does not clearly reflect income, the computation of taxable income shall be made under such method as, in the opinion of the Secretary, does clearly reflect income.

**(c) Permissible methods**

Subject to the provisions of subsections (a) and (b), a taxpayer may compute taxable income under any of the following methods of accounting—

- (1) the cash receipts and disbursements method;
- (2) an accrual method;
- (3) any other method permitted by this chapter; or
- (4) any combination of the foregoing methods permitted under regulations prescribed by the Secretary.

## **§448. LIMITATION ON USE OF CASH METHOD OF ACCOUNTING**

**(a) General rule**

Except as otherwise provided in this section, in the case of a—

- (1) C corporation,
- (2) partnership which has a C corporation as a partner, or
- (3) tax shelter,

taxable income shall not be computed under the cash receipts and disbursements method of accounting.

**(b) Exceptions**

**(1) Farming business** Paragraphs (1) and (2) of subsection (a) shall not apply to any farming business.

**(2) Qualified personal service corporations** Paragraphs (1) and (2) of subsection (a) shall not apply to a qualified personal service corporation, and such a corporation shall be treated as an individual for purposes of determining whether paragraph (2) of subsection (a) applies to any partnership.

**(3) Entities which meet gross receipts test** Paragraphs (1) and (2) of subsection (a) shall not

apply to any corporation or partnership for any taxable year if such entity (or any predecessor) meets the gross receipts test of subsection (c) for such taxable year.

**(c) Gross receipts test**

For purposes of this section—

**(1) In general** A corporation or partnership meets the gross receipts test of this subsection for any taxable year if the average annual gross receipts of such entity for the 3-taxable-year period ending with the taxable year which precedes such taxable year does not exceed \$25,000,000.

**(2) Aggregation rules** All persons treated as a single employer under subsection (a) or (b) of section 52 or subsection (m) or (o) of section 414 shall be treated as one person for purposes of paragraph (1).

**(3) Special rules** For purposes of this subsection—

**(A) Not in existence for entire 3-year period** If the entity was not in existence for the entire 3-year period referred to in paragraph (1), such paragraph shall be applied on the basis of the period during which such entity (or trade or business) was in existence.

**(B) Short taxable years** Gross receipts for any taxable year of less than 12 months shall be annualized by multiplying the gross receipts for the short period by 12 and dividing the result by the number of months in the short period.

**(C) Gross receipts** Gross receipts for any taxable year shall be reduced by returns and allowances made during such year.

**(D) Treatment of predecessors** Any reference in this subsection to an entity shall include a reference to any predecessor of such entity.

**(4) Adjustment for inflation** In the case of any taxable year beginning after December 31, 2018, the dollar amount in paragraph (1) shall be increased by an amount equal to—

**(A)** such dollar amount, multiplied by

**(B)** the cost-of-living adjustment determined under section 1(f)(3) for the calendar year in which the taxable year begins, by substituting “calendar year 2017” for “calendar year 2016” in subparagraph (A)(ii) thereof.

If any amount as increased under the preceding sentence is not a multiple of \$1,000,000, such amount shall be rounded to the nearest multiple of \$1,000,000.

## **§451. GENERAL RULE FOR TAXABLE YEAR OF INCLUSION**

**(a) General rule**

The amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period.

## §453. INSTALLMENT METHOD

### (a) General rule

Except as otherwise provided in this section, income from an installment sale shall be taken into account for purposes of this title under the installment method.

### (b) Installment sale defined

For purposes of this section—

**(1) In general** The term “installment sale” means a disposition of property where at least 1 payment is to be received after the close of the taxable year in which the disposition occurs.

**(2) Exceptions** The term “installment sale” does not include—

**(A) Dealer dispositions** Any dealer disposition (as defined in subsection (f)).

**(B) Inventories of personal property** A disposition of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year.

### (c) Installment method defined

For purposes of this section, the term “installment method” means a method under which the income recognized for any taxable year from a disposition is that proportion of the payments received in that year which the gross profit (realized or to be realized when payment is completed) bears to the total contract price.

### (d) Election out

**(1) In general** Subsection (a) shall not apply to any disposition if the taxpayer elects to have subsection (a) not apply to such disposition.

**(2) Time and manner for making election** Except as otherwise provided by regulations, an election under paragraph (1) with respect to a disposition may be made only on or before the due date prescribed by law (including extensions) for filing the taxpayer’s return of the tax imposed by this chapter for the taxable year in which the disposition occurs. Such an election shall be made in the manner prescribed by regulations.

**(3) Election revocable only with consent** An election under paragraph (1) with respect to any disposition may be revoked only with the consent of the Secretary.

### (e) Second dispositions by related persons

**(1) In general** If—

**(A)** any person disposes of property to a related person (hereinafter in this subsection

referred to as the “first disposition”), and

(B) before the person making the first disposition receives all payments with respect to such disposition, the related person disposes of the property (hereinafter in this subsection referred to as the “second disposition”),

then, for purposes of this section, the amount realized with respect to such second disposition shall be treated as received at the time of the second disposition by the person making the first disposition.

**(2) 2-year cutoff for property other than marketable securities**

(A) **In general** Except in the case of marketable securities, paragraph (1) shall apply only if the date of the second disposition is not more than 2 years after the date of the first disposition.

(B) **Substantial diminishing of risk of ownership** The running of the 2-year period set forth in subparagraph (A) shall be suspended with respect to any property for any period during which the related person’s risk of loss with respect to the property is substantially diminished by—

- (i) the holding of a put with respect to such property (or similar property),
- (ii) the holding by another person of a right to acquire the property, or
- (iii) a short sale or any other transaction.

(3) **Limitation on amount treated as received** The amount treated for any taxable year as received by the person making the first disposition by reason of paragraph (1) shall not exceed the excess of—

(A) the lesser of—

- (i) the total amount realized with respect to any second disposition of the property occurring before the close of the taxable year, or
- (ii) the total contract price for the first disposition, over

(B) the sum of—

- (i) the aggregate amount of payments received with respect to the first disposition before the close of such year, plus
- (ii) the aggregate amount treated as received with respect to the first disposition for prior taxable years by reason of this subsection.

(4) **Fair market value where disposition is not sale or exchange** For purposes of this subsection, if the second disposition is not a sale or exchange, an amount equal to the fair market value of the property disposed of shall be substituted for the amount realized.

(5) **Later payments treated as receipt of tax paid amounts** If paragraph (1) applies for any taxable year, payments received in subsequent taxable years by the person making the first disposition shall not be treated as the receipt of payments with respect to the first disposition to the extent that the aggregate of such payments does not exceed the amount treated as received by reason of paragraph (1).

(6) **Exception for certain dispositions** For purposes of this subsection—

**(A) Reacquisitions of stock by issuing corporation not treated as first dispositions** Any sale or exchange of stock to the issuing corporation shall not be treated as a first disposition.

**(B) Involuntary conversions not treated as second dispositions** A compulsory or involuntary conversion (within the meaning of section 1033) and any transfer thereafter shall not be treated as a second disposition if the first disposition occurred before the threat or imminence of the conversion.

**(C) Dispositions after death** Any transfer after the earlier of—

- (i) the death of the person making the first disposition, or
  - (ii) the death of the person acquiring the property in the first disposition,
- and any transfer thereafter shall not be treated as a second disposition.

**(7) Exception where tax avoidance not a principal purpose** This subsection shall not apply to a second disposition (and any transfer thereafter) if it is established to the satisfaction of the Secretary that neither the first disposition nor the second disposition had as one of its principal purposes the avoidance of Federal income tax.

**(8) Extension of statute of limitations** The period for assessing a deficiency with respect to a first disposition (to the extent such deficiency is attributable to the application of this subsection) shall not expire before the day which is 2 years after the date on which the person making the first disposition furnishes (in such manner as the Secretary may by regulations prescribe) a notice that there was a second disposition of the property to which this subsection may have applied. Such deficiency may be assessed notwithstanding the provisions of any law or rule of law which would otherwise prevent such assessment.

#### **(f) Definitions and special rules**

For purposes of this section—

**(1) Related person** Except for purposes of subsections (g) and (h), the term “related person” means—

**(A)** a person whose stock would be attributed under section 318(a) (other than paragraph (4) thereof) to the person first disposing of the property, or

**(B)** a person who bears a relationship described in section 267(b) to the person first disposing of the property.

**(2) Marketable securities** The term “marketable securities” means any security for which, as of the date of the disposition, there was a market on an established securities market or otherwise.

**(3) Payment** Except as provided in paragraph (4), the term “payment” does not include the receipt of evidences of indebtedness of the person acquiring the property (whether or not payment of such indebtedness is guaranteed by another person).

**(4) Purchaser evidences of indebtedness payable on demand or readily tradable** Receipt of a bond or other evidence of indebtedness which—

- (A)** is payable on demand, or

(B) is readily tradable,  
shall be treated as receipt of payment.

**(5) Readily tradable defined** For purposes of paragraph (4), the term “readily tradable” means a bond or other evidence of indebtedness which is issued—

(A) with interest coupons attached or in registered form (other than one in registered form which the taxpayer establishes will not be readily tradable in an established securities market), or

(B) in any other form designed to render such bond or other evidence of indebtedness readily tradable in an established securities market.

**(6) Like-kind exchanges** In the case of any exchange described in section 1031(b)—

(A) the total contract price shall be reduced to take into account the amount of any property permitted to be received in such exchange without recognition of gain,

(B) the gross profit from such exchange shall be reduced to take into account any amount not recognized by reason of section 1031(b), and

(C) the term “payment”, when used in any provision of this section other than subsection (b)(1), shall not include any property permitted to be received in such exchange without recognition of gain.

Similar rules shall apply in the case of an exchange which is described in section 356(a) and is not treated as a dividend.

**(7) Depreciable property** The term “depreciable property” means property of a character which (in the hands of the transferee) is subject to the allowance for depreciation provided in section 167.

**(8) Payments to be received defined** The term “payments to be received” includes—

(A) the aggregate amount of all payments which are not contingent as to amount, and

(B) the fair market value of any payments which are contingent as to amount.

## §461. GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION

### (a) General rule

The amount of any deduction or credit allowed by this subtitle shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.

### (h) Certain liabilities not incurred before economic performance

**(1) In general** For purposes of this title, in determining whether an amount has been incurred with respect to any item during any taxable year, the all events test shall not be treated as met any earlier than when economic performance with respect to such item occurs.



**(2) Time when economic performance occurs** Except as provided in regulations prescribed by the Secretary, the time when economic performance occurs shall be determined under the following principles:

**(A) Services and property provided to the taxpayer** If the liability of the taxpayer arises out of—

- (i) the providing of services to the taxpayer by another person, economic performance occurs as such person provides such services,
- (ii) the providing of property to the taxpayer by another person, economic performance occurs as the person provides such property, or
- (iii) the use of property by the taxpayer, economic performance occurs as the taxpayer uses such property.

**(B) Services and property provided by the taxpayer** If the liability of the taxpayer requires the taxpayer to provide property or services, economic performance occurs as the taxpayer provides such property or services.

**(C) Workers compensation and tort liabilities of the taxpayer** If the liability of the taxpayer requires a payment to another person and—

- (i) arises under any workers compensation act, or
  - (ii) arises out of any tort,
- economic performance occurs as the payments to such person are made. Subparagraphs (A) and (B) shall not apply to any liability described in the preceding sentence.

**(D) Other items** In the case of any other liability of the taxpayer, economic performance occurs at the time determined under regulations prescribed by the Secretary.

### **(3) Exception for certain recurring items**

**(A) In general** Notwithstanding paragraph (1) an item shall be treated as incurred during any taxable year if—

- (i) the all events test with respect to such item is met during such taxable year (determined without regard to paragraph (1)),
- (ii) economic performance with respect to such item occurs within the shorter of—
  - (I) a reasonable period after the close of such taxable year, or
  - (II) 8½ months after the close of such taxable year,
- (iii) such item is recurring in nature and the taxpayer consistently treats items of such kind as incurred in the taxable year in which the requirements of clause (i) are met, and
- (iv) either—
  - (I) such item is not a material item, or
  - (II) the accrual of such item in the taxable year in which the requirements of clause (i) are met results in a more proper match against income than accruing such item in the taxable year in which economic performance occurs.

**(B) Financial statements considered under subparagraph (A)(iv)** In making a determination

under subparagraph (A)(iv), the treatment of such item on financial statements shall be taken into account.

**(C) Paragraph not to apply to workers compensation and tort liabilities** This paragraph shall not apply to any item described in subparagraph (C) of paragraph (2).

**(4) All events test** For purposes of this subsection, the all events test is met with respect to any item if all events have occurred which determine the fact of liability and the amount of such liability can be determined with reasonable accuracy.

**(5) Subsection not to apply to certain items** This subsection shall not apply to any item for which a deduction is allowable under a provision of this title which specifically provides for a deduction for a reserve for estimated expenses.

## **§501. EXEMPTION FROM TAX ON CORPORATIONS, CERTAIN TRUSTS, ETC.**

### **(c) List of exempt organizations**

The following organizations are referred to in subsection (a):

**(1)** Any corporation organized under Act of Congress which is an instrumentality of the United States but only if such corporation—

**(A)** is exempt from Federal income taxes—

**(i)** under such Act as amended and supplemented before July 18, 1984, or

**(ii)** under this title without regard to any provision of law which is not contained in this title and which is not contained in a revenue Act, or

**(B)** is described in subsection (I).

**(2)** Corporations organized for the exclusive purpose of holding title to property, collecting income therefrom, and turning over the entire amount thereof, less expenses, to an organization which itself is exempt under this section. Rules similar to the rules of subparagraph (G) of paragraph (25) shall apply for purposes of this paragraph.

**(3)** Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

**(4)**

**(A)** Civic leagues or organizations not organized for profit but operated exclusively for the

promotion of social welfare, or local associations of employees, the membership of which is limited to the employees of a designated person or persons in a particular municipality, and the net earnings of which are devoted exclusively to charitable, educational, or recreational purposes.

(B) Subparagraph (A) shall not apply to an entity unless no part of the net earnings of such entity inures to the benefit of any private shareholder or individual.

(5) Labor, agricultural, or horticultural organizations.

(6) Business leagues, chambers of commerce, real-estate boards, boards of trade, or professional football leagues (whether or not administering a pension fund for football players), not organized for profit and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(7) Clubs organized for pleasure, recreation, and other nonprofitable purposes, substantially all of the activities of which are for such purposes and no part of the net earnings of which inures to the benefit of any private shareholder.

(8) Fraternal beneficiary societies, orders, or associations—

(A) operating under the lodge system or for the exclusive benefit of the members of a fraternity itself operating under the lodge system, and

(B) providing for the payment of life, sick, accident, or other benefits to the members of such society, order, or association or their dependents.

(9) Voluntary employees' beneficiary associations providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, if no part of the net earnings of such association inures (other than through such payments) to the benefit of any private shareholder or individual. For purposes of providing for the payment of sick and accident benefits to members of such an association and their dependents, the term "dependent" shall include any individual who is a child (as defined in section 152(f)(1)) of a member who as of the end of the calendar year has not attained age 27.

(10) Domestic fraternal societies, orders, or associations, operating under the lodge system—

(A) the net earnings of which are devoted exclusively to religious, charitable, scientific, literary, educational, and fraternal purposes, and

(B) which do not provide for the payment of life, sick, accident, or other benefits.

(11) Teachers' retirement fund associations of a purely local character, if—

(A) no part of their net earnings inures (other than through payment of retirement benefits) to the benefit of any private shareholder or individual, and

(B) the income consists solely of amounts received from public taxation, amounts received from assessments on the teaching salaries of members, and income in respect of investments.

(12)

(A) Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but

only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses.

(B) In the case of a mutual or cooperative telephone company, subparagraph (A) shall be applied without taking into account any income received or accrued—

(i) from a nonmember telephone company for the performance of communication services which involve members of the mutual or cooperative telephone company,

(ii) from qualified pole rentals,

(iii) from the sale of display listings in a directory furnished to the members of the mutual or cooperative telephone company, or

(iv) from the prepayment of a loan under section 306A, 306B, or 3111 of the Rural Electrification Act of 1936 (as in effect on January 1, 1987).

(C) In the case of a mutual or cooperative electric company, subparagraph (A) shall be applied without taking into account any income received or accrued—

(i) from qualified pole rentals, or

(ii) from any provision or sale of electric energy transmission services or ancillary services if such services are provided on a nondiscriminatory open access basis under an open access transmission tariff approved or accepted by FERC or under an independent transmission provider agreement approved or accepted by FERC (other than income received or accrued directly or indirectly from a member),

(iii) from the provision or sale of electric energy distribution services or ancillary services if such services are provided on a nondiscriminatory open access basis to distribute electric energy not owned by the mutual or electric cooperative company—

(I) to end-users who are served by distribution facilities not owned by such company or any of its members (other than income received or accrued directly or indirectly from a member), or

(II) generated by a generation facility not owned or leased by such company or any of its members and which is directly connected to distribution facilities owned by such company or any of its members (other than income received or accrued directly or indirectly from a member),

(iv) from any nuclear decommissioning transaction, or

(v) from any asset exchange or conversion transaction.

(D) For purposes of this paragraph, the term “qualified pole rental” means any rental of a pole (or other structure used to support wires) if such pole (or other structure)—

(i) is used by the telephone or electric company to support one or more wires which are used by such company in providing telephone or electric services to its members, and

(ii) is used pursuant to the rental to support one or more wires (in addition to the wires described in clause (i)) for use in connection with the transmission by wire of electricity or of telephone or other communications.

For purposes of the preceding sentence, the term “rental” includes any sale of the right to use the pole (or other structure).

(E) For purposes of subparagraph (C)(ii), the term “FERC” means—

(i) the Federal Energy Regulatory Commission, or

(ii) in the case of any utility with respect to which all of the electricity generated, transmitted, or distributed by such utility is generated, transmitted, distributed, and consumed in the same State, the State agency of such State with the authority to regulate electric utilities.

(F) For purposes of subparagraph (C)(iv), the term “nuclear decommissioning transaction” means—

(i) any transfer into a trust, fund, or instrument established to pay any nuclear decommissioning costs if the transfer is in connection with the transfer of the mutual or cooperative electric company’s interest in a nuclear power plant or nuclear power plant unit,

(ii) any distribution from any trust, fund, or instrument established to pay any nuclear decommissioning costs, or

(iii) any earnings from any trust, fund, or instrument established to pay any nuclear decommissioning costs.

(G) For purposes of subparagraph (C)(v), the term “asset exchange or conversion transaction” means any voluntary exchange or involuntary conversion of any property related to generating, transmitting, distributing, or selling electric energy by a mutual or cooperative electric company, the gain from which qualifies for deferred recognition under section 1031 or 1033, but only if the replacement property acquired by such company pursuant to such section constitutes property which is used, or to be used, for—

(i) generating, transmitting, distributing, or selling electric energy, or

(ii) producing, transmitting, distributing, or selling natural gas.

(H)

(i) In the case of a mutual or cooperative electric company described in this paragraph or an organization described in section 1381(a)(2)(C), income received or accrued from a load loss transaction shall be treated as an amount collected from members for the sole purpose of meeting losses and expenses.

(ii) For purposes of clause (i), the term “load loss transaction” means any wholesale or retail sale of electric energy (other than to members) to the extent that the aggregate sales during the recovery period do not exceed the load loss mitigation sales limit for such period.

(iii) For purposes of clause (ii), the load loss mitigation sales limit for the recovery period is the sum of the annual load losses for each year of such period.

(iv) For purposes of clause (iii), a mutual or cooperative electric company’s annual load loss for each year of the recovery period is the amount (if any) by which—

(I) the megawatt hours of electric energy sold during such year to members of such electric company are less than

(II) the megawatt hours of electric energy sold during the base year to such

members.

(v) For purposes of clause (iv)(II), the term “base year” means—

(I) the calendar year preceding the start-up year, or

(II) at the election of the mutual or cooperative electric company, the second or third calendar years preceding the start-up year.

(vi) For purposes of this subparagraph, the recovery period is the 7-year period beginning with the start-up year.

(vii) For purposes of this subparagraph, the start-up year is the first year that the mutual or cooperative electric company offers nondiscriminatory open access or the calendar year which includes the date of the enactment of this subparagraph, if later, at the election of such company.

(viii) A company shall not fail to be treated as a mutual or cooperative electric company for purposes of this paragraph or as a corporation operating on a cooperative basis for purposes of section 1381(a)(2)(C) by reason of the treatment under clause (i).

(ix) For purposes of subparagraph (A), in the case of a mutual or cooperative electric company, income received, or accrued, indirectly from a member shall be treated as an amount collected from members for the sole purpose of meeting losses and expenses.

(I) In the case of a mutual or cooperative electric company described in this paragraph or an organization described in section 1381(a)(2), income received or accrued in connection with an election under section 45J(e)(1) shall be treated as an amount collected from members for the sole purpose of meeting losses and expenses.

(J) In the case of a mutual or cooperative telephone or electric company described in this paragraph, subparagraph (A) shall be applied without taking into account any income received or accrued from—

(i) any grant, contribution, or assistance provided pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act or any similar grant, contribution, or assistance by any local, State, or regional governmental entity for the purpose of relief, recovery, or restoration from, or preparation for, a disaster or emergency, or

(ii) any grant or contribution by any governmental entity (other than a contribution in aid of construction or any other contribution as a customer or potential customer) the purpose of which is substantially related to providing, constructing, restoring, or relocating electric, communication, broadband, internet, or other utility facilities or services.

(13) Cemetery companies owned and operated exclusively for the benefit of their members or which are not operated for profit; and any corporation chartered solely for the purpose of the disposal of bodies by burial or cremation which is not permitted by its charter to engage in any business not necessarily incident to that purpose and no part of the net earnings of which inures to the benefit of any private shareholder or individual.

(14)

(A) Credit unions without capital stock organized and operated for mutual purposes and without profit.

(B) Corporations or associations without capital stock organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for, and insurance of shares or deposits in—

(i) domestic building and loan associations,

(ii) cooperative banks without capital stock organized and operated for mutual purposes and without profit,

(iii) mutual savings banks not having capital stock represented by shares, or

(iv) mutual savings banks described in section 591(b).

(C) Corporations or associations organized before September 1, 1957, and operated for mutual purposes and without profit for the purpose of providing reserve funds for associations or banks described in clause (i), (ii), or (iii) of subparagraph (B); but only if 85 percent or more of the income is attributable to providing such reserve funds and to investments. This subparagraph shall not apply to any corporation or association entitled to exemption under subparagraph (B).

(15)

(A) Insurance companies (as defined in section 816(a)) other than life (including interinsurers and reciprocal underwriters) if—

(i)

(I) the gross receipts for the taxable year do not exceed \$600,000, and

(II) more than 50 percent of such gross receipts consist of premiums, or

(ii) in the case of a mutual insurance company—

(I) the gross receipts of which for the taxable year do not exceed \$150,000, and

(II) more than 35 percent of such gross receipts consist of premiums.

Clause (ii) shall not apply to a company if any employee of the company, or a member of the employee's family (as defined in section 2032A(e)(2)), is an employee of another company exempt from taxation by reason of this paragraph (or would be so exempt but for this sentence).

(B) For purposes of subparagraph (A), in determining whether any company or association is described in subparagraph (A), such company or association shall be treated as receiving during the taxable year amounts described in subparagraph (A) which are received during such year by all other companies or associations which are members of the same controlled group as the insurance company or association for which the determination is being made.

(C) For purposes of subparagraph (B), the term "controlled group" has the meaning given such term by section 831(b)(2)(B)(ii),<sup>1</sup> except that in applying section 831(b)(2)(B)(ii)<sup>1</sup> for purposes of this subparagraph, subparagraphs (B) and (C) of section 1563(b)(2) shall be disregarded.

(16) Corporations organized by an association subject to part IV of this subchapter or members thereof, for the purpose of financing the ordinary crop operations of such members or other producers, and operated in conjunction with such association. Exemption shall not be

denied any such corporation because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the corporation, on dissolution or otherwise, beyond the fixed dividends) is owned by such association, or members thereof; nor shall exemption be denied any such corporation because there is accumulated and maintained by it a reserve required by State law or a reasonable reserve for any necessary purpose.

(17)

(A) A trust or trusts forming part of a plan providing for the payment of supplemental unemployment compensation benefits, if—

(i) under the plan, it is impossible, at any time prior to the satisfaction of all liabilities, with respect to employees under the plan, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of supplemental unemployment compensation benefits,

(ii) such benefits are payable to employees under a classification which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated employees (within the meaning of section 414(q)), and

(iii) such benefits do not discriminate in favor of employees who are highly compensated employees (within the meaning of section 414(q)). A plan shall not be considered discriminatory within the meaning of this clause merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan.

(B) In determining whether a plan meets the requirements of subparagraph (A), any benefits provided under any other plan shall not be taken into consideration, except that a plan shall not be considered discriminatory—

(i) merely because the benefits under the plan which are first determined in a nondiscriminatory manner within the meaning of subparagraph (A) are then reduced by any sick, accident, or unemployment compensation benefits received under State or Federal law (or reduced by a portion of such benefits if determined in a nondiscriminatory manner), or

(ii) merely because the plan provides only for employees who are not eligible to receive sick, accident, or unemployment compensation benefits under State or Federal law the same benefits (or a portion of such benefits if determined in a nondiscriminatory manner) which such employees would receive under such laws if such employees were eligible for such benefits, or

(iii) merely because the plan provides only for employees who are not eligible under another plan (which meets the requirements of subparagraph (A)) of supplemental unemployment compensation benefits provided wholly by the employer the same benefits (or a portion of such benefits if determined in a nondiscriminatory manner) which such employees would receive under such other plan if such employees were eligible under



such other plan, but only if the employees eligible under both plans would make a classification which would be nondiscriminatory within the meaning of subparagraph (A).

(C) A plan shall be considered to meet the requirements of subparagraph (A) during the whole of any year of the plan if on one day in each quarter it satisfies such requirements.

(D) The term “supplemental unemployment compensation benefits” means only—

(i) benefits which are paid to an employee because of his involuntary separation from the employment of the employer (whether or not such separation is temporary) resulting directly from a reduction in force, the discontinuance of a plant or operation, or other similar conditions, and

(ii) sick and accident benefits subordinate to the benefits described in clause (i).

(E) Exemption shall not be denied under subsection (a) to any organization entitled to such exemption as an association described in paragraph (9) of this subsection merely because such organization provides for the payment of supplemental unemployment benefits (as defined in subparagraph (D)(i)).

(18) A trust or trusts created before June 25, 1959, forming part of a plan providing for the payment of benefits under a pension plan funded only by contributions of employees, if—

(A) under the plan, it is impossible, at any time prior to the satisfaction of all liabilities with respect to employees under the plan, for any part of the corpus or income to be (within the taxable year or thereafter) used for, or diverted to, any purpose other than the providing of benefits under the plan,

(B) such benefits are payable to employees under a classification which is set forth in the plan and which is found by the Secretary not to be discriminatory in favor of employees who are highly compensated employees (within the meaning of section 414(q)),

(C) such benefits do not discriminate in favor of employees who are highly compensated employees (within the meaning of section 414(q)). A plan shall not be considered discriminatory within the meaning of this subparagraph merely because the benefits received under the plan bear a uniform relationship to the total compensation, or the basic or regular rate of compensation, of the employees covered by the plan, and

(D) in the case of a plan under which an employee may designate certain contributions as deductible—

(i) such contributions do not exceed the amount with respect to which a deduction is allowable under section 219(b)(3),

(ii) requirements similar to the requirements of section 401(k)(3)(A)(ii) are met with respect to such elective contributions,

(iii) such contributions are treated as elective deferrals for purposes of section 402(g), and

(iv) the requirements of section 401(a)(30) are met.

For purposes of subparagraph (D)(ii), rules similar to the rules of section 401(k)(8) shall apply. For purposes of section 4979, any excess contribution under clause (ii) shall be treated as an excess contribution under a cash or deferred arrangement.

(19) A post or organization of past or present members of the Armed Forces of the United States, or an auxiliary unit or society of, or a trust or foundation for, any such post or organization—

(A) organized in the United States or any of its possessions,

(B) at least 75 percent of the members of which are past or present members of the Armed Forces of the United States and substantially all of the other members of which are individuals who are cadets or are spouses, widows, widowers, ancestors, or lineal descendants of past or present members of the Armed Forces of the United States or of cadets, and

(C) no part of the net earnings of which inures to the benefit of any private shareholder or individual.

[(20) Repealed. Pub. L. 113–295, div. A, title II, §221(a)(19)(B)(iii), Dec. 19, 2014, 128 Stat. 4040.]

(21)

(A) A trust or trusts established in writing, created or organized in the United States, and contributed to by any person (except an insurance company) if—

(i) the purpose of such trust or trusts is exclusively—

(I) to satisfy, in whole or in part, the liability of such person for, or with respect to, claims for compensation for disability or death due to pneumoconiosis under Black Lung Acts,

(II) to pay premiums for insurance exclusively covering such liability,

(III) to pay administrative and other incidental expenses of such trust in connection with the operation of the trust and the processing of claims against such person under Black Lung Acts, and

(IV) to pay accident or health benefits for retired miners and their spouses and dependents (including administrative and other incidental expenses of such trust in connection therewith) or premiums for insurance exclusively covering such benefits; and

(ii) no part of the assets of the trust may be used for, or diverted to, any purpose other than—

(I) the purposes described in clause (i),

(II) investment (but only to the extent that the trustee determines that a portion of the assets is not currently needed for the purposes described in clause (i)) in qualified investments, or

(III) payment into the Black Lung Disability Trust Fund established under section 9501, or into the general fund of the United States Treasury (other than in satisfaction of any tax or other civil or criminal liability of the person who established or contributed to the trust).

(B) No deduction shall be allowed under this chapter for any payment described in subparagraph (A)(i)(IV) from such trust.

(C) Payments described in subparagraph (A)(i)(IV) may be made from such trust during a taxable year only to the extent that the aggregate amount of such payments during such taxable year does not exceed the excess (if any), as of the close of the preceding taxable year, of—

(i) the fair market value of the assets of the trust, over

(ii) 110 percent of the present value of the liability described in subparagraph (A)(i)(I) of such person.

The determinations under the preceding sentence shall be made by an independent actuary using actuarial methods and assumptions (not inconsistent with the regulations prescribed under section 192(c)(1)(A)) each of which is reasonable and which are reasonable in the aggregate.

(D) For purposes of this paragraph:

(i) The term “Black Lung Acts” means part C of title IV of the Federal Mine Safety and Health Act of 1977, and any State law providing compensation for disability or death due to that pneumoconiosis.

(ii) The term “qualified investments” means—

(I) public debt securities of the United States,

(II) obligations of a State or local government which are not in default as to principal or interest, and

(III) time or demand deposits in a bank (as defined in section 581) or an insured credit union (within the meaning of section 101(7) of the Federal Credit Union Act, 12 U.S.C. 1752(7)) located in the United States.

(iii) The term “miner” has the same meaning as such term has when used in section 402(d) of the Black Lung Benefits Act (30 U.S.C. 902(d)).

(iv) The term “incidental expenses” includes legal, accounting, actuarial, and trustee expenses.

(22) A trust created or organized in the United States and established in writing by the plan sponsors of multiemployer plans if—

(A) the purpose of such trust is exclusively—

(i) to pay any amount described in section 4223(c) or (h) of the Employee Retirement Income Security Act of 1974, and

(ii) to pay reasonable and necessary administrative expenses in connection with the establishment and operation of the trust and the processing of claims against the trust,

(B) no part of the assets of the trust may be used for, or diverted to, any purpose other than —

(i) the purposes described in subparagraph (A), or

(ii) the investment in securities, obligations, or time or demand deposits described in clause (ii) of paragraph (21)(D),

(C) such trust meets the requirements of paragraphs (2), (3), and (4) of section 4223(b),

4223(h), or, if applicable, section 4223(c) of the Employee Retirement Income Security Act of 1974, and

(D) the trust instrument provides that, on dissolution of the trust, assets of the trust may not be paid other than to plans which have participated in the plan or, in the case of a trust established under section 4223(h) of such Act, to plans with respect to which employers have participated in the fund.

(23) Any association organized before 1880 more than 75 percent of the members of which are present or past members of the Armed Forces and a principal purpose of which is to provide insurance and other benefits to veterans or their dependents.

(24) A trust described in section 4049 of the Employee Retirement Income Security Act of 1974 (as in effect on the date of the enactment of the Single-Employer Pension Plan Amendments Act of 1986).

(25)

(A) Any corporation or trust which—

(i) has no more than 35 shareholders or beneficiaries,

(ii) has only 1 class of stock or beneficial interest, and

(iii) is organized for the exclusive purposes of—

(I) acquiring real property and holding title to, and collecting income from, such property, and

(II) remitting the entire amount of income from such property (less expenses) to 1 or more organizations described in subparagraph (C) which are shareholders of such corporation or beneficiaries of such trust.

For purposes of clause (iii), the term “real property” shall not include any interest as a tenant in common (or similar interest) and shall not include any indirect interest.

(B) A corporation or trust shall be described in subparagraph (A) without regard to whether the corporation or trust is organized by 1 or more organizations described in subparagraph (C).

(C) An organization is described in this subparagraph if such organization is—

(i) a qualified pension, profit sharing, or stock bonus plan that meets the requirements of section 401(a),

(ii) a governmental plan (within the meaning of section 414(d)),

(iii) the United States, any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing, or

(iv) any organization described in paragraph (3).

(D) A corporation or trust shall in no event be treated as described in subparagraph (A) unless such corporation or trust permits its shareholders or beneficiaries—

(i) to dismiss the corporation’s or trust’s investment adviser, following reasonable notice, upon a vote of the shareholders or beneficiaries holding a majority of interest in the corporation or trust, and

(ii) to terminate their interest in the corporation or trust by either, or both, of the following alternatives, as determined by the corporation or trust:

(I) by selling or exchanging their stock in the corporation or interest in the trust (subject to any Federal or State securities law) to any organization described in subparagraph (C) so long as the sale or exchange does not increase the number of shareholders or beneficiaries in such corporation or trust above 35, or

(II) by having their stock or interest redeemed by the corporation or trust after the shareholder or beneficiary has provided 90 days notice to such corporation or trust.

(E)

(i) For purposes of this title—

(I) a corporation which is a qualified subsidiary shall not be treated as a separate corporation, and

(II) all assets, liabilities, and items of income, deduction, and credit of a qualified subsidiary shall be treated as assets, liabilities, and such items (as the case may be) of the corporation or trust described in subparagraph (A).

(ii) For purposes of this subparagraph, the term “qualified subsidiary” means any corporation if, at all times during the period such corporation was in existence, 100 percent of the stock of such corporation is held by the corporation or trust described in subparagraph (A).

(iii) For purposes of this subtitle, if any corporation which was a qualified subsidiary ceases to meet the requirements of clause (ii), such corporation shall be treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before such cessation from the corporation or trust described in subparagraph (A) in exchange for its stock.

(F) For purposes of subparagraph (A), the term “real property” includes any personal property which is leased under, or in connection with, a lease of real property, but only if the rent attributable to such personal property (determined under the rules of section 856(d)(1)) for the taxable year does not exceed 15 percent of the total rent for the taxable year attributable to both the real and personal property leased under, or in connection with, such lease.

(G)

(i) An organization shall not be treated as failing to be described in this paragraph merely by reason of the receipt of any otherwise disqualifying income which is incidentally derived from the holding of real property.

(ii) Clause (i) shall not apply if the amount of gross income described in such clause exceeds 10 percent of the organization’s gross income for the taxable year unless the organization establishes to the satisfaction of the Secretary that the receipt of gross income described in clause (i) in excess of such limitation was inadvertent and reasonable steps are being taken to correct the circumstances giving rise to such income.

(26) Any membership organization if—

(A) such organization is established by a State exclusively to provide coverage for medical

care (as defined in section 213(d)) on a not-for-profit basis to individuals described in subparagraph (B) through—

- (i) insurance issued by the organization, or
  - (ii) a health maintenance organization under an arrangement with the organization,
- (B) the only individuals receiving such coverage through the organization are individuals

—

- (i) who are residents of such State, and
- (ii) who, by reason of the existence or history of a medical condition—
  - (I) are unable to acquire medical care coverage for such condition through insurance or from a health maintenance organization, or
  - (II) are able to acquire such coverage only at a rate which is substantially in excess of the rate for such coverage through the membership organization,
- (C) the composition of the membership in such organization is specified by such State, and
- (D) no part of the net earnings of the organization inures to the benefit of any private shareholder or individual.

A spouse and any qualifying child (as defined in section 24(c)) of an individual described in subparagraph (B) (without regard to this sentence) shall be treated as described in subparagraph (B).

(27)

(A) Any membership organization if—

- (i) such organization is established before June 1, 1996, by a State exclusively to reimburse its members for losses arising under workmen's compensation acts,
- (ii) such State requires that the membership of such organization consist of—
  - (I) all persons who issue insurance covering workmen's compensation losses in such State, and
  - (II) all persons and governmental entities who self-insure against such losses, and
- (iii) such organization operates as a non-profit organization by—
  - (I) returning surplus income to its members or workmen's compensation policyholders on a periodic basis, and
  - (II) reducing initial premiums in anticipation of investment income.

(B) Any organization (including a mutual insurance company) if—

- (i) such organization is created by State law and is organized and operated under State law exclusively to—
  - (I) provide workmen's compensation insurance which is required by State law or with respect to which State law provides significant disincentives if such insurance is not purchased by an employer, and
  - (II) provide related coverage which is incidental to workmen's compensation insurance,

(ii) such organization must provide workmen's compensation insurance to any employer in the State (for employees in the State or temporarily assigned out-of-State) which seeks such insurance and meets other reasonable requirements relating thereto,

(iii)

(I) the State makes a financial commitment with respect to such organization either by extending the full faith and credit of the State to the initial debt of such organization or by providing the initial operating capital of such organization, and (II) in the case of periods after the date of enactment of this subparagraph, the assets of such organization revert to the State upon dissolution or State law does not permit the dissolution of such organization, and

(iv) the majority of the board of directors or oversight body of such organization are appointed by the chief executive officer or other executive branch official of the State, by the State legislature, or by both.

(28) The National Railroad Retirement Investment Trust established under section 15(j) of the Railroad Retirement Act of 1974.

(29) CO-OP health insurance issuers.—

(A) **In general.**— A qualified nonprofit health insurance issuer (within the meaning of section 1322 of the Patient Protection and Affordable Care Act) which has received a loan or grant under the CO-OP program under such section, but only with respect to periods for which the issuer is in compliance with the requirements of such section and any agreement with respect to the loan or grant.

(B) **Conditions for exemption.**— Subparagraph (A) shall apply to an organization only if—

(i) the organization has given notice to the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition of its status under this paragraph,

(ii) except as provided in section 1322(c)(4) of the Patient Protection and Affordable Care Act, no part of the net earnings of which inures to the benefit of any private shareholder or individual,

(iii) no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, and

(iv) the organization does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office.

## **§1001. DETERMINATION OF AMOUNT OF AND RECOGNITION OF GAIN OR LOSS**

### **(a) Computation of gain or loss**

The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 1011 for determining gain, and the loss

shall be the excess of the adjusted basis provided in such section for determining loss over the amount realized.

**(b) Amount realized**

The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received. In determining the amount realized—

- (1) there shall not be taken into account any amount received as reimbursement for real property taxes which are treated under section 164(d) as imposed on the purchaser, and
- (2) there shall be taken into account amounts representing real property taxes which are treated under section 164(d) as imposed on the taxpayer if such taxes are to be paid by the purchaser.

**(c) Recognition of gain or loss**

Except as otherwise provided in this subtitle, the entire amount of the gain or loss, determined under this section, on the sale or exchange of property shall be recognized.

**(d) Installment sales**

Nothing in this section shall be construed to prevent (in the case of property sold under contract providing for payment in installments) the taxation of that portion of any installment payment representing gain or profit in the year in which such payment is received.

**(e) Certain term interests**

(1) **In general** In determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

(2) **Term interest in property defined** For purposes of paragraph (1), the term “term interest in property” means—

- (A) a life interest in property,
- (B) an interest in property for a term of years, or
- (C) an income interest in a trust.

(3) **Exception** Paragraph (1) shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

## **§1011. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS**

**(a) General rule**



The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis (determined under section 1012 or other applicable sections of this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses)), adjusted as provided in section 1016.

**(b) Bargain sale to a charitable organization**

If a deduction is allowable under section 170 (relating to charitable contributions) by reason of a sale, then the adjusted basis for determining the gain from such sale shall be that portion of the adjusted basis which bears the same ratio to the adjusted basis as the amount realized bears to the fair market value of the property.

## **§1012. BASIS OF PROPERTY—COST**

**(a) In general**

The basis of property shall be the cost of such property, except as otherwise provided in this subchapter and subchapters C (relating to corporate distributions and adjustments), K (relating to partners and partnerships), and P (relating to capital gains and losses).

**(b) Special rule for apportioned real estate taxes**

The cost of real property shall not include any amount in respect of real property taxes which are treated under section 164(d) as imposed on the taxpayer.

**(c) Determinations by account**

**(1) In general** In the case of the sale, exchange, or other disposition of a specified security on or after the applicable date, the conventions prescribed by regulations under this section shall be applied on an account by account basis.

**(2) Application to certain regulated investment companies**

**(A) In general** Except as provided in subparagraph (B), any stock for which an average basis method is permissible under this section which is acquired before January 1, 2012, shall be treated as a separate account from any such stock acquired on or after such date.

**(B) Election for treatment as single account** If a regulated investment company described in subparagraph (A) elects to have this subparagraph apply with respect to one or more of its stockholders—

**(i)** subparagraph (A) shall not apply with respect to any stock in such regulated investment company held by such stockholders, and

**(ii)** all stock in such regulated investment company which is held by such stockholders shall be treated as covered securities described in section 6045(g)(3) without regard to the date of the acquisition of such stock.

A rule similar to the rule of the preceding sentence shall apply with respect to a broker holding such stock as a nominee.

**(3) Definitions** For purposes of this section, the terms “specified security” and “applicable date” shall have the meaning given such terms in section 6045(g).

**(d) Average basis for stock acquired pursuant to a dividend reinvestment plan**

**(1) In general** In the case of any stock acquired after December 31, 2011, in connection with a dividend reinvestment plan, the basis of such stock while held as part of such plan shall be determined using one of the methods which may be used for determining the basis of stock in a regulated investment company.

**(2) Treatment after transfer** In the case of the transfer to another account of stock to which paragraph (1) applies, such stock shall have a cost basis in such other account equal to its basis in the dividend reinvestment plan immediately before such transfer (properly adjusted for any fees or other charges taken into account in connection with such transfer).

**(3) Separate accounts; election for treatment as single account**

**(A) In general** Rules similar to the rules of subsection (c)(2) shall apply for purposes of this subsection.

**(B) Average basis method** Notwithstanding paragraph (1), in the case of an election under rules similar to the rules of subsection (c)(2)(B) with respect to stock held in connection with a dividend reinvestment plan, the average basis method is permissible with respect to all such stock without regard to the date of the acquisition of such stock.

**(4) Dividend reinvestment plan** For purposes of this subsection—

**(A) In general** The term “dividend reinvestment plan” means any arrangement under which dividends on any stock are reinvested in stock identical to the stock with respect to which the dividends are paid.

**(B) Initial stock acquisition treated as acquired in connection with plan** Stock shall be treated as acquired in connection with a dividend reinvestment plan if such stock is acquired pursuant to such plan or if the dividends paid on such stock are subject to such plan.

## **§1014. BASIS OF PROPERTY ACQUIRED FROM A DECEDENT**

**(a) In general**

Except as otherwise provided in this section, the basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent’s death by such person, be—

**(1)** the fair market value of the property at the date of the decedent’s death,

**(2)** in the case of an election under section 2032, its value at the applicable valuation date prescribed by such section,

(3) in the case of an election under section 2032A, its value determined under such section, or

(4) to the extent of the applicability of the exclusion described in section 2031(c), the basis in the hands of the decedent.

## **§1015. BASIS OF PROPERTY ACQUIRED BY GIFTS AND TRANSFERS IN TRUST**

### **(a) Gifts after December 31, 1920**

If the property was acquired by gift after December 31, 1920, the basis shall be the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift, except that if such basis (adjusted for the period before the date of the gift as provided in section 1016) is greater than the fair market value of the property at the time of the gift, then for the purpose of determining loss the basis shall be such fair market value. If the facts necessary to determine the basis in the hands of the donor or the last preceding owner are unknown to the donee, the Secretary shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Secretary finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the Secretary as of the date or approximate date at which, according to the best information that the Secretary is able to obtain, such property was acquired by such donor or last preceding owner.

### **(e) Gifts between spouses**

In the case of any property acquired by gift in a transfer described in section 1041(a), the basis of such property in the hands of the transferee shall be determined under section 1041(b)(2) and not this section.

## **§1016. ADJUSTMENTS TO BASIS**

### **(a) General rule**

Proper adjustment in respect of the property shall in all cases be made—

(1) for expenditures, receipts, losses, or other items, properly chargeable to capital account, but no such adjustment shall be made—

(A) for—

(i) taxes or other carrying charges described in section 266; or

(ii) expenditures described in section 173 (relating to circulation expenditures), for which deductions have been taken by the taxpayer in determining taxable income for the taxable year or prior taxable years; or

(B) for mortality, expense, or other reasonable charges incurred under an annuity or life insurance contract;

(2) in respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent of the amount—

(A) allowed as deductions in computing taxable income under this subtitle or prior income tax laws, and

(B) resulting (by reason of the deductions so allowed) in a reduction for any taxable year of the taxpayer's taxes under this subtitle (other than chapter 2, relating to tax on self-employment income), or prior income, war-profits, or excess-profits tax laws, but not less than the amount allowable under this subtitle or prior income tax laws. Where no method has been adopted under section 167 (relating to depreciation deduction), the amount allowable shall be determined under the straight line method. Subparagraph (B) of this paragraph shall not apply in respect of any period since February 28, 1913, and before January 1, 1952, unless an election has been made under section 1020 (as in effect before the date of the enactment of the Tax Reform Act of 1976). Where for any taxable year before the taxable year 1932 the depletion allowance was based on discovery value or a percentage of income, then the adjustment for depletion for such year shall be based on the depletion which would have been allowable for such year if computed without reference to discovery value or a percentage of income;

(3) in respect of any period—

(A) before March 1, 1913,

(B) since February 28, 1913, during which such property was held by a person or an organization not subject to income taxation under this chapter or prior income tax laws,

(C) since February 28, 1913, and before January 1, 1958, during which such property was held by a person subject to tax under part I of subchapter L (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply, and

(D) since February 28, 1913, during which such property was held by a person subject to tax under part II of subchapter L as in effect prior to its repeal by the Tax Reform Act of 1986 (or the corresponding provisions of prior income tax laws), to the extent that paragraph (2) does not apply,

for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent sustained;

(4) in the case of stock (to the extent not provided for in the foregoing paragraphs) for the amount of distributions previously made which, under the law applicable to the year in which the distribution was made, either were tax-free or were applicable in reduction of basis (not including distributions made by a corporation which was classified as a personal service corporation under the provisions of the Revenue Act of 1918 (40 Stat. 1057), or the Revenue Act of 1921 (42 Stat. 227), out of its earnings or profits which were taxable in accordance with the provisions of section 218 of the Revenue Act of 1918 or 1921);

(5) in the case of any bond (as defined in section 171(d)) the interest on which is wholly exempt from the tax imposed by this subtitle, to the extent of the amortizable bond premium

disallowable as a deduction pursuant to section 171(a)(2), and in the case of any other bond (as defined in section 171(d)) to the extent of the deductions allowable pursuant to section 171(a)(1) (or the amount applied to reduce interest payments under section 171(e)(2)) with respect thereto;

(6) in the case of any municipal bond (as defined in section 75(b)), to the extent provided in section 75(a)(2);

(7) in the case of a residence the acquisition of which resulted, under section 1034 (as in effect on the day before the date of the enactment of the Taxpayer Relief Act of 1997), in the nonrecognition of any part of the gain realized on the sale, exchange, or involuntary conversion of another residence, to the extent provided in section 1034(e) (as so in effect);

(8) in the case of property pledged to the Commodity Credit Corporation, to the extent of the amount received as a loan from the Commodity Credit Corporation and treated by the taxpayer as income for the year in which received pursuant to section 77, and to the extent of any deficiency on such loan with respect to which the taxpayer has been relieved from liability;

(9) for amounts allowed as deductions as deferred expenses under section 616(b) (relating to certain expenditures in the development of mines) and resulting in a reduction of the taxpayer's taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

[(10) Repealed. Pub. L. 94-455, title XIX, §1901(b)(21)(G), Oct. 4, 1976, 90 Stat. 1798]

(11) for deductions to the extent disallowed under section 268 (relating to sale of land with unharvested crops), notwithstanding the provisions of any other paragraph of this subsection;

[(12) Repealed. Pub. L. 113-295, div. A, title II, §221(a)(75), Dec. 19, 2014, 128 Stat. 4049]

[(13) Repealed. Pub. L. 108-357, title IV, §413(c)(19), Oct. 22, 2004, 118 Stat. 1509]

(14) for amounts allowed as deductions as deferred expenses under section 174(b)(1) (relating to research and experimental expenditures) and resulting in a reduction of the taxpayers' taxes under this subtitle, but not less than the amounts allowable under such section for the taxable year and prior years;

(15) for deductions to the extent disallowed under section 272 (relating to disposal of coal or domestic iron ore), notwithstanding the provisions of any other paragraph of this subsection;

(16) in the case of any evidence of indebtedness referred to in section 811(b) (relating to amortization of premium and accrual of discount in the case of life insurance companies), to the extent of the adjustments required under section 811(b) (or the corresponding provisions of prior income tax laws) for the taxable year and all prior taxable years;

(17) to the extent provided in section 1367 in the case of stock of, and indebtedness owed to, shareholders of an S corporation;

(18) to the extent provided in section 961 in the case of stock in controlled foreign corporations (or foreign corporations which were controlled foreign corporations) and of property by reason of which a person is considered as owning such stock;

(19) to the extent provided in section 50(c), in the case of expenditures with respect to which a credit has been allowed under section 38;

(20) for amounts allowed as deductions under section 59(e) (relating to optional 10-year writeoff of certain tax preferences);

(21) to the extent provided in section 1059 (relating to reduction in basis for extraordinary dividends);

(22) in the case of qualified replacement property the acquisition of which resulted under section 1042 in the nonrecognition of any part of the gain realized on the sale or exchange of any property, to the extent provided in section 1042(d),<sup>2</sup>

(23) in the case of property the acquisition of which resulted under section 1043, 1045, or 1397B in the nonrecognition of any part of the gain realized on the sale of other property, to the extent provided in section 1043(c), 1045(b)(3), or 1397B(b)(4), as the case may be,<sup>2</sup>

[(24) Repealed. Pub. L. 113–295, div. A, title II, §221(a)(34)(G), Dec. 19, 2014, 128 Stat. 4042]

[(25) Repealed. Pub. L. 113–295, div. A, title II, §221(a)(2)(D), Dec. 19, 2014, 128 Stat. 4037]

(26) to the extent provided in sections 23(g) and 137(e),<sup>2</sup>

[(27) Repealed. Pub. L. 115–141, div. U, title IV, §401(d)(4)(B)(iv), Mar. 23, 2018, 132 Stat. 1209]

(28) in the case of a facility with respect to which a credit was allowed under section 45F, to the extent provided in section 45F(f)(1),<sup>2</sup>

(29) in the case of railroad track with respect to which a credit was allowed under section 45G, to the extent provided in section 45G(e)(3),<sup>2</sup>

(30) to the extent provided in section 179B(c),<sup>2</sup>

(31) to the extent provided in section 179D(e),<sup>2</sup>

(32) to the extent provided in section 45L(e), in the case of amounts with respect to which a credit has been allowed under section 45L,<sup>2</sup>

(33) to the extent provided in section 25C(g), in the case of amounts with respect to which a credit has been allowed under section 25C,<sup>2</sup>

(34) to the extent provided in section 25D(f), in the case of amounts with respect to which a credit has been allowed under section 25D,<sup>2</sup>

(35) to the extent provided in section 30B(h)(4),<sup>2</sup>

(36) to the extent provided in section 30C(e)(1),<sup>2</sup>

(37) to the extent provided in section 30D(f)(1),<sup>2</sup> and

(38) to the extent provided in subsections (b)(2) and (c) of section 1400Z–2.

## **§1031. EXCHANGE OF REAL PROPERTY HELD FOR PRODUCTIVE USE OR INVESTMENT**

### **(a) Nonrecognition of gain or loss from exchanges solely in kind**

**(1) In general** No gain or loss shall be recognized on the exchange of real property held for productive use in a trade or business or for investment if such real property is exchanged solely for real property of like kind which is to be held either for productive use in a trade or business or for investment.

**(2) Exception for real property held for sale** This subsection shall not apply to any exchange of real property held primarily for sale.

**(3) Requirement that property be identified and that exchange be completed not more than 180 days after transfer of exchanged property** For purposes of this subsection, any property received by the taxpayer shall be treated as property which is not like-kind property if—

**(A)** such property is not identified as property to be received in the exchange on or before the day which is 45 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

**(B)** such property is received after the earlier of—

**(i)** the day which is 180 days after the date on which the taxpayer transfers the property relinquished in the exchange, or

**(ii)** the due date (determined with regard to extension) for the transferor's return of the tax imposed by this chapter for the taxable year in which the transfer of the relinquished property occurs.

### **(b) Gain from exchanges not solely in kind**

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

### **(c) Loss from exchanges not solely in kind**

If an exchange would be within the provisions of subsection (a), of section 1035(a), of section 1036(a), or of section 1037(a), if it were not for the fact that the property received in exchange consists not only of property permitted by such provisions to be received without the recognition of gain or loss, but also of other property or money, then no loss from the exchange shall be recognized.

### **(d) Basis**

If property was acquired on an exchange described in this section, section 1035(a), section 1036(a), or section 1037(a), then the basis shall be the same as that of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized on such exchange. If the property so acquired consisted in part of the type of property permitted by this section, section 1035(a), section 1036(a), or section 1037(a), to be received without the recognition of gain or loss, and in part of other property, the basis provided in this subsection shall be allocated between the properties (other than money) received, and for the purpose of the allocation there shall be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. For purposes of this section, section 1035(a), and section 1036(a), where as part of the consideration to the taxpayer another party to the exchange assumed (as determined under section 357(d)) a liability of the taxpayer, such assumption shall be considered as money received by the taxpayer on the exchange.

**(e) Application to certain partnerships**

For purposes of this section, an interest in a partnership which has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K shall be treated as an interest in each of the assets of such partnership and not as an interest in a partnership.

## **§1041. TRANSFERS OF PROPERTY BETWEEN SPOUSES OR INCIDENT TO DIVORCE**

**(a) General rule**

No gain or loss shall be recognized on a transfer of property from an individual to (or in trust for the benefit of)—

- (1) a spouse, or
- (2) a former spouse, but only if the transfer is incident to the divorce.

**(b) Transfer treated as gift; transferee has transferor's basis**

In the case of any transfer of property described in subsection (a)—

- (1) for purposes of this subtitle, the property shall be treated as acquired by the transferee by gift, and
- (2) the basis of the transferee in the property shall be the adjusted basis of the transferor.

**(c) Incident to divorce**

For purposes of subsection (a)(2), a transfer of property is incident to the divorce if such transfer —

- (1) occurs within 1 year after the date on which the marriage ceases, or
- (2) is related to the cessation of the marriage.



**(d) Special rule where spouse is nonresident alien**

Subsection (a) shall not apply if the spouse (or former spouse) of the individual making the transfer is a nonresident alien.

**(e) Transfers in trust where liability exceeds basis**

Subsection (a) shall not apply to the transfer of property in trust to the extent that—

(1) the sum of the amount of the liabilities assumed, plus the amount of the liabilities to which the property is subject, exceeds

(2) the total of the adjusted basis of the property transferred.

Proper adjustment shall be made under subsection (b) in the basis of the transferee in such property to take into account gain recognized by reason of the preceding sentence.

## **§1211. LIMITATION ON CAPITAL LOSSES**

**(b) Other taxpayers**

In the case of a taxpayer other than a corporation, losses from sales or exchanges of capital assets shall be allowed only to the extent of the gains from such sales or exchanges, plus (if such losses exceed such gains) the lower of—

(1) \$3,000 (\$1,500 in the case of a married individual filing a separate return), or

(2) the excess of such losses over such gains.

## **§1212. CAPITAL LOSS CARRYBACKS AND CARRYOVERS**

**(b) Other taxpayers**

(1) **In general** If a taxpayer other than a corporation has a net capital loss for any taxable year

(A) the excess of the net short-term capital loss over the net long-term capital gain for such year shall be a short-term capital loss in the succeeding taxable year, and

(B) the excess of the net long-term capital loss over the net short-term capital gain for such year shall be a long-term capital loss in the succeeding taxable year.

(2) **Treatment of amounts allowed under section 1211(b)(1) or (2)**

(A) **In general** For purposes of determining the excess referred to in subparagraph (A) or (B) of paragraph (1), there shall be treated as a short-term capital gain in the taxable year an amount equal to the lesser of—

(i) the amount allowed for the taxable year under paragraph (1) or (2) of section 1211(b), or

(ii) the adjusted taxable income for such taxable year.

**(B) Adjusted taxable income** For purposes of subparagraph (A), the term “adjusted taxable income” means taxable income increased by the sum of—

(i) the amount allowed for the taxable year under paragraph (1) or (2) of section 1211(b), and

(ii) the deduction allowed for such year under section 151 or any deduction in lieu thereof.

For purposes of the preceding sentence, any excess of the deductions allowed for the taxable year over the gross income for such year shall be taken into account as negative taxable income.

## §1221. CAPITAL ASSET DEFINED

### (a) In general

For purposes of this subtitle, the term “capital asset” means property held by the taxpayer (whether or not connected with his trade or business), but does not include—

(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;

(2) property, used in his trade or business, of a character which is subject to the allowance for depreciation provided in section 167, or real property used in his trade or business;

(3) a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by—

(A) a taxpayer whose personal efforts created such property,

(B) in the case of a letter, memorandum, or similar property, a taxpayer for whom such property was prepared or produced, or

(C) a taxpayer in whose hands the basis of such property is determined, for purposes of determining gain from a sale or exchange, in whole or part by reference to the basis of such property in the hands of a taxpayer described in subparagraph (A) or (B);

(4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);

(5) a publication of the United States Government (including the Congressional Record) which is received from the United States Government or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by—

(A) a taxpayer who so received such publication, or

(B) a taxpayer in whose hands the basis of such publication is determined, for purposes of

determining gain from a sale or exchange, in whole or in part by reference to the basis of such publication in the hands of a taxpayer described in subparagraph (A);

(6) any commodities derivative financial instrument held by a commodities derivatives dealer, unless—

(A) it is established to the satisfaction of the Secretary that such instrument has no connection to the activities of such dealer as a dealer, and

(B) such instrument is clearly identified in such dealer's records as being described in subparagraph (A) before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe);

(7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the Secretary may by regulations prescribe); or

(8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

## **(b) Definitions and special rules**

**(1) Commodities derivative financial instruments** For purposes of subsection (a)(6)—

**(A) Commodities derivatives dealer** The term “commodities derivatives dealer” means a person which regularly offers to enter into, assume, offset, assign, or terminate positions in commodities derivative financial instruments with customers in the ordinary course of a trade or business.

**(B) Commodities derivative financial instrument**

**(i) In general** The term “commodities derivative financial instrument” means any contract or financial instrument with respect to commodities (other than a share of stock in a corporation, a beneficial interest in a partnership or trust, a note, bond, debenture, or other evidence of indebtedness, or a section 1256 contract (as defined in section 1256(b))), the value or settlement price of which is calculated by or determined by reference to a specified index.

**(ii) Specified index** The term “specified index” means any one or more or any combination of—

(I) a fixed rate, price, or amount, or

(II) a variable rate, price, or amount,

which is based on any current, objectively determinable financial or economic information with respect to commodities which is not within the control of any of the parties to the contract or instrument and is not unique to any of the parties' circumstances.

**(2) Hedging transaction**

**(A) In general** For purposes of this section, the term “hedging transaction” means any transaction entered into by the taxpayer in the normal course of the taxpayer's trade or business primarily—

(i) to manage risk of price changes or currency fluctuations with respect to ordinary property which is held or to be held by the taxpayer,

(ii) to manage risk of interest rate or price changes or currency fluctuations with respect to borrowings made or to be made, or ordinary obligations incurred or to be incurred, by the taxpayer, or

(iii) to manage such other risks as the Secretary may prescribe in regulations.

**(B) Treatment of nonidentification or improper identification of hedging transactions** Notwithstanding subsection (a)(7), the Secretary shall prescribe regulations to properly characterize any income, gain, expense, or loss arising from a transaction—

(i) which is a hedging transaction but which was not identified as such in accordance with subsection (a)(7), or

(ii) which was so identified but is not a hedging transaction.

**(3) Sale or exchange of self-created musical works** At the election of the taxpayer, paragraphs (1) and (3) of subsection (a) shall not apply to musical compositions or copyrights in musical works sold or exchanged by a taxpayer described in subsection (a)(3).

**(4) Regulations** The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of paragraph (6) and (7) of subsection (a) in the case of transactions involving related parties.

## §1222. OTHER TERMS RELATING TO CAPITAL GAINS AND LOSSES

For purposes of this subtitle—

**(1) Short-term capital gain** The term “short-term capital gain” means gain from the sale or exchange of a capital asset held for not more than 1 year, if and to the extent such gain is taken into account in computing gross income.

**(2) Short-term capital loss** The term “short-term capital loss” means loss from the sale or exchange of a capital asset held for not more than 1 year, if and to the extent that such loss is taken into account in computing taxable income.

**(3) Long-term capital gain** The term “long-term capital gain” means gain from the sale or exchange of a capital asset held for more than 1 year, if and to the extent such gain is taken into account in computing gross income.

**(4) Long-term capital loss** The term “long-term capital loss” means loss from the sale or exchange of a capital asset held for more than 1 year, if and to the extent that such loss is taken into account in computing taxable income.

**(5) Net short-term capital gain** The term “net short-term capital gain” means the excess of short-term capital gains for the taxable year over the short-term capital losses for such year.

**(6) Net short-term capital loss** The term “net short-term capital loss” means the excess of short-term capital losses for the taxable year over the short-term capital gains for such year.

**(7) Net long-term capital gain** The term “net long-term capital gain” means the excess of

long-term capital gains for the taxable year over the long-term capital losses for such year.

**(8) Net long-term capital loss** The term “net long-term capital loss” means the excess of long-term capital losses for the taxable year over the long-term capital gains for such year.

**(9) Capital gain net income** The term “capital gain net income” means the excess of the gains from sales or exchanges of capital assets over the losses from such sales or exchanges.

**(10) Net capital loss** The term “net capital loss” means the excess of the losses from sales or exchanges of capital assets over the sum allowed under section 1211. In the case of a corporation, for the purpose of determining losses under this paragraph, amounts which are short-term capital losses under section 1212(a)(1) shall be excluded.

**(11) Net capital gain** The term “net capital gain” means the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year.

## §1223. HOLDING PERIOD OF PROPERTY

For purposes of this subtitle—

(1) In determining the period for which the taxpayer has held property received in an exchange, there shall be included the period for which he held the property exchanged if, under this chapter, the property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as the property exchanged, and, in the case of such exchanges the property exchanged at the time of such exchange was a capital asset as defined in section 1221 or property described in section 1231. For purposes of this paragraph

(A) an involuntary conversion described in section 1033 shall be considered an exchange of the property converted for the property acquired, and

(B) a distribution to which section 355 (or so much of section 356 as relates to section 355) applies shall be treated as an exchange.

(2) In determining the period for which the taxpayer has held property however acquired there shall be included the period for which such property was held by any other person, if under this chapter such property has, for the purpose of determining gain or loss from a sale or exchange, the same basis in whole or in part in his hands as it would have in the hands of such other person.

(3) In determining the period for which the taxpayer has held stock or securities the acquisition of which (or the contract or option to acquire which) resulted in the nondeductibility (under section 1091 relating to wash sales) of the loss from the sale or other disposition of substantially identical stock or securities, there shall be included the period for which he held the stock or securities the loss from the sale or other disposition of which was not deductible.

(4) In determining the period for which the taxpayer has held stock or rights to acquire stock received on a distribution, if the basis of such stock or rights is determined under section 307, there shall (under regulations prescribed by the Secretary) be included the period for which he held the stock in the distributing corporation before the receipt of such stock or rights upon

such distribution.

(5) In determining the period for which the taxpayer has held stock or securities acquired from a corporation by the exercise of rights to acquire such stock or securities, there shall be included only the period beginning with the date on which the right to acquire was exercised.

[(6) Repealed. Pub. L. 113–295, div. A, title II, §221(a)(80)(C), Dec. 19, 2014, 128 Stat. 4049.]

(7) In determining the period for which the taxpayer has held a commodity acquired in satisfaction of a commodity futures contract (other than a commodity futures contract to which section 1256 applies) there shall be included the period for which he held the commodity futures contract if such commodity futures contract was a capital asset in his hands.

[(8) Repealed. Pub. L. 113–295, div. A, title II, §221(a)(80)(C), Dec. 19, 2014, 128 Stat. 4049.]

(9) In the case of a person acquiring property from a decedent or to whom property passed from a decedent (within the meaning of section 1014(b)), if—

(A) the basis of such property in the hands of such person is determined under section 1014, and

(B) such property is sold or otherwise disposed of by such person within 1 year after the decedent's death,

then such person shall be considered to have held such property for more than 1 year.

(10) If—

(A) property is acquired by any person in a transfer to which section 1040 applies,

(B) such property is sold or otherwise disposed of by such person within 1 year after the decedent's death, and

(C) such sale or disposition is to a person who is a qualified heir (as defined in section 2032A(e)(1)) with respect to the decedent,

then the person making such sale or other disposition shall be considered to have held such property for more than 1 year.

(11) In determining the period for which the taxpayer has held qualified replacement property (within the meaning of section 1042(b)) the acquisition of which resulted under section 1042 in the nonrecognition of any part of the gain realized on the sale of qualified securities (within the meaning of section 1042(b)), there shall be included the period for which such qualified securities had been held by the taxpayer.

(12) In determining the period for which the taxpayer has held property the acquisition of which resulted under section 1043 in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which such other property had been held as of the date of such sale.

(13) Except for purposes of subsections (a)(2) and (c)(2)(A) of section 1202, in determining the period for which the taxpayer has held property the acquisition of which resulted under section 1045 or 1397B in the nonrecognition of any part of the gain realized on the sale of other property, there shall be included the period for which such other property has been held as of

the date of such sale.

(14) If the security to which a securities futures contract (as defined in section 1234B) relates (other than a contract to which section 1256 applies) is acquired in satisfaction of such contract, in determining the period for which the taxpayer has held such security, there shall be included the period for which the taxpayer held such contract if such contract was a capital asset in the hands of the taxpayer.

(15) **Cross reference.**— For special holding period provision relating to certain partnership distributions, see section 735(b).

## **§1231. PROPERTY USED IN THE TRADE OR BUSINESS AND INVOLUNTARY CONVERSIONS**

### **(a) General rule**

#### **(1) Gains exceed losses** If—

(A) the section 1231 gains for any taxable year, exceed

(B) the section 1231 losses for such taxable year,  
such gains and losses shall be treated as long-term capital gains or long-term capital losses, as the case may be.

#### **(2) Gains do not exceed losses** If—

(A) the section 1231 gains for any taxable year, do not exceed

(B) the section 1231 losses for such taxable year,  
such gains and losses shall not be treated as gains and losses from sales or exchanges of capital assets.

#### **(3) Section 1231 gains and losses** For purposes of this subsection—

##### **(A) Section 1231 gain** The term “section 1231 gain” means—

(i) any recognized gain on the sale or exchange of property used in the trade or business, and

(ii) any recognized gain from the compulsory or involuntary conversion (as a result of destruction in whole or in part, theft or seizure, or an exercise of the power of requisition or condemnation or the threat or imminence thereof) into other property or money of—

(I) property used in the trade or business, or

(II) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit.

(B) **Section 1231 loss** The term “section 1231 loss” means any recognized loss from a sale or exchange or conversion described in subparagraph (A).

#### **(4) Special rules** For purposes of this subsection—

(A) In determining under this subsection whether gains exceed losses—

(i) the section 1231 gains shall be included only if and to the extent taken into account in computing gross income, and

(ii) the section 1231 losses shall be included only if and to the extent taken into account in computing taxable income, except that section 1211 shall not apply.

(B) Losses (including losses not compensated for by insurance or otherwise) on the destruction, in whole or in part, theft or seizure, or requisition or condemnation of—

(i) property used in the trade or business, or

(ii) capital assets which are held for more than 1 year and are held in connection with a trade or business or a transaction entered into for profit,  
shall be treated as losses from a compulsory or involuntary conversion.

(C) In the case of any involuntary conversion (subject to the provisions of this subsection but for this sentence) arising from fire, storm, shipwreck, or other casualty, or from theft, of any—

(i) property used in the trade or business, or

(ii) any capital asset which is held for more than 1 year and is held in connection with a trade or business or a transaction entered into for profit,  
this subsection shall not apply to such conversion (whether resulting in gain or loss) if during the taxable year the recognized losses from such conversions exceed the recognized gains from such conversions.

#### **(b) Definition of property used in the trade or business**

For purposes of this section—

**(1) General rule** The term “property used in the trade or business” means property used in the trade or business, of a character which is subject to the allowance for depreciation provided in section 167, held for more than 1 year, and real property used in the trade or business, held for more than 1 year, which is not—

(A) property of a kind which would properly be includible in the inventory of the taxpayer if on hand at the close of the taxable year,

(B) property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business,

(C) a patent, invention, model or design (whether or not patented), a secret formula or process, a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property, held by a taxpayer described in paragraph (3) of section 1221(a), or

(D) a publication of the United States Government (including the Congressional Record) which is received from the United States Government, or any agency thereof, other than by purchase at the price at which it is offered for sale to the public, and which is held by a taxpayer described in paragraph (5) of section 1221(a).

**(2) Timber, coal, or domestic iron ore** Such term includes timber, coal, and iron ore with



respect to which section 631 applies.

**(3) Livestock** Such term includes—

(A) cattle and horses, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 24 months or more from the date of acquisition, and

(B) other livestock, regardless of age, held by the taxpayer for draft, breeding, dairy, or sporting purposes, and held by him for 12 months or more from the date of acquisition.

Such term does not include poultry.

**(4) Unharvested crop** In the case of an unharvested crop on land used in the trade or business and held for more than 1 year, if the crop and the land are sold or exchanged (or compulsorily or involuntarily converted) at the same time and to the same person, the crop shall be considered as “property used in the trade or business.”

## **§1245. GAIN FROM DISPOSITIONS OF CERTAIN DEPRECIABLE PROPERTY**

### **(a) General rule**

**(1) Ordinary income** Except as otherwise provided in this section, if section 1245 property is disposed of the amount by which the lower of—

(A) the recomputed basis of the property, or

(B)

(i) in the case of a sale, exchange, or involuntary conversion, the amount realized, or

(ii) in the case of any other disposition, the fair market value of such property, exceeds the adjusted basis of such property shall be treated as ordinary income. Such gain shall be recognized notwithstanding any other provision of this subtitle.

**(2) Recomputed basis** For purposes of this section—

(A) **In general** The term “recomputed basis” means, with respect to any property, its adjusted basis recomputed by adding thereto all adjustments reflected in such adjusted basis on account of deductions (whether in respect of the same or other property) allowed or allowable to the taxpayer or to any other person for depreciation or amortization.

(B) **Taxpayer may establish amount allowed** For purposes of subparagraph (A), if the taxpayer can establish by adequate records or other sufficient evidence that the amount allowed for depreciation or amortization for any period was less than the amount allowable, the amount added for such period shall be the amount allowed.

(C) **Certain deductions treated as amortization** Any deduction allowable under section 179, 179B, 179C, 179D, 179E, 181, 190, 193, or 194 shall be treated as if it were a deduction allowable for amortization.

**(3) Section 1245 property** For purposes of this section, the term “section 1245 property”

means any property which is or has been property of a character subject to the allowance for depreciation provided in section 167 and is either—

(A) personal property,

(B) other property (not including a building or its structural components) but only if such other property is tangible and has an adjusted basis in which there are reflected adjustments described in paragraph (2) for a period in which such property (or other property)—

(i) was used as an integral part of manufacturing, production, or extraction or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services,

(ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or

(iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state),

(C) so much of any real property (other than any property described in subparagraph (B)) which has an adjusted basis in which there are reflected adjustments for amortization under section 169, 179, 179B, 179C, 179D, 179E, 188 (as in effect before its repeal by the Revenue Reconciliation Act of 1990), 190, 193, or 1941

(D) a single purpose agricultural or horticultural structure (as defined in section 168(i)(13)),

(E) a storage facility (not including a building or its structural components) used in connection with the distribution of petroleum or any primary product of petroleum, or

(F) any railroad grading or tunnel bore (as defined in section 168(e)(4)).

## **(b) Exceptions and limitations**

**(1) Gifts** Subsection (a) shall not apply to a disposition by gift.

**(2) Transfers at death** Except as provided in section 691 (relating to income in respect of a decedent), subsection (a) shall not apply to a transfer at death.

**(3) Certain tax-free transactions** If the basis of property in the hands of a transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 332, 351, 361, 721, or 731, then the amount of gain taken into account by the transferor under subsection (a)(1) shall not exceed the amount of gain recognized to the transferor on the transfer of such property (determined without regard to this section). Except as provided in paragraph (6), this paragraph shall not apply to a disposition to an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter.

**(4) Like kind exchanges; involuntary conversions, etc.** If property is disposed of and gain (determined without regard to this section) is not recognized in whole or in part under section 1031 or 1033, then the amount of gain taken into account by the transferor under subsection (a)

(1) shall not exceed the sum of—

(A) the amount of gain recognized on such disposition (determined without regard to this section), plus

(B) the fair market value of property acquired which is not section 1245 property and which is not taken into account under subparagraph (A).

**(5) Property distributed by a partnership to a partner**

(A) **In general** For purposes of this section, the basis of section 1245 property distributed by a partnership to a partner shall be deemed to be determined by reference to the adjusted basis of such property to the partnership.

(B) **Adjustments added back** In the case of any property described in subparagraph (A), for purposes of computing the recomputed basis of such property the amount of the adjustments added back for periods before the distribution by the partnership shall be—

(i) the amount of the gain to which subsection (a) would have applied if such property had been sold by the partnership immediately before the distribution at its fair market value at such time, reduced by

(ii) the amount of such gain to which section 751(b) applied.

**(6) Transfers to tax-exempt organization where property will be used in unrelated business**

(A) **In general** The second sentence of paragraph (3) shall not apply to a disposition of section 1245 property to an organization described in section 511(a)(2) or 511(b)(2) if, immediately after such disposition, such organization uses such property in an unrelated trade or business (as defined in section 513).

(B) **Later change in use** If any property with respect to the disposition of which gain is not recognized by reason of subparagraph (A) ceases to be used in an unrelated trade or business of the organization acquiring such property, such organization shall be treated for purposes of this section as having disposed of such property on the date of such cessation.

(7) **Timber property** In determining, under subsection (a)(2), the recomputed basis of property with respect to which a deduction under section 194 was allowed for any taxable year, the taxpayer shall not take into account adjustments under section 194 to the extent such adjustments are attributable to the amortizable basis of the taxpayer acquired before the 10th taxable year preceding the taxable year in which gain with respect to the property is recognized.

**(8) Disposition of amortizable section 197 intangibles**

(A) **In general** If a taxpayer disposes of more than 1 amortizable section 197 intangible (as defined in section 197(c)) in a transaction or a series of related transactions, all such amortizable 197 intangibles shall be treated as 1 section 1245 property for purposes of this section.

(B) **Exception** Subparagraph (A) shall not apply to any amortizable section 197 intangible (as so defined) with respect to which the adjusted basis exceeds the fair market value.

**(d) Application of section**

This section shall apply notwithstanding any other provision of this subtitle.

## §7701. DEFINITIONS

(a)

When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

(1) **Person** The term “person” shall be construed to mean and include an individual, a trust, estate, partnership, association, company or corporation.

(2) **Partnership and partner** The term “partnership” includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term “partner” includes a member in such a syndicate, group, pool, joint venture, or organization.

(3) **Corporation** The term “corporation” includes associations, joint-stock companies, and insurance companies.

(4) **Domestic** The term “domestic” when applied to a corporation or partnership means created or organized in the United States or under the law of the United States or of any State unless, in the case of a partnership, the Secretary provides otherwise by regulations.

(5) **Foreign** The term “foreign” when applied to a corporation or partnership means a corporation or partnership which is not domestic.

(6) **Fiduciary** The term “fiduciary” means a guardian, trustee, executor, administrator, receiver, conservator, or any person acting in any fiduciary capacity for any person.

(7) **Stock** The term “stock” includes shares in an association, joint-stock company, or insurance company.

(8) **Shareholder** The term “shareholder” includes a member in an association, joint-stock company, or insurance company.

(9) **United States** The term “United States” when used in a geographical sense includes only the States and the District of Columbia.

(10) **State** The term “State” shall be construed to include the District of Columbia, where such construction is necessary to carry out provisions of this title.

(11) **Secretary of the Treasury and Secretary**

(A) **Secretary of the Treasury** The term “Secretary of the Treasury” means the Secretary of the Treasury, personally, and shall not include any delegate of his.

(B) **Secretary** The term “Secretary” means the Secretary of the Treasury or his delegate.

(12) **Delegate**

(A) **In general** The term “or his delegate”—

(i) when used with reference to the Secretary of the Treasury, means any officer, employee, or agency of the Treasury Department duly authorized by the Secretary of the Treasury directly, or indirectly by one or more redelegations of authority, to perform the function mentioned or described in the context; and

(ii) when used with reference to any other official of the United States, shall be similarly construed.

**(B) Performance of certain functions in Guam or American Samoa** The term “delegate,” in relation to the performance of functions in Guam or American Samoa with respect to the taxes imposed by chapters 1, 2, and 21, also includes any officer or employee of any other department or agency of the United States, or of any possession thereof, duly authorized by the Secretary (directly, or indirectly by one or more redelegations of authority) to perform such functions.

**(13) Commissioner** The term “Commissioner” means the Commissioner of Internal Revenue.

**(14) Taxpayer** The term “taxpayer” means any person subject to any internal revenue tax.

**(15) Military or naval forces and armed forces of the United States** The term “military or naval forces of the United States” and the term “Armed Forces of the United States” each includes all regular and reserve components of the uniformed services which are subject to the jurisdiction of the Secretary of Defense, the Secretary of the Army, the Secretary of the Navy, or the Secretary of the Air Force, and each term also includes the Coast Guard. The members of such forces include commissioned officers and personnel below the grade of commissioned officers in such forces.

**(16) Withholding agent** The term “withholding agent” means any person required to deduct and withhold any tax under the provisions of section 1441, 1442, 1443, or 1461.

**(17) Husband and wife** As used in section 2516, if the husband and wife therein referred to are divorced, wherever appropriate to the meaning of such section, the term “wife” shall be read “former wife” and the term “husband” shall be read “former husband”; and, if the payments described in such section are made by or on behalf of the wife or former wife to the husband or former husband instead of vice versa, wherever appropriate to the meaning of such section, the term “husband” shall be read “wife” and the term “wife” shall be read “husband.”

**(18) International organization** The term “international organization” means a public international organization entitled to enjoy privileges, exemptions, and immunities as an international organization under the International Organizations Immunities Act (22 U.S.C. 288–288f).

**(19) Domestic building and loan association** The term “domestic building and loan association” means a domestic building and loan association, a domestic savings and loan association, and a Federal savings and loan association—

(A) which is subject by law to supervision and examination by State or Federal authority having supervision over such associations;

(B) the business of which consists principally of acquiring the savings of the public and investing in loans; and

(C) at least 60 percent of the amount of the total assets of which (at the close of the taxable year) consists of—

(i) cash,

(ii) obligations of the United States or of a State or political subdivision thereof, and stock or obligations of a corporation which is an instrumentality of the United States or of a State or political subdivision thereof, but not including obligations the interest on which is excludable from gross income under section 103,

(iii) certificates of deposit in, or obligations of, a corporation organized under a State law which specifically authorizes such corporation to insure the deposits or share accounts of member associations,

(iv) loans secured by a deposit or share of a member,

(v) loans (including redeemable ground rents, as defined in section 1055) secured by an interest in real property which is (or, from the proceeds of the loan, will become) residential real property or real property used primarily for church purposes, loans made for the improvement of residential real property or real property used primarily for church purposes, provided that for purposes of this clause, residential real property shall include single or multifamily dwellings, facilities in residential developments dedicated to public use or property used on a nonprofit basis for residents, and mobile homes not used on a transient basis,

(vi) loans secured by an interest in real property located within an urban renewal area to be developed for predominantly residential use under an urban renewal plan approved by the Secretary of Housing and Urban Development under part A or part B of title I of the Housing Act of 1949, as amended, or located within any area covered by a program eligible for assistance under section 103 of the Demonstration Cities and Metropolitan Development Act of 1966, as amended, and loans made for the improvement of any such real property,

(vii) loans secured by an interest in educational, health, or welfare institutions or facilities, including structures designed or used primarily for residential purposes for students, residents, and persons under care, employees, or members of the staff of such institutions or facilities,

(viii) property acquired through the liquidation of defaulted loans described in clause (v), (vi), or (vii),

(ix) loans made for the payment of expenses of college or university education or vocational training, in accordance with such regulations as may be prescribed by the Secretary,

(x) property used by the association in the conduct of the business described in subparagraph (B), and

(xi) any regular or residual interest in a REMIC, but only in the proportion which the assets of such REMIC consist of property described in any of the preceding clauses of this subparagraph; except that if 95 percent or more of the assets of such REMIC are assets described in clauses (i) through (x), the entire interest in the REMIC shall qualify.

At the election of the taxpayer, the percentage specified in this subparagraph shall be applied

on the basis of the average assets outstanding during the taxable year, in lieu of the close of the taxable year, computed under regulations prescribed by the Secretary. For purposes of clause (v), if a multifamily structure securing a loan is used in part for nonresidential purposes, the entire loan is deemed a residential real property loan if the planned residential use exceeds 80 percent of the property's planned use (determined as of the time the loan is made). For purposes of clause (v), loans made to finance the acquisition or development of land shall be deemed to be loans secured by an interest in residential real property if, under regulations prescribed by the Secretary, there is reasonable assurance that the property will become residential real property within a period of 3 years from the date of acquisition of such land; but this sentence shall not apply for any taxable year unless, within such 3-year period, such land becomes residential real property. For purposes of determining whether any interest in a REMIC qualifies under clause (xi), any regular interest in another REMIC held by such REMIC shall be treated as a loan described in a preceding clause under principles similar to the principles of clause (xi); except that, if such REMIC's are part of a tiered structure, they shall be treated as 1 REMIC for purposes of clause (xi).

**(20) Employee** For the purpose of applying the provisions of section 79 with respect to group-term life insurance purchased for employees, for the purpose of applying the provisions of sections 104, 105, and 106 with respect to accident and health insurance or accident and health plans, and for the purpose of applying the provisions of subtitle A with respect to contributions to or under a stock bonus, pension, profit-sharing, or annuity plan, and with respect to distributions under such a plan, or by a trust forming part of such a plan, and for purposes of applying section 125 with respect to cafeteria plans, the term "employee" shall include a full-time life insurance salesman who is considered an employee for the purpose of chapter 21.

**(21) Levy** The term "levy" includes the power of distraint and seizure by any means.

**(22) Attorney General** The term "Attorney General" means the Attorney General of the United States.

**(23) Taxable year** The term "taxable year" means the calendar year, or the fiscal year ending during such calendar year, upon the basis of which the taxable income is computed under subtitle A. "Taxable year" means, in the case of a return made for a fractional part of a year under the provisions of subtitle A or under regulations prescribed by the Secretary, the period for which such return is made.

**(24) Fiscal year** The term "fiscal year" means an accounting period of 12 months ending on the last day of any month other than December.

**(25) Paid or incurred, paid or accrued** The terms "paid or incurred" and "paid or accrued" shall be construed according to the method of accounting upon the basis of which the taxable income is computed under subtitle A.

**(26) Trade or business** The term "trade or business" includes the performance of the functions of a public office.

**(27) Tax Court** The term "Tax Court" means the United States Tax Court.

**(28) Other terms** Any term used in this subtitle with respect to the application of, or in connection with, the provisions of any other subtitle of this title shall have the same meaning as

in such provisions.

**(29) Internal Revenue Code** The term “Internal Revenue Code of 1986” means this title, and the term “Internal Revenue Code of 1939” means the Internal Revenue Code enacted February 10, 1939, as amended.

**(30) United States person** The term “United States person” means—

- (A) a citizen or resident of the United States,
- (B) a domestic partnership,
- (C) a domestic corporation,
- (D) any estate (other than a foreign estate, within the meaning of paragraph (31)), and
- (E) any trust if—
  - (i) a court within the United States is able to exercise primary supervision over the administration of the trust, and
  - (ii) one or more United States persons have the authority to control all substantial decisions of the trust.

**(31) Foreign estate or trust**

**(A) Foreign estate** The term “foreign estate” means an estate the income of which, from sources without the United States which is not effectively connected with the conduct of a trade or business within the United States, is not includible in gross income under subtitle A.

**(B) Foreign trust** The term “foreign trust” means any trust other than a trust described in subparagraph (E) of paragraph (30).

**(32) Cooperative bank** The term “cooperative bank” means an institution without capital stock organized and operated for mutual purposes and without profit, which—

(A) is subject by law to supervision and examination by State or Federal authority having supervision over such institutions, and

(B) meets the requirements of subparagraphs (B) and (C) of paragraph (19) of this subsection (relating to definition of domestic building and loan association).

In determining whether an institution meets the requirements referred to in subparagraph (B) of this paragraph, any reference to an association or to a domestic building and loan association contained in paragraph (19) shall be deemed to be a reference to such institution.

**(33) Regulated public utility** The term “regulated public utility” means—

- (A) A corporation engaged in the furnishing or sale of—
    - (i) electric energy, gas, water, or sewerage disposal services, or
    - (ii) transportation (not included in subparagraph (C)) on an intrastate, suburban, municipal, or interurban electric railroad, on an intrastate, municipal, or suburban trackless trolley system, or on a municipal or suburban bus system, or
    - (iii) transportation (not included in clause (ii)) by motor vehicle—
- if the rates for such furnishing or sale, as the case may be, have been established or approved



by a State or political subdivision thereof, by an agency or instrumentality of the United States, by a public service or public utility commission or other similar body of the District of Columbia or of any State or political subdivision thereof, or by a foreign country or an agency or instrumentality or political subdivision thereof.

(B) A corporation engaged as a common carrier in the furnishing or sale of transportation of gas by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission.

(C) A corporation engaged as a common carrier (i) in the furnishing or sale of transportation by railroad, if subject to the jurisdiction of the Surface Transportation Board, or (ii) in the furnishing or sale of transportation of oil or other petroleum products (including shale oil) by pipe line, if subject to the jurisdiction of the Federal Energy Regulatory Commission or if the rates for such furnishing or sale are subject to the jurisdiction of a public service or public utility commission or other similar body of the District of Columbia or of any State.

(D) A corporation engaged in the furnishing or sale of telephone or telegraph service, if the rates for such furnishing or sale meet the requirements of subparagraph (A).

(E) A corporation engaged in the furnishing or sale of transportation as a common carrier by air, subject to the jurisdiction of the Secretary of Transportation.

(F) A corporation engaged in the furnishing or sale of transportation by a water carrier subject to jurisdiction under subchapter II of chapter 135 of title 49.

(G) A rail carrier subject to part A of subtitle IV of title 49, if (i) substantially all of its railroad properties have been leased to another such railroad corporation or corporations by an agreement or agreements entered into before January 1, 1954, (ii) each lease is for a term of more than 20 years, and (iii) at least 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from such leases and from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, an agreement for lease of railroad properties entered into before January 1, 1954, shall be considered to be a lease including such term as the total number of years of such agreement may, unless sooner terminated, be renewed or continued under the terms of the agreement, and any such renewal or continuance under such agreement shall be considered part of the lease entered into before January 1, 1954.

(H) A common parent corporation which is a common carrier by railroad subject to part A of subtitle IV of title 49 if at least 80 percent of its gross income (computed without regard to capital gains or losses) is derived directly or indirectly from sources described in subparagraphs (A) through (F), inclusive. For purposes of the preceding sentence, dividends and interest, and income from leases described in subparagraph (G), received from a regulated public utility shall be considered as derived from sources described in subparagraphs (A) through (F), inclusive, if the regulated public utility is a member of an affiliated group (as defined in section 1504) which includes the common parent corporation. The term “regulated public utility” does not (except as provided in subparagraphs (G) and (H)) include a corporation described in subparagraphs (A) through (F), inclusive, unless 80 percent or more of its gross income (computed without regard to dividends and capital gains and losses) for the taxable year is derived from sources described in subparagraphs (A) through (F),

inclusive. If the taxpayer establishes to the satisfaction of the Secretary that (i) its revenue from regulated rates described in subparagraph (A) or (D) and its revenue derived from unregulated rates are derived from the operation of a single interconnected and coordinated system or from the operation of more than one such system, and (ii) the unregulated rates have been and are substantially as favorable to users and consumers as are the regulated rates, then such revenue from such unregulated rates shall be considered, for purposes of the preceding sentence, as income derived from sources described in subparagraph (A) or (D).

**[(34) Repealed. Pub. L. 98–369, div. A, title IV, §4112(b)(11), July 18, 1984, 98 Stat. 792]**

**(35) Enrolled actuary** The term “enrolled actuary” means a person who is enrolled by the Joint Board for the Enrollment of Actuaries established under subtitle C of the title III of the Employee Retirement Income Security Act of 1974.

**(36) Tax return preparer**

**(A) In general** The term “tax return preparer” means any person who prepares for compensation, or who employs one or more persons to prepare for compensation, any return of tax imposed by this title or any claim for refund of tax imposed by this title. For purposes of the preceding sentence, the preparation of a substantial portion of a return or claim for refund shall be treated as if it were the preparation of such return or claim for refund.

**(B) Exceptions** A person shall not be a “tax return preparer” merely because such person—

- (i)** furnishes typing, reproducing, or other mechanical assistance,
- (ii)** prepares a return or claim for refund of the employer (or of an officer or employee of the employer) by whom he is regularly and continuously employed,
- (iii)** prepares as a fiduciary a return or claim for refund for any person, or
- (iv)** prepares a claim for refund for a taxpayer in response to any notice of deficiency issued to such taxpayer or in response to any waiver of restriction after the commencement of an audit of such taxpayer or another taxpayer if a determination in such audit of such other taxpayer directly or indirectly affects the tax liability of such taxpayer.

**(37) Individual retirement plan** The term “individual retirement plan” means—

- (A)** an individual retirement account described in section 408(a), and
- (B)** an individual retirement annuity described in section 408(b).

**(38) Joint return** The term “joint return” means a single return made jointly under section 6013 by a husband and wife.

**(39) Persons residing outside United States** If any citizen or resident of the United States does not reside in (and is not found in) any United States judicial district, such citizen or resident shall be treated as residing in the District of Columbia for purposes of any provision of this title relating to—

- (A)** jurisdiction of courts, or
- (B)** enforcement of summons.

**(40) Indian tribal government**

(A) **In general** The term “Indian tribal government” means the governing body of any tribe, band, community, village, or group of Indians, or (if applicable) Alaska Natives, which is determined by the Secretary, after consultation with the Secretary of the Interior, to exercise governmental functions.

(B) **Special rule for Alaska Natives** No determination under subparagraph (A) with respect to Alaska Natives shall grant or defer any status or powers other than those enumerated in section 7871. Nothing in the Indian Tribal Governmental Tax Status Act of 1982, or in the amendments made thereby, shall validate or invalidate any claim by Alaska Natives of sovereign authority over lands or people.

(41) **TIN** The term “TIN” means the identifying number assigned to a person under section 6109.

(42) **Substituted basis property** The term “substituted basis property” means property which is

(A) transferred basis property, or

(B) exchanged basis property.

(43) **Transferred basis property** The term “transferred basis property” means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to the basis in the hands of the donor, grantor, or other transferor.

(44) **Exchanged basis property** The term “exchanged basis property” means property having a basis determined under any provision of subtitle A (or under any corresponding provision of prior income tax law) providing that the basis shall be determined in whole or in part by reference to other property held at any time by the person for whom the basis is to be determined.

(45) **Nonrecognition transaction** The term “nonrecognition transaction” means any disposition of property in a transaction in which gain or loss is not recognized in whole or in part for purposes of subtitle A.

(46) **Determination of whether there is a collective bargaining agreement** In determining whether there is a collective bargaining agreement between employee representatives and 1 or more employers, the term “employee representatives” shall not include any organization more than one-half of the members of which are employees who are owners, officers, or executives of the employer. An agreement shall not be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and 1 or more employers.

[(47) Repealed. Pub. L. 111–312, title III, §301(a), Dec. 17, 2010, 124 Stat. 3300]

(48) **Off-highway vehicles**

(A) **Off-highway transportation vehicles**

(i) **In general** A vehicle shall not be treated as a highway vehicle if such vehicle is specially designed for the primary function of transporting a particular type of load other than over the public highway and because of this special design such vehicle’s capability

to transport a load over the public highway is substantially limited or impaired.

**(ii) Determination of vehicle's design** For purposes of clause (i), a vehicle's design is determined solely on the basis of its physical characteristics.

**(iii) Determination of substantial limitation or impairment** For purposes of clause (i), in determining whether substantial limitation or impairment exists, account may be taken of factors such as the size of the vehicle, whether such vehicle is subject to the licensing, safety, and other requirements applicable to highway vehicles, and whether such vehicle can transport a load at a sustained speed of at least 25 miles per hour. It is immaterial that a vehicle can transport a greater load off the public highway than such vehicle is permitted to transport over the public highway.

**(B) Nontransportation trailers and semitrailers** A trailer or semitrailer shall not be treated as a highway vehicle if it is specially designed to function only as an enclosed stationary shelter for the carrying on of an off-highway function at an off-highway site.

**(49) Qualified blood collector organization** The term "qualified blood collector organization" means an organization which is—

- (A) described in section 501(c)(3) and exempt from tax under section 501(a),
- (B) primarily engaged in the activity of the collection of human blood,
- (C) registered with the Secretary for purposes of excise tax exemptions, and
- (D) registered by the Food and Drug Administration to collect blood.

**(50) Termination of United States citizenship**

**(A) In general** An individual shall not cease to be treated as a United States citizen before the date on which the individual's citizenship is treated as relinquished under section 877A(g)(4).

**(B) Dual citizens** Under regulations prescribed by the Secretary, subparagraph (A) shall not apply to an individual who became at birth a citizen of the United States and a citizen of another country.

Code of Federal Regulations  
Title 26  
Selected Sections

## **§1.61-1 GROSS INCOME.**

(a) *General definition.* Gross income means all income from whatever source derived, unless excluded by law. Gross income includes income realized in any form, whether in money, property, or services. Income may be realized, therefore, in the form of services, meals, accommodations, stock, or other property, as well as in cash. Section 61 lists the more common items of gross income for purposes of illustration. For purposes of further illustration, § 1.61-14 mentions several miscellaneous items of gross income not listed specifically in section 61. Gross income, however, is not limited to the items so enumerated.

## **§1.61-2 COMPENSATION FOR SERVICES, INCLUDING FEES, COMMISSIONS, AND SIMILAR ITEMS.**

(a) *In general.*

(1) Wages, salaries, commissions paid salesmen, compensation for services on the basis of a percentage of profits, commissions on insurance premiums, tips, bonuses (including Christmas bonuses), termination or severance pay, rewards, jury fees, marriage fees and other contributions received by a clergyman for services, pay of persons in the military or naval forces of the United States, retired pay of employees, pensions, and retirement allowances are income to the recipients unless excluded by law. Several special rules apply to members of the Armed Forces, National Oceanic and Atmospheric Administration, and Public Health Service of the United States; see paragraph (b) of this section.

(2) The Code provides special rules including the following items in gross income:

(i) Distributions from employees' trusts, see sections 72, 402, and 403, and the regulations thereunder;

(ii) Compensation for child's services (in child's gross income), see section 73 and the regulations thereunder;

(iii) Prizes and awards, see section 74 and the regulations thereunder.

(3) Similarly, the Code provides special rules excluding the following items from gross income in whole or in part:

(i) Gifts, see section 102 and the regulations thereunder;

(ii) Compensation for injuries or sickness, see section 104 and the regulations thereunder;

(iii) Amounts received under accident and health plans, see section 105 and the regulations thereunder;

(iv) Scholarship and fellowship grants, see section 117 and the regulations thereunder;

(v) Miscellaneous items, see section 122.

(d) *Compensation paid other than in cash -*

(1) *In general.* Except as otherwise provided in paragraph (d)(6)(i) of this section (relating to certain property transferred after June 30, 1969), if services are paid for in property, the fair market value of the property taken in payment must be included in income as compensation. If services are paid for in exchange for other services, the fair market value of such other services taken in payment must be included in income as compensation. If the services are rendered at a stipulated price, such price will be presumed to be the fair market value of the compensation received in the absence of evidence to the contrary. For special rules relating to certain options received as compensation, see §§ 1.61-15, 1.83-7, and section 421 and the regulations thereunder. For special rules relating to premiums paid by an employer for an annuity contract which is not subject to section 403(a), see section 403(c) and the regulations thereunder and § 1.83-8(a). For special rules relating to contributions made to an employees' trust which is not exempt under section 501, see section 402(b) and the regulations thereunder and § 1.83-8(a).

(2) *Property transferred to employee or independent contractor.*

(i) Except as otherwise provided in section 421 and the regulations thereunder and § 1.61-15 (relating to stock options), and paragraph (d)(6)(i) of this section, if property is transferred by an employer to an employee or if property is transferred to an independent contractor, as compensation for services, for an amount less than its fair market value, then regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value at the time of the transfer is compensation and shall be included in the gross income of the employee or independent contractor. In computing the gain or loss from the subsequent sale of such property, its basis shall be the amount paid for the property increased by the amount of such difference included in gross income

(ii)

(A) *Cost of life insurance on the life of the employee.* Generally, life insurance premiums paid by an employer on the life of his employee where the proceeds of such insurance are payable to the beneficiary of such employee are part of the gross income of the employee. However, the amount includible in the employee's gross income is determined with regard to the provisions of section 403 and the regulations thereunder in the case of an individual contract issued after December 31, 1962, or a group contract, which provides incidental life insurance protection and which satisfies the requirements of section 401(g) and § 1.401-9, relating to the nontransferability of annuity contracts. For example, if an employee or independent contractor is the owner (as defined in § 1.61-22(c)(1)) of a life insurance contract and the payments with regard to such contract are not split-dollar loans under § 1.7872-15(b)(1), the employee or independent contractor must include in income the amount of any such payments by the employer or service recipient with respect to such contract during any year to the extent that the employee's or independent contractor's rights

to the life insurance contract are substantially vested (within the meaning of § 1.83-3(b)). This result is the same regardless of whether the employee or independent contractor has at all times been the owner of the life insurance contract or the contract previously has been owned by the employer or service recipient as part of a split-dollar life insurance arrangement (as defined in § 1.61-22(b)(1) or (2)) and was transferred by the employer or service recipient to the employee or independent contractor under § 1.61-22(g). For the special rules relating to the includibility in an employee's gross income of an amount equal to the cost of certain group term life insurance on the employee's life which is carried directly or indirectly by his employer, see section 79 and the regulations thereunder. For special rules relating to the exclusion of contributions by an employer to accident and health plans for the employee, see section 106 and the regulations thereunder.

*(B) Cost of group-term life insurance on the life of an individual other than an employee.* The cost (determined under paragraph (d)(2) of § 1.79-3) of group-term life insurance on the life of an individual other than an employee (such as the spouse or dependent of the employee) provided in connection with the performance of services by the employee is includible in the gross income of the employee.

*(3) Meals and living quarters.* The value of living quarters or meals which an employee receives in addition to his salary constitutes gross income unless they are furnished for the convenience of the employer and meet the conditions specified in section 119 and the regulations thereunder. For the treatment of rental value of parsonages or rental allowance paid to ministers, see section 107 and the regulations thereunder; for the treatment of statutory subsistence allowances received by police, see section 120 and the regulations thereunder.

*(4) Stock and notes transferred to employee or independent contractor.* Except as otherwise provided by section 421 and the regulations thereunder and § 1.61-15 (relating to stock options), and paragraph (d)(6)(i) of this section, if a corporation transfers its own stock to an employee or independent contractor as compensation for services, the fair market value of the stock at the time of transfer shall be included in the gross income of the employee or independent contractor. Notes or other evidences of indebtedness received in payment for services constitute income in the amount of their fair market value at the time of the transfer. A taxpayer receiving as compensation a note regarded as good for its face value at maturity, but not bearing interest, shall treat as income as of the time of receipt its fair discounted value computed at the prevailing rate. As payments are received on such a note, there shall be included in income that portion of each payment which represents the proportionate part of the discount originally taken on the entire note.

*(5) Property transferred on or before June 30, 1969, subject to restrictions.* Notwithstanding paragraph (d) (1), (2), or (4) of this section, if any property is transferred after September 24, 1959, by an employer to an employee or independent contractor as compensation for services, and such property is subject to a restriction which has a significant effect on its value at the time of transfer, the rules of § 1.421-6(d)(2) shall apply in determining the time and the amount of compensation to be included in the gross income of the employee or independent contractor. This (5) is also applicable to transfers subject to a restriction which has a significant effect on its value at the time of transfer and to which § 1.83-8(b) (relating to transitional rules with respect to transfers of restricted property) applies. For special rules relating to options to



purchase stock or other property which are issued as compensation for services, see § 1.61-15 and section 421 and the regulations thereunder.

*(6) Certain property transferred, premiums paid, and contributions made in connection with the performance of services after June 30, 1969 -*

(i) *Exception.* Paragraph (d) (1), (2), (4), and (5) of this section and § 1.61-15 do not apply to the transfer of property (as defined in § 1.83-3(e)) after June 30, 1969, unless § 1.83-8 (relating to the applicability of section 83 and transitional rules) applies. If section 83 applies to a transfer of property, and the property is not subject to a restriction that has a significant effect on the fair market value of such property, then the rules contained in paragraph (d) (1), (2), and (4) of this section and § 1.61-15 shall also apply to such transfer to the extent such rules are not inconsistent with section 83.

(ii) *Cross references.* For rules relating to premiums paid by an employer for an annuity contract which is not subject to section 403(a), see section 403(c) and the regulations thereunder. For rules relating to contributions made to an employees' trust which is not exempt under section 501(a), see section 402(b) and the regulations thereunder.

## **§1.61-3 GROSS INCOME DERIVED FROM BUSINESS.**

(a) *In general.* In a manufacturing, merchandising, or mining business, “gross income” means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. Gross income is determined without subtraction of depletion allowances based on a percentage of income to the extent that it exceeds cost depletion which may be required to be included in the amount of inventoriable costs as provided in § 1.471-11 and without subtraction of selling expenses, losses or other items not ordinarily used in computing costs of goods sold or amounts which are of a type for which a deduction would be disallowed under section 162 (c), (f), or (g) in the case of a business expense. The cost of goods sold should be determined in accordance with the method of accounting consistently used by the taxpayer. Thus, for example, an amount cannot be taken into account in the computation of cost of goods sold any earlier than the taxable year in which economic performance occurs with respect to the amount (see § 1.446-1(c)(1)(ii)).

## **§1.61-14 MISCELLANEOUS ITEMS OF GROSS INCOME.**

(a) *In general.* In addition to the items enumerated in section 61(a), there are many other kinds of gross income. For example, punitive damages such as treble damages under the antitrust laws and exemplary damages for fraud are gross income. Another person's payment of the taxpayer's income taxes constitutes gross income to the taxpayer unless excluded by law. Illegal gains constitute gross income. Treasure trove, to the extent of its value in United States currency, constitutes gross income for the taxable year in which it is reduced to undisputed possession.

## **§1.61-21 TAXATION OF FRINGE BENEFITS.**

(a) *Fringe benefits* -

(1) *In general.* Section 61(a)(1) provides that, except as otherwise provided in subtitle A of the Internal Revenue Code of 1986, gross income includes compensation for services, including fees, commissions, fringe benefits, and similar items. For an outline of the regulations under this section relating to fringe benefits, see paragraph (a)(7) of this section. Examples of fringe benefits include: an employer-provided automobile, a flight on an employer-provided aircraft, an employer-provided free or discounted commercial airline flight, an employer-provided vacation, an employer-provided discount on property or services, an employer-provided membership in a country club or other social club, and an employer-provided ticket to an entertainment or sporting event.

(2) *Fringe benefits excluded from income.* To the extent that a particular fringe benefit is specifically excluded from gross income pursuant to another section of subtitle A of the Internal Revenue Code of 1986, that section shall govern the treatment of that fringe benefit. Thus, if the requirements of the governing section are satisfied, the fringe benefits may be excludable from gross income. Examples of excludable fringe benefits include qualified tuition reductions provided to an employee (section 117(d)); meals or lodging furnished to an employee for the convenience of the employer (section 119); benefits provided under a dependent care assistance program (section 129); and no-additional-cost services, qualified employee discounts, working condition fringes, and de minimis fringes (section 132). Similarly, the value of the use by an employee of an employer-provided vehicle or a flight provided to an employee on an employer-provided aircraft may be excludable from income under section 105 (because, for example, the transportation is provided for medical reasons) if and to the extent that the requirements of that section are satisfied. Section 134 excludes from gross income “qualified military benefits.” An example of a benefit that is not a qualified military benefit is the personal use of an employer-provided vehicle. The fact that another section of subtitle A of the Internal Revenue Code addresses the taxation of a particular fringe benefit will not preclude section 61 and the regulations thereunder from applying, to the extent that they are not inconsistent with such other section. For example, many fringe benefits specifically addressed in other sections of subtitle A of the Internal Revenue Code are excluded from gross income only to the extent that they do not exceed specific dollar or percentage limits, or only if certain other requirements are met. If the limits are exceeded or the requirements are not met, some or all of the fringe benefit may be includible in gross income pursuant to section 61. See paragraph (b)(3) of this section.

(3) *Compensation for services.* A fringe benefit provided in connection with the performance of services shall be considered to have been provided as compensation for such services. Refraining from the performance of services (such as pursuant to a covenant not to compete) is deemed to be the performance of services for purposes of this section.

(4) *Person to whom fringe benefit is taxable* -

(i) *In general.* A taxable fringe benefit is included in the income of the person performing the services in connection with which the fringe benefit is furnished. Thus, a fringe benefit may be taxable to a person even though that person did not actually receive the fringe benefit. If a fringe benefit is furnished to someone other than the service provider such benefit is

considered in this section as furnished to the service provider, and use by the other person is considered use by the service provider. For example, the provision of an automobile by an employer to an employee's spouse in connection with the performance of services by the employee is taxable to the employee. The automobile is considered available to the employee and use by the employee's spouse is considered use by the employee.

(ii) *All persons to whom benefits are taxable referred to as employees.* The person to whom a fringe benefit is taxable need not be an employee of the provider of the fringe benefit, but may be, for example, a partner, director, or an independent contractor. For convenience, the term “employee” includes any person performing services in connection with which a fringe benefit is furnished, unless otherwise specifically provided in this section.

(5) *Provider of a fringe benefit referred to as an employer.* The “provider” of a fringe benefit is that person for whom the services are performed, regardless of whether that person actually provides the fringe benefit to the recipient. The provider of a fringe benefit need not be the employer of the recipient of the fringe benefit, but may be, for example, a client or customer of the employer or of an independent contractor. For convenience, the term “employer” includes any provider of a fringe benefit in connection with payment for the performance of services, unless otherwise specifically provided in this section.

(6) *Effective date.* Except as otherwise provided, this section is effective as of January 1, 1989 with respect to fringe benefits provided after December 31, 1988.

(7) *Outline of this section.* The following is an outline of the regulations in this section relating to fringe benefits:

§ 1.61-21 (a) Fringe benefits.

- (1) In general.
- (2) Fringe benefits excluded from income.
- (3) Compensation for services.
- (4) Person to whom fringe benefit is taxable.
- (5) Provider of a fringe benefit referred to as an employer.
- (6) Effective date.
- (7) Outline of this section.

§ 1.61-21 (b) Valuation of fringe benefits

- (1) In general.
- (2) Fair market value.

- (3) Exclusion from income based on cost.
- (4) Fair market value of the availability of an employer-provided vehicle.
- (5) Fair market value of chauffeur services.
- (6) Fair market value of a flight on an employer-provided piloted aircraft.
- (7) Fair market value of the use of an employer-provided aircraft for which the employer does not furnish a pilot.

§ 1.61-21 (c) Special valuation rules.

- (1) In general.
- (2) Use of the special valuation rules.
- (3) Additional rules for using special valuation.
- (4) Application of section 414 to employers.
- (5) Valuation formulae contained in the special valuation rules.
- (6) Modification of the special valuation rules.
- (7) Special accounting rule.

§ 1.61-21 (d) Automobile lease valuation rule.

- (1) In general.
- (2) Calculation of Annual Lease Value.
- (3) Services included in, or excluded from, the Annual Lease Value Table.
- (4) Availability of an automobile for less than an entire calendar year.
- (5) Fair market value.
- (6) Special rules for continuous availability of certain automobiles.
- (7) Consistency rules.

§ 1.61-21 (e) Vehicle cents-per-mile valuation rule.

- (1) In general.
- (2) Definition of vehicle.
- (3) Services included in, or excluded from, the cents-per-mile rate.

(4) Valuation of personal use only.

(5) Consistency rules.

§ 1.61-21 (f) Commuting valuation rule.

(1) In general.

(2) Special rules.

(3) Commuting value.

(4) Definition of vehicle.

(5) Control employee defined - Non-government employer.

(6) Control employee defined - Government employer.

(7) “Compensation” defined.

§ 1.61-21 (g) Non-commercial flight valuation rule.

(1) In general.

(2) Eligible flights and eligible aircraft.

(3) Definition of a flight.

(4) Personal and non-personal flights.

(5) Aircraft valuation formula.

(6) Discretion to provide new formula.

(7) Aircraft multiples.

(8) Control employee defined - Non-government employer.

(9) Control employee defined - Government employer.

(10) “Compensation” defined.

(11) Treatment of former employees.

(12) Seating capacity rule.

(13) Erroneous use of the non-commercial flight valuation rule.

(14) Consistency rules.

§ 1.61-21 (h) Commercial flight valuation rule.

- (1) In general.
- (2) Space-available flight.
- (3) Commercial aircraft.
- (4) Timing of inclusion.
- (5) Consistency rules.

§ 1.61-21 (i) [Reserved]

§ 1.61-21 (j) Valuation of meals provided at an employer-operated eating facility for employees.

- (1) In general.
- (2) Valuation formula.

§ 1.61-21 (k) Commuting valuation rule for certain employees.

- (1) In general.
- (2) Trip-by-trip basis.
- (3) Commuting value.
- (4) Definition of employer-provided transportation.
- (5) Unsafe conditions.
- (6) Qualified employee defined.
- (7) Examples.
- (8) Effective date.

(b) *Valuation of fringe benefits* -

(1) *In general.* An employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of -

- (i) The amount, if any, paid for the benefit by or on behalf of the recipient, and
- (ii) The amount, if any, specifically excluded from gross income by some other section of subtitle A of the Internal Revenue Code of 1986.

Therefore, for example, if the employee pays fair market value for what is received, no

amount is includible in the gross income of the employee. In general, the determination of the fair market value of a fringe benefit must be made before subtracting out the amount, if any, paid for the benefit and the amount, if any, specifically excluded from gross income by another section of subtitle A. See paragraphs (d)(2)(ii) and (e)(1)(iii) of this section.

(2) *Fair market value.* In general, fair market value is determined on the basis of all the facts and circumstances. Specifically, the fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's-length transaction. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded. Similarly, an employee's subjective perception of the value of a fringe benefit is not relevant to the determination of the fringe benefit's fair market value nor is the cost incurred by the employer determinative of its fair market value. For special rules relating to the valuation of certain fringe benefits, see paragraph (c) of this section.

(3) *Exclusion from income based on cost.* If a statutory exclusion phrased in terms of cost applies to the provision of a fringe benefit, section 61 does not require the inclusion in the recipient's gross income of the difference between the fair market value and the excludable cost of that fringe benefit. For example, section 129 provides an exclusion from an employee's gross income for amounts contributed by an employer to a dependent care assistance program for employees. Even if the fair market value of the dependent care assistance exceeds the employer's cost, the excess is not subject to inclusion under section 61 and this section. However, if the statutory cost exclusion is a limited amount, the fair market value of the fringe benefit attributable to any excess cost is subject to inclusion. This would be the case, for example, where an employer pays or incurs a cost of more than \$5,000 to provide dependent care assistance to an employee.

(4) *Fair market value of the availability of an employer-provided vehicle -*

(i) *In general.* If the vehicle special valuation rules of paragraph (d), (e), or (f) of this section do not apply with respect to an employer-provided vehicle, the value of the availability of that vehicle is determined under the general valuation principles set forth in this section. In general, that value equals the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is available for use. An example of a comparable condition is the amount of time that the vehicle is available to the employee for use, e.g., a one-year period. Unless the employee can substantiate that the same or comparable vehicle could have been leased on a cents-per-mile basis, the value of the availability of the vehicle cannot be computed by applying a cents-per-mile rate to the number of miles the vehicle is driven.

(ii) *Certain equipment excluded.* The fair market value of a vehicle does not include the fair market value of any specialized equipment not susceptible to personal use or any telephone that is added to or carried in the vehicle, provided that the presence of that equipment or telephone is necessitated by, and attributable to, the business needs of the employer. However, the value of specialized equipment must be included, if the employee to whom the vehicle is available uses the specialized equipment in a trade or business of the employee other than the employee's trade or business of being an employee of the employer.

(5) *Fair market value of chauffeur services -*

(i) *Determination of value -*

(A) *In general.* The fair market value of chauffeur services provided to the employee by the employer is the amount that an individual would have to pay in an arm's-length transaction to obtain the same or comparable chauffeur services in the geographic area for the period in which the services are provided. In determining the applicable fair market value, the amount of time, if any, the chauffeur remains on-call to perform chauffeur services must be included. For example, assume that A, an employee of corporation M, needs a chauffeur to be on-call to provide services to A during a twenty-four hour period. If during that twenty-four hour period, the chauffeur actually drives A for only six hours, the fair market value of the chauffeur services would have to be the value of having a chauffeur on-call for a twenty-four hour period. The cost of taxi fare or limousine service for the six hours the chauffeur actually drove A would not be an accurate measure of the fair market value of chauffeur services provided to A. Moreover, all other aspects of the chauffeur's services (including any special qualifications of the chauffeur (e.g., training in evasive driving skills) or the ability of the employee to choose the particular chauffeur) must be taken into consideration.

(B) *Alternative valuation with reference to compensation paid.* Alternatively, the fair market value of the chauffeur services may be determined by reference to the compensation (as defined in paragraph (b)(5)(ii) of this section) received by the chauffeur from the employer.

(C) *Separate valuation for chauffeur services.* The value of chauffeur services is determined separately from the value of the availability of an employer-provided vehicle.

(ii) *Definition of compensation -*

(A) *In general.* For purposes of this paragraph (b)(5)(ii), the term “compensation” means compensation as defined in section 414(q)(7) and the fair market value of nontaxable lodging (if any) provided by the employer to the chauffeur in the current year.

(B) *Adjustments to compensation -* For purposes of this paragraph (b)(5)(ii), a chauffeur's compensation is reduced proportionately to reflect the amount of time during which the chauffeur performs substantial services for the employer other than as a chauffeur and is not on-call as a chauffeur. For example, assume a chauffeur is paid \$25,000 a year for working a ten-hour day, five days a week and also receives \$5,000 in nontaxable lodging. Further assume that during four hours of each day, the chauffeur is not on-call to perform services as a chauffeur because that individual is performing secretarial functions for the employer. Then, for purposes of determining the fair market value of this chauffeur's services, the employer may reduce the chauffeur's compensation by 4/10 or \$12,000 ( $.4 \times (\$25,000 + \$5,000) = \$12,000$ ). Therefore, in this example, the fair market value of the chauffeur's services is \$18,000 ( $\$30,000 - \$12,000$ ). However, for purposes of this paragraph (b)(5)(ii), a chauffeur's compensation is not to be reduced by any amounts paid to the chauffeur for time spent “on-call,” even though the chauffeur actually performs other



services for the employer during such time. For purposes of this paragraph (b)(5)(ii), a determination that a chauffeur is performing substantial services for the employer other than as a chauffeur is based upon the facts and circumstances of each situation. An employee will be deemed to be performing substantial services for the employer other than as a chauffeur if a certain portion of each working day is regularly spent performing other services for the employer.

(iii) *Calculation of chauffeur services for personal purposes of the employee.* The fair market value of chauffeur services provided to the employee for personal purposes may be determined by multiplying the fair market value of chauffeur services, as determined pursuant to paragraph (b)(5)(i) (A) or (B) of this section, by a fraction, the numerator of which is equal to the sum of the hours spent by the chauffeur actually providing personal driving services to the employee and the hours spent by the chauffeur in “personal on-call time,” and the denominator of which is equal to all hours the chauffeur spends in driving services of any kind paid for by the employer, including all hours that are “on-call.”

(iv) *Definition of on-call time.* For purposes of this paragraph, the term “on-call time” means the total amount of time that the chauffeur is not engaged in the actual performance of driving services, but during which time the chauffeur is available to perform such services. With respect to a round-trip, time spent by a chauffeur waiting for an employee to make a return trip is generally not treated as on-call time; rather such time is treated as part of the round-trip.

(v) *Definition of personal on-call time.* For purposes of this paragraph, the term “personal on-call time” means the amount of time outside the employee's normal working hours for the employer when the chauffeur is available to the employee to perform driving services.

(vi) *Presumptions.*

(A) An employee's normal working hours will be presumed to consist of a ten hour period during which the employee usually conducts business activities for that employer.

(B) It will be presumed that if the chauffeur is on-call to provide driving services to an employee during the employee's normal working hours, then that on-call time will be performed for business purposes.

(C) Similarly, if the chauffeur is on-call to perform driving services to an employee after normal working hours, then that on-call time will be presumed to be “personal on-call time.”

(D) The presumptions set out in paragraph (b)(5)(vi) (A), (B), and (C) of this section may be rebutted. For example, an employee may demonstrate by adequate substantiation that his or her normal working hours consist of more than ten hours. Furthermore, if the employee keeps adequate records and is able to substantiate that some portion of the driving services performed by the chauffeur after normal working hours is attributable to business purposes, then personal on-call time may be reduced by an amount equal to such personal on-call time multiplied by a fraction, the numerator of which is equal to the time spent by the

chauffeur after normal working hours driving the employee for business purposes, and the denominator of which is equal to the total time spent by the chauffeur driving the employee after normal working hours for all purposes.

(vii) *Examples.* The rules of this paragraph (b)(5) may be illustrated by the following examples:

#### **Example 1.**

An employer makes available to employee A an automobile and a full-time chauffeur B (who performs no other services for A's employer) for an entire calendar year. Assume that the automobile lease valuation rule of paragraph (d) of this section is used and that the Annual Lease Value of the automobile is \$9,250. Assume further that B's compensation for the year is \$12,000 (as defined in section 414(q)(7)) and that B is furnished lodging with a value of \$3,000 that is excludable from B's gross income. The maximum amount subject to inclusion in A's gross income for use of the automobile and chauffeur is therefore \$24,250 (\$12,000 + \$3,000 + \$9,250). If 70 percent of the miles placed on the automobile during the year are for A's employer's business, then \$6,475 is excludable from A's gross income with respect to the automobile as a working condition fringe ( $\$9,250 \times .70$ ). Thus, \$2,775 is includible in A's gross income with respect to the automobile ( $\$9,250 - \$6,475$ ). With respect to the chauffeur, if 20 percent of the chauffeur's time is spent actually driving A or being on-call to drive A for personal purposes; then \$3,000 is includible in A's income ( $.20 \times \$15,000$ ). Eighty percent of \$15,000, or \$12,000, is excluded from A's income as a working condition fringe.

#### **Example 2.**

Assume the same facts as in example (1) except that in addition to providing chauffeur services, B is responsible for performing substantial non-chauffeur-related duties (such as clerical or secretarial functions) during which time B is not "on-call" as a chauffeur. If B spends only 75 percent of the time performing chauffeur services, then the maximum amount subject to inclusion in A's gross income for use of the automobile and chauffeur is \$20,500 ( $(\$15,000 \times .75) + \$9,250$ ). If B is actually driving A for personal purposes or is on-call to drive A for personal purposes for 20 percent of the time during which B is available to provide chauffeur services, then \$2,250 is includible in A's gross income ( $.20 \times \$11,250$ ). The income inclusion with respect to the automobile is the same as in example (1).

#### **Example 3.**

Assume the same facts as in example (2) except that while B is performing non-chauffeur-related duties, B is on call as A's chauffeur. No part of B's compensation is excluded when determining the value of the benefit provided to A. Thus, as in example (1), \$3,000 is includible in A's gross income with respect to the chauffeur.

#### **(6) Fair market value of a flight on an employer-provided piloted aircraft -**

(i) *In general.* If the non-commercial flight special valuation rule of paragraph (g) of this section does not apply, the value of a flight on an employer-provided piloted aircraft is determined under the general valuation principles set forth in this paragraph.

(ii) *Value of flight.* If an employee takes a flight on an employer-provided piloted aircraft and that employee's flight is primarily personal (see § 1.162-2(b)(2)), the value of the flight is equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable piloted aircraft for that period for the same or a comparable flight. A flight taken under these circumstances may not be valued by reference to the cost of commercial airfare for the same or a comparable flight. The cost to charter the aircraft must be allocated among all employees on board the aircraft based on all the facts and circumstances unless one or more of the employees controlled the use of the aircraft. Where one or more employees control the use of the aircraft, the value of the flight shall be allocated solely among such controlling employees, unless a written agreement among all the employees on the flight otherwise allocates the value of such flight. Notwithstanding the allocation required by the preceding sentence, no additional amount shall be included in the income of any employee whose flight is properly valued under the special valuation rule of paragraph (g) of this section. For purposes of this paragraph (b)(6), "control" means the ability of the employee to determine the route, departure time and destination of the flight. The rules provided in paragraph (g)(3) of this section will be used for purposes of this section in defining a flight. Notwithstanding the allocation required by the preceding sentence, no additional amount shall be included in the income of an employee for that portion of any such flight which is excludible from income pursuant to section 132(d) or § 1.132-5 as a working condition fringe.

(iii) *Examples.* The rules of paragraph (b)(6) of this section may be illustrated by the following examples:

#### **Example 1.**

An employer makes available to employees A and B a piloted aircraft in New York, New York. A wants to go to Los Angeles, California for personal purposes. B needs to go to Chicago, Illinois for business purposes, and then wants to go to Los Angeles, California for personal purposes. Therefore, the aircraft first flies to Chicago, and B deplanes and then boards the plane again. The aircraft then flies to Los Angeles, California where A and B deplane. The value of the flight to employee A will be no more than the amount that an individual would have to pay in an arm's length transaction to charter the same or a comparable piloted aircraft for the same or comparable flight from New York City to Los Angeles. No amount will be imputed to employee A for the stop at Chicago. As to employee B, the value of the personal flight will be no more than the value of the flight from Chicago to Los Angeles. Pursuant to the rules set forth in § 1.132-5(k), the flight from New York to Chicago will not be included in employee B's income since that flight was taken solely for business purposes. The charter cost must be allocated between A and B, since both employees controlled portions of the flight. Assume that the employer allocates according to the relative value of each employee's flight. If the charter value of A's flight from New York City to Los Angeles is \$1,000 and the value of B's flight from Chicago to Los Angeles is \$600 and the value of the actual flight from New York to Chicago to Los Angeles is \$1,200, then the amount to be allocated to employee A is \$750 ( $\$1,000/(\$1,000 + \$600) \times \$1,200$ ) and the amount to be allocated to employee B is \$450 ( $\$600/(\$1,000 + \$600) \times \$1,200$ ).

#### **Example 2.**

Assume the same facts as in example (1), except that employee A also deplanes at Chicago, Illinois, but for personal purposes. The value of the flight to employee A then becomes the value of a flight from New York to Chicago to Los Angeles, *i.e.*, \$1,200. Therefore, the amount to be allocated to employee A is \$800 ( $\$1,200/(\$1,200 + \$600) \times \$1,200$ ) and the amount to be allocated to employee B is \$400 ( $\$600/(\$1,200 + \$600) \times \$1,200$ ).

*(7) Fair market value of the use of an employer-provided aircraft for which the employer does not furnish a pilot -*

(i) *In general.* If the non-commercial flight special valuation rule of paragraph (g) of this section does not apply and if an employer provides an employee with the use of an aircraft without a pilot, the value of the use of the employer-provided aircraft is determined under the general valuation principles set forth in this paragraph (b)(7).

(ii) *Value of flight.* In general, if an employee takes a flight on an employer-provided aircraft for which the employer does not furnish a pilot, the value of that flight is equal to the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable aircraft on the same or comparable terms for the same period in the geographic area in which the aircraft is used. For example, if an employer makes its aircraft available to an employee who will pilot the aircraft for a two-hour flight, the value of the use of the aircraft is the amount that an individual would have to pay in an arm's-length transaction to rent a comparable aircraft for that period in the geographic area in which the aircraft is used. As another example, assume that an employee uses an employer-provided aircraft to commute between home and work. The value of the use of the aircraft is the amount that an individual would have to pay in an arm's-length transaction to rent a comparable aircraft for commuting in the geographic area in which the aircraft is used. If the availability of the flight is of benefit to more than one employee, then such value shall be allocated among such employees on the basis of the relevant facts and circumstances.

## **§1.83-1 PROPERTY TRANSFERRED IN CONNECTION WITH THE PERFORMANCE OF SERVICES.**

*(a) Inclusion in gross income -*

(1) *General rule.* Section 83 provides rules for the taxation of property transferred to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services by such employee or independent contractor. In general, such property is not taxable under section 83(a) until it has been transferred (as defined in § 1.83-3(a)) to such person and become substantially vested (as defined in § 1.83-3(b)) in such person. In that case, the excess of -

(i) The fair market value of such property (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) at the time that the property becomes substantially vested, over

(ii) The amount (if any) paid for such property,

shall be included as compensation in the gross income of such employee or independent contractor for the taxable year in which the property becomes substantially vested. Until such property becomes substantially vested, the transferor shall be regarded as the owner of such property, and any income from such property received by the employee or independent contractor (or beneficiary thereof) or the right to the use of such property by the employee or independent contractor constitutes additional compensation and shall be included in the gross income of such employee or independent contractor for the taxable year in which such income is received or such use is made available. This paragraph applies to a transfer of property in connection with the performance of services even though the transferor is not the person for whom such services are performed.

(2) *Life insurance.* The cost of life insurance protection under a life insurance contract, retirement income contract, endowment contract, or other contract providing life insurance protection is taxable generally under section 61 and the regulations thereunder during the period such contract remains substantially nonvested (as defined in § 1.83-3(b)). For the taxation of life insurance protection under a split-dollar life insurance arrangement (as defined in § 1.61-22(b)(1) or (2)), see § 1.61-22.

(3) *Cross references.* For rules concerning the treatment of employers and other transferors of property in connection with the performance of services, see section 83(h) and § 1.83-6. For rules concerning the taxation of beneficiaries of an employees' trust that is not exempt under section 501(a), see section 402(b) and the regulations thereunder.

(b) *Subsequent sale, forfeiture, or other disposition of nonvested property.*

(1) If substantially nonvested property (that has been transferred in connection with the performance of services) is subsequently sold or otherwise disposed of to a third party in an arm's length transaction while still substantially nonvested, the person who performed such services shall realize compensation in an amount equal to the excess of -

(i) The amount realized on such sale or other disposition, over

(ii) The amount (if any) paid for such property.

Such amount of compensation is includible in his gross income in accordance with his method of accounting. Two preceding sentences also apply when the person disposing of the property has received it in a non-arm's length transaction described in paragraph (c) of this section. In addition, section 83(a) and paragraph (a) of this section shall thereafter cease to apply with respect to such property.

(2) If substantially nonvested property that has been transferred in connection with the performance of services to the person performing such services is forfeited while still substantially nonvested and held by such person, the difference between the amount paid (if any) and the amount received upon forfeiture (if any) shall be treated as an ordinary gain or loss. This paragraph (b)(2) does not apply to property to which § 1.83-2(a) applies.

(3) This paragraph (b) shall not apply to, and no gain shall be recognized on, any sale,

forfeiture, or other disposition described in this paragraph to the extent that any property received in exchange therefor is substantially nonvested. Instead, section 83 and this section shall apply with respect to such property received (as if it were substituted for the property disposed of).

## **§1.83-2 ELECTION TO INCLUDE IN GROSS INCOME IN YEAR OF TRANSFER.**

(a) *In general.* If property is transferred (within the meaning of § 1.83-3(a)) in connection with the performance of services, the person performing such services may elect to include in gross income under section 83(b) the excess (if any) of the fair market value of the property at the time of transfer (determined without regard to any lapse restriction, as defined in § 1.83-3(i)) over the amount (if any) paid for such property, as compensation for services. The fact that the transferee has paid full value for the property transferred, realizing no bargain element in the transaction, does not preclude the use of the election as provided for in this section. If this election is made, the substantial vesting rules of section 83(a) and the regulations thereunder do not apply with respect to such property, and except as otherwise provided in section 83(d)(2) and the regulations thereunder (relating to the cancellation of a nonlapse restriction), any subsequent appreciation in the value of the property is not taxable as compensation to the person who performed the services. Thus, property with respect to which this election is made shall be includible in gross income as of the time of transfer, even though such property is substantially nonvested (as defined in § 1.83-3(b)) at the time of transfer, and no compensation will be includible in gross income when such property becomes substantially vested (as defined in § 1.83-3(b)). In computing the gain or loss from the subsequent sale or exchange of such property, its basis shall be the amount paid for the property increased by the amount included in gross income under section 83(b). If property for which a section 83(b) election is in effect is forfeited while substantially nonvested, such forfeiture shall be treated as a sale or exchange upon which there is realized a loss equal to the excess (if any) of -

- (1) The amount paid (if any) for such property, over,
- (2) The amount realized (if any) upon such forfeiture.

If such property is a capital asset in the hands of the taxpayer, such loss shall be a capital loss. A sale or other disposition of the property that is in substance a forfeiture, or is made in contemplation of a forfeiture, shall be treated as a forfeiture under the two immediately preceding sentences.

## **§1.83-3 MEANING AND USE OF CERTAIN TERMS.**

(c) *Substantial risk of forfeiture -*

- (1) *In general.* For purposes of section 83 and these regulations, whether a risk of forfeiture is substantial or not depends upon the facts and circumstances. Except as set forth in paragraphs (j) and (k) of this section, a substantial risk of forfeiture exists only if rights in property that are

transferred are conditioned, directly or indirectly, upon the future performance (or refraining from performance) of substantial services by any person, or upon the occurrence of a condition related to a purpose of the transfer if the possibility of forfeiture is substantial. Property is not transferred subject to a substantial risk of forfeiture if at the time of transfer the facts and circumstances demonstrate that the forfeiture condition is unlikely to be enforced. Further, property is not transferred subject to a substantial risk of forfeiture to the extent that the employer is required to pay the fair market value of a portion of such property to the employee upon the return of such property. The risk that the value of property will decline during a certain period of time does not constitute a substantial risk of forfeiture. A nonlapse restriction, standing by itself, will not result in a substantial risk of forfeiture. A restriction on the transfer of property, whether contractual or by operation of applicable law, will result in a substantial risk of forfeiture only if and to the extent that the restriction is described in paragraph (j) or (k) of this section. For this purpose, transfer restrictions that will not result in a substantial risk of forfeiture include, but are not limited to, restrictions that if violated, whether by transfer or attempted transfer of the property, would result in the forfeiture of some or all of the property, or liability by the employee for any damages, penalties, fees, or other amount.

(2) *Illustrations of substantial risks of forfeiture.* The regularity of the performance of services and the time spent in performing such services tend to indicate whether services required by a condition are substantial. The fact that the person performing services has the right to decline to perform such services without forfeiture may tend to establish that services are insubstantial. Where stock is transferred to an underwriter prior to a public offering and the full enjoyment of such stock is expressly or impliedly conditioned upon the successful completion of the underwriting, the stock is subject to a substantial risk of forfeiture. Where an employee receives property from an employer subject to a requirement that it be returned if the total earnings of the employer do not increase, such property is subject to a substantial risk of forfeiture. On the other hand, requirements that the property be returned to the employer if the employee is discharged for cause or for committing a crime will not be considered to result in a substantial risk of forfeiture. An enforceable requirement that the property be returned to the employer if the employee accepts a job with a competing firm will not ordinarily be considered to result in a substantial risk of forfeiture unless the particular facts and circumstances indicate to the contrary. Factors which may be taken into account in determining whether a covenant not to compete constitutes a substantial risk of forfeiture are the age of the employee, the availability of alternative employment opportunities, the likelihood of the employee's obtaining such other employment, the degree of skill possessed by the employee, the employee's health, and the practice (if any) of the employer to enforce such covenants. Similarly, rights in property transferred to a retiring employee subject to the sole requirement that it be returned unless he renders consulting services upon the request of his former employer will not be considered subject to a substantial risk of forfeiture unless he is in fact expected to perform substantial services.

(3) *Enforcement of forfeiture condition.* In determining whether the possibility of forfeiture is substantial in the case of rights in property transferred to an employee of a corporation who owns a significant amount of the total combined voting power or value of all classes of stock of the employer corporation or of its parent corporation, there will be taken into account

- (i) the employee's relationship to other stockholders and the extent of their control, potential

control and possible loss of control of the corporation,

(ii) the position of the employee in the corporation and the extent to which he is subordinate to other employees,

(iii) the employee's relationship to the officers and directors of the corporation,

(iv) the person or persons who must approve the employee's discharge, and

(v) past actions of the employer in enforcing the provisions of the restrictions. For example, if an employee would be considered as having received rights in property subject to a substantial risk of forfeiture, but for the fact that the employee owns 20 percent of the single class of stock in the transferor corporation, and if the remaining 80 percent of the class of stock is owned by an unrelated individual (or members of such an individual's family) so that the possibility of the corporation enforcing a restriction on such rights is substantial, then such rights are subject to a substantial risk of forfeiture. On the other hand, if 4 percent of the voting power of all the stock of a corporation is owned by the president of such corporation and the remaining stock is so diversely held by the public that the president, in effect, controls the corporation, then the possibility of the corporation enforcing a restriction on rights in property transferred to the president is not substantial, and such rights are not subject to a substantial risk of forfeiture.

(4) *Examples.* The rules contained in paragraph (c)(1) of this section may be illustrated by the following examples. In each example it is assumed that, if the conditions on transfer are not satisfied, the forfeiture provision will be enforced.

#### **Example 1.**

On November 1, 1971, corporation X transfers in connection with the performance of services to E, an employee, 100 shares of corporation X stock for \$90 per share. Under the terms of the transfer, E will be subject to a binding commitment to resell the stock to corporation X at \$90 per share if he leaves the employment of corporation X for any reason prior to the expiration of a 2-year period from the date of such transfer. Since E must perform substantial services for corporation X and will not be paid more than \$90 for the stock, regardless of its value, if he fails to perform such services during such 2-year period, E's rights in the stock are subject to a substantial risk of forfeiture during such period.

#### **Example 2.**

On November 10, 1971, corporation X transfers in connection with the performance of services to a trust for the benefit of employees, \$100x. Under the terms of the trust any child of an employee who is an enrolled full-time student at an accredited educational institution as a candidate for a degree will receive an annual grant of cash for each academic year the student completes as a student in good standing, up to a maximum of four years. E, an employee, has a child who is enrolled as a full-time student at an accredited college as a candidate for a degree. Therefore, E has a beneficial interest in the assets of the trust equalling the value of four cash grants. Since E's child must complete one year of college in order to receive a cash grant, E's interest in the trust assets are subject to a substantial risk of forfeiture to the extent E's child has



not become entitled to any grants.

### Example 3.

On November 25, 1971, corporation X gives to E, an employee, in connection with his performance of services to corporation X, a bonus of 100 shares of corporation X stock. Under the terms of the bonus arrangement E is obligated to return the corporation X stock to corporation X if he terminates his employment for any reason. However, for each year occurring after November 25, 1971, during which E remains employed with corporation X, E ceases to be obligated to return 10 shares of the corporation X stock. Since in each year occurring after November 25, 1971, for which E remains employed he is not required to return 10 shares of corporation X's stock, E's rights in 10 shares each year for 10 years cease to be subject to a substantial risk of forfeiture for each year he remains so employed.

### Example 4.

(a) Assume the same facts as in example (3) except that for each year occurring after November 25, 1971, for which E remains employed with corporation X, X agrees to pay, in redemption of the bonus shares given to E if he terminates employment for any reason, 10 percent of the fair market value of each share of stock on the date of such termination of employment. Since corporation X will pay E 10 percent of the value of his bonus stock for each of the 10 years after November 25, 1971, in which he remains employed by X, and the risk of a decline in value is not a substantial risk of forfeiture, E's interest in 10 percent of such bonus stock becomes substantially vested in each of those years.

(b) The following chart illustrates the fair market value of the bonus stock and the fair market value of the portion of bonus stock that becomes substantially vested on November 25, for the following years:

Fair market value of		
Year	All stock	Portion of stock that becomes vested
1972	\$200	\$20
1973	300	30
1974	150	15
1975	150	15
1976	100	10

If E terminates his employment on July 1, 1977, when the fair market value of the bonus stock is \$100, E must return the bonus stock to X, and X must pay, in redemption of the bonus stock, \$50 (50 percent of the value of the bonus stock on the date of termination of employment). E has recognized income under section 83(a) and § 1.83-1(a) with respect to 50 percent of the bonus stock, and E's basis in that portion of the stock equals the amount of income recognized, \$90. Under § 1.83-1(e), the \$40 loss E incurred upon forfeiture (\$90 basis less \$50 redemption payment) is an ordinary loss.

### Example 5.

On January 7, 1971, corporation X, a computer service company, transfers to E, 100 shares of corporation X stock for \$50. E is a highly compensated salesman who sold X's products in a three-state area since 1960. At the time of transfer each share of X stock has a fair market value of \$100. The stock is transferred to E in connection with his termination of employment with X. Each share of X stock is subject to the sole condition that E can keep such share only if he does not engage in competition with X for a 5-year period in the three-state area where E had previously sold X's products. E, who is 45 years old, has no intention of retiring from the work force. In order to earn a salary comparable to his current compensation, while preventing the risk of forfeiture from arising, E will have to expend a substantial amount of time and effort in another industry or market to establish the necessary business contacts. Thus, under these facts and circumstances E's rights in the stock are subject to a substantial risk of forfeiture.

#### **Example 6.**

On April 3, 2013, Y corporation grants to Q, an officer of Y, a nonstatutory option to purchase Y common stock. Although the option is immediately exercisable, it has no readily ascertainable fair market value when it is granted. Under the option, Q has the right to purchase 100 shares of Y common stock for \$10 per share, which is the fair market value of a Y share on the date of grant of the option. On August 1, 2013, Y sells its common stock in an initial public offering. Pursuant to an underwriting agreement entered into in connection with the initial public offering, Q agrees not to sell, otherwise dispose of, or hedge any Y common stock from August 1 through February 1 of 2014 ("the lock-up period"). Q exercises the option and Y shares are transferred to Q on November 15, 2013, during the lock-up period. The underwriting agreement does not impose a substantial risk of forfeiture on the Y shares acquired by Q because the provisions of the agreement do not condition Q's rights in the shares upon anyone's future performance (or refraining from performance) of substantial services or on the occurrence of a condition related to the purpose of the transfer of shares to Q. Accordingly, neither section 83(c)(3) nor the imposition of the lock-up period by the underwriting agreement precludes taxation under section 83 when the shares resulting from exercise of the option are transferred to Q.

#### **Example 7.**

Assume the same facts as in *Example 6*, except that on August 1, 2013, Y also adopts an insider trading compliance program, under which, as applied to 2013, insiders (such as Q) may trade Y shares only during a limited number of days following each quarterly earnings release ("a trading window"). Under the program, if Q trades Y shares outside a trading window without Y's permission, Y has the right to terminate Q's employment. However, the exercise of the nonstatutory options outside a trading window for Y shares is not prohibited under the insider trading compliance program. Q fully exercises the option, and Y shares are transferred to Q, on November 15, 2013. The exercise of the option occurs outside a trading window, and, on the date of exercise, Q is in possession of material nonpublic information concerning Y that would subject him to liability under Rule 10b-5 under the Securities Exchange Act of 1934 if Q sold the Y shares while in possession of such information. Neither the insider trading compliance program nor the potential liability under Rule 10b-5 impose a substantial risk of forfeiture on the Y shares acquired by Q because the provisions of the program and Rule 10b-5 do not condition Q's rights in the shares upon anyone's future performance (or refraining from performance) of substantial services or on the occurrence of a condition related to the purpose of the transfer of

shares to Q. Accordingly, none of section 83(c)(3), the imposition of the trading windows by the insider trading compliance program, and the potential liability under Rule 10b-5 preclude taxation under section 83 when the shares resulting from exercise of the option are transferred to Q.

## §1.83-7 TAXATION OF NONQUALIFIED STOCK OPTIONS.

(a) *In general.* If there is granted to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services, an option to which section 421 (relating generally to certain qualified and other options) does not apply, section 83(a) shall apply to such grant if the option has a readily ascertainable fair market value (determined in accordance with paragraph (b) of this section) at the time the option is granted. The person who performed such services realizes compensation upon such grant at the time and in the amount determined under section 83(a). If section 83(a) does not apply to the grant of such an option because the option does not have a readily ascertainable fair market value at the time of grant, sections 83(a) and 83(b) shall apply at the time the option is exercised or otherwise disposed of, even though the fair market value of such option may have become readily ascertainable before such time. If the option is exercised, sections 83(a) and 83(b) apply to the transfer of property pursuant to such exercise, and the employee or independent contractor realizes compensation upon such transfer at the time and in the amount determined under section 83(a) or 83(b). If the option is sold or otherwise disposed of in an arm's length transaction, sections 83(a) and 83(b) apply to the transfer of money or other property received in the same manner as sections 83(a) and 83(b) would have applied to the transfer of property pursuant to an exercise of the option. The preceding sentence does not apply to a sale or other disposition of the option to a person related to the service provider that occurs on or after July 2, 2003. For this purpose, a person is related to the service provider if -

(1) The person and the service provider bear a relationship to each other that is specified in section 267(b) or 707(b)(1), subject to the modifications that the language "20 percent" is used instead of "50 percent" each place it appears in sections 267(b) and 707(b)(1), and section 267(c)(4) is applied as if the family of an individual includes the spouse of any member of the family; or

(2) The person and the service provider are engaged in trades or businesses under common control (within the meaning of section 52(a) and (b)); provided that a person is not related to the service provider if the person is the service recipient with respect to the option or the grantor of the option.

(b) *Readily ascertainable defined -*

(1) *Actively traded on an established market.* Options have a value at the time they are granted, but that value is ordinarily not readily ascertainable unless the option is actively traded on an established market. If an option is actively traded on an established market, the fair market value of such option is readily ascertainable for purposes of this section by applying the rules of valuation set forth in § 20.2031-2.

(2) *Not actively traded on an established market.* When an option is not actively traded on an established market, it does not have a readily ascertainable fair market value unless its fair market value can otherwise be measured with reasonable accuracy. For purposes of this section, if an option is not actively traded on an established market, the option does not have a readily ascertainable fair market value when granted unless the taxpayer can show that all of the following conditions exist:

- (i) The option is transferable by the optionee;
- (ii) The option is exercisable immediately in full by the optionee;
- (iii) The option or the property subject to the option is not subject to any restriction or condition (other than a lien or other condition to secure the payment of the purchase price) which has a significant effect upon the fair market value of the option; and
- (iv) The fair market value of the option privilege is readily ascertainable in accordance with paragraph (b)(3) of this section.

(3) *Option privilege.* The option privilege in the case of an option to buy is the opportunity to benefit during the option's exercise period from any increase in the value of property subject to the option during such period, without risking any capital. Similarly, the option privilege in the case of an option to sell is the opportunity to benefit during the exercise period from a decrease in the value of property subject to the option. For example, if at some time during the exercise period of an option to buy, the fair market value of the property subject to the option is greater than the option's exercise price, a profit may be realized by exercising the option and immediately selling the property so acquired for its higher fair market value. Irrespective of whether any such gain may be realized immediately at the time an option is granted, the fair market value of an option to buy includes the value of the right to benefit from any future increase in the value of the property subject to the option (relative to the option exercise price), without risking any capital. Therefore, the fair market value of an option is not merely the difference that may exist at a particular time between the option's exercise price and the value of the property subject to the option, but also includes the value of the option privilege for the remainder of the exercise period. Accordingly, for purposes of this section, in determining whether the fair market value of an option is readily ascertainable, it is necessary to consider whether the value of the entire option privilege can be measured with reasonable accuracy. In determining whether the value of the option privilege is readily ascertainable, and in determining the amount of such value when such value is readily ascertainable, it is necessary to consider -

- (i) Whether the value of the property subject to the option can be ascertained;
- (ii) The probability of any ascertainable value of such property increasing or decreasing; and
- (iii) The length of the period during which the option can be exercised.

## §1.121-1 EXCLUSION OF GAIN FROM SALE OR EXCHANGE OF A

## PRINCIPAL RESIDENCE.

(a) *In general.* Section 121 provides that, under certain circumstances, gross income does not include gain realized on the sale or exchange of property that was owned and used by a taxpayer as the taxpayer's principal residence. Subject to the other provisions of section 121, a taxpayer may exclude gain only if, during the 5-year period ending on the date of the sale or exchange, the taxpayer owned and used the property as the taxpayer's principal residence for periods aggregating 2 years or more.

### (b) *Residence* -

(1) *In general.* Whether property is used by the taxpayer as the taxpayer's residence depends upon all the facts and circumstances. A property used by the taxpayer as the taxpayer's residence may include a houseboat, a house trailer, or the house or apartment that the taxpayer is entitled to occupy as a tenant-stockholder in a cooperative housing corporation (as those terms are defined in section 216(b)(1) and (2)). Property used by the taxpayer as the taxpayer's residence does not include personal property that is not a fixture under local law.

(2) *Principal residence.* In the case of a taxpayer using more than one property as a residence, whether property is used by the taxpayer as the taxpayer's principal residence depends upon all the facts and circumstances. If a taxpayer alternates between 2 properties, using each as a residence for successive periods of time, the property that the taxpayer uses a majority of the time during the year ordinarily will be considered the taxpayer's principal residence. In addition to the taxpayer's use of the property, relevant factors in determining a taxpayer's principal residence, include, but are not limited to -

(i) The taxpayer's place of employment;

(ii) The principal place of abode of the taxpayer's family members;

(iii) The address listed on the taxpayer's federal and state tax returns, driver's license, automobile registration, and voter registration card;

(iv) The taxpayer's mailing address for bills and correspondence;

(v) The location of the taxpayer's banks; and

(vi) The location of religious organizations and recreational clubs with which the taxpayer is affiliated.

### (3) *Vacant land* -

(i) *In general.* The sale or exchange of vacant land is not a sale or exchange of the taxpayer's principal residence unless -

(A) The vacant land is adjacent to land containing the dwelling unit of the taxpayer's

principal residence;

(B) The taxpayer owned and used the vacant land as part of the taxpayer's principal residence;

(C) The taxpayer sells or exchanges the dwelling unit in a sale or exchange that meets the requirements of section 121 within 2 years before or 2 years after the date of the sale or exchange of the vacant land; and

(D) The requirements of section 121 have otherwise been met with respect to the vacant land.

(ii) *Limitations* -

(A) *Maximum limitation amount.* For purposes of section 121(b)(1) and (2) (relating to the maximum limitation amount of the section 121 exclusion), the sale or exchange of the dwelling unit and the vacant land are treated as one sale or exchange. Therefore, only one maximum limitation amount of \$250,000 (\$500,000 for certain joint returns) applies to the combined sales or exchanges of vacant land and the dwelling unit. In applying the maximum limitation amount to sales or exchanges that occur in different taxable years, gain from the sale or exchange of the dwelling unit, up to the maximum limitation amount under section 121(b)(1) or (2), is excluded first and each spouse is treated as excluding one-half of the gain from a sale or exchange to which section 121(b)(2)(A) and § 1.121-2(a)(3)(i) (relating to the limitation for certain joint returns) apply.

(B) *Sale or exchange of more than one principal residence in 2-year period.* If a dwelling unit and vacant land are sold or exchanged in separate transactions that qualify for the section 121 exclusion under this paragraph (b)(3), each of the transactions is disregarded in applying section 121(b)(3) (restricting the application of section 121 to only 1 sale or exchange every 2 years) to the other transactions but is taken into account as a sale or exchange of a principal residence on the date of the transaction in applying section 121(b)(3) to that transaction and the sale or exchange of any other principal residence.

(C) *Sale or exchange of vacant land before dwelling unit.* If the sale or exchange of the dwelling unit occurs in a later taxable year than the sale or exchange of the vacant land and after the date prescribed by law (including extensions) for the filing of the return for the taxable year of the sale or exchange of the vacant land, any gain from the sale or exchange of the vacant land must be treated as taxable on the taxpayer's return for the taxable year of the sale or exchange of the vacant land. If the taxpayer has reported gain from the sale or exchange of the vacant land as taxable, after satisfying the requirements of this paragraph (b)(3) the taxpayer may claim the section 121 exclusion with regard to the sale or exchange of the vacant land (for any period for which the period of limitation under section 6511 has not expired) by filing an amended return.

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

**Example 1.**

Taxpayer A owns 2 residences, one in New York and one in Florida. From 1999 through 2004, he lives in the New York residence for 7 months and the Florida residence for 5 months of each year. In the absence of facts and circumstances indicating otherwise, the New York residence is A's principal residence. A would be eligible for the section 121 exclusion of gain from the sale or exchange of the New York residence, but not the Florida residence.

#### **Example 2.**

Taxpayer B owns 2 residences, one in Virginia and one in Maine. During 1999 and 2000, she lives in the Virginia residence. During 2001 and 2002, she lives in the Maine residence. During 2003, she lives in the Virginia residence. B's principal residence during 1999, 2000, and 2003 is the Virginia residence. B's principal residence during 2001 and 2002 is the Maine residence. B would be eligible for the 121 exclusion of gain from the sale or exchange of either residence (but not both) during 2003.

#### **Example 3.**

In 1991 Taxpayer C buys property consisting of a house and 10 acres that she uses as her principal residence. In May 2005 C sells 8 acres of the land and realizes a gain of \$110,000. C does not sell the dwelling unit before the due date for filing C's 2005 return, therefore C is not eligible to exclude the \$110,000 of gain. In March 2007 C sells the house and remaining 2 acres realizing a gain of \$180,000 from the sale of the house. C may exclude the \$180,000 of gain. Because the sale of the 8 acres occurred within 2 years from the date of the sale of the dwelling unit, the sale of the 8 acres is treated as a sale of the taxpayer's principal residence under paragraph (b)(3) of this section. C may file an amended return for 2005 to claim an exclusion for \$70,000 (\$250,000-\$180,000 gain previously excluded) of the \$110,000 gain from the sale of the 8 acres.

#### **Example 4.**

In 1998 Taxpayer D buys a house and 1 acre that he uses as his principal residence. In 1999 D buys 29 acres adjacent to his house and uses the vacant land as part of his principal residence. In 2003 D sells the house and 1 acre and the 29 acres in 2 separate transactions. D sells the house and 1 acre at a loss of \$25,000. D realizes \$270,000 of gain from the sale of the 29 acres. D may exclude the \$245,000 gain from the 2 sales.

#### **(c) *Ownership and use requirements -***

(1) *In general.* The requirements of ownership and use for periods aggregating 2 years or more may be satisfied by establishing ownership and use for 24 full months or for 730 days ( $365 \times 2$ ). The requirements of ownership and use may be satisfied during nonconcurrent periods if both the ownership and use tests are met during the 5-year period ending on the date of the sale or exchange.

#### **(2) *Use.***

(i) In establishing whether a taxpayer has satisfied the 2-year use requirement, occupancy of the residence is required. However, short temporary absences, such as for vacation or other

seasonal absence (although accompanied with rental of the residence), are counted as periods of use.

(ii) *Determination of use during periods of out-of-residence care.* If a taxpayer has become physically or mentally incapable of self-care and the taxpayer sells or exchanges property that the taxpayer owned and used as the taxpayer's principal residence for periods aggregating at least 1 year during the 5-year period preceding the sale or exchange, the taxpayer is treated as using the property as the taxpayer's principal residence for any period of time during the 5-year period in which the taxpayer owns the property and resides in any facility (including a nursing home) licensed by a State or political subdivision to care for an individual in the taxpayer's condition.

### (3) *Ownership -*

(i) *Trusts.* If a residence is owned by a trust, for the period that a taxpayer is treated under sections 671 through 679 (relating to the treatment of grantors and others as substantial owners) as the owner of the trust or the portion of the trust that includes the residence, the taxpayer will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the trust will be treated as if made by the taxpayer.

(ii) *Certain single owner entities.* If a residence is owned by an eligible entity (within the meaning of § 301.7701-3(a) of this chapter) that has a single owner and is disregarded for federal tax purposes as an entity separate from its owner under § 301.7701-3 of this chapter, the owner will be treated as owning the residence for purposes of satisfying the 2-year ownership requirement of section 121, and the sale or exchange by the entity will be treated as if made by the owner.

(4) *Examples.* The provisions of this paragraph (c) are illustrated by the following examples. The examples assume that § 1.121-3 (relating to the reduced maximum exclusion) does not apply to the sale of the property. The examples are as follows:

#### **Example 1.**

Taxpayer A has owned and used his house as his principal residence since 1986. On January 31, 1998, A moves to another state. A rents his house to tenants from that date until April 18, 2000, when he sells it. A is eligible for the section 121 exclusion because he has owned and used the house as his principal residence for at least 2 of the 5 years preceding the sale.

#### **Example 2.**

Taxpayer B owns and uses a house as her principal residence from 1986 to the end of 1997. On January 4, 1998, B moves to another state and ceases to use the house. B's son moves into the house in March 1999 and uses the residence until it is sold on July 1, 2001. B may not exclude gain from the sale under section 121 because she did not use the property as her principal residence for at least 2 years out of the 5 years preceding the sale.

#### **Example 3.**



Taxpayer C lives in a townhouse that he rents from 1993 through 1996. On January 18, 1997, he purchases the townhouse. On February 1, 1998, C moves into his daughter's home. On May 25, 2000, while still living in his daughter's home, C sells his townhouse. The section 121 exclusion will apply to gain from the sale because C owned the townhouse for at least 2 years out of the 5 years preceding the sale (from January 19, 1997 until May 25, 2000) and he used the townhouse as his principal residence for at least 2 years during the 5-year period preceding the sale (from May 25, 1995 until February 1, 1998).

#### **Example 4.**

Taxpayer D, a college professor, purchases and moves into a house on May 1, 1997. He uses the house as his principal residence continuously until September 1, 1998, when he goes abroad for a 1-year sabbatical leave. On October 1, 1999, 1 month after returning from the leave, D sells the house. Because his leave is not considered to be a short temporary absence under paragraph (c) (2) of this section, the period of the sabbatical leave may not be included in determining whether D used the house for periods aggregating 2 years during the 5-year period ending on the date of the sale. Consequently, D is not entitled to exclude gain under section 121 because he did not use the residence for the requisite period.

#### **Example 5.**

Taxpayer E purchases a house on February 1, 1998, that he uses as his principal residence. During 1998 and 1999, E leaves his residence for a 2-month summer vacation. E sells the house on March 1, 2000. Although, in the 5-year period preceding the date of sale, the total time E used his residence is less than 2 years (21 months), the section 121 exclusion will apply to gain from the sale of the residence because, under paragraph (c)(2) of this section, the 2-month vacations are short temporary absences and are counted as periods of use in determining whether E used the residence for the requisite period.

### **§1.121-3 REDUCED MAXIMUM EXCLUSION FOR TAXPAYERS FAILING TO MEET CERTAIN REQUIREMENTS.**

#### ***(e) Sale or exchange by reason of unforeseen circumstances -***

(1) *In general.* A sale or exchange is by reason of unforeseen circumstances if the primary reason for the sale or exchange is the occurrence of an event that the taxpayer could not reasonably have anticipated before purchasing and occupying the residence. A sale or exchange by reason of unforeseen circumstances (other than a sale or exchange deemed to be by reason of unforeseen circumstances under paragraph (e)(2) or (3) of this section) does not qualify for the reduced maximum exclusion if the primary reason for the sale or exchange is a preference for a different residence or an improvement in financial circumstances.

(2) *Specific event safe harbors.* A sale or exchange is deemed to be by reason of unforeseen circumstances (within the meaning of paragraph (e)(1) of this section) if any of the events specified in paragraphs (e)(2)(i) through (iii) of this section occur during the period of the taxpayer's ownership and use of the residence as the taxpayer's principal residence:

(i) The involuntary conversion of the residence.

(ii) Natural or man-made disasters or acts of war or terrorism resulting in a casualty to the residence (without regard to deductibility under section 165(h)).

(iii) In the case of a qualified individual described in paragraph (f) of this section -

(A) Death;

(B) The cessation of employment as a result of which the qualified individual is eligible for unemployment compensation (as defined in section 85(b));

(C) A change in employment or self-employment status that results in the taxpayer's inability to pay housing costs and reasonable basic living expenses for the taxpayer's household (including amounts for food, clothing, medical expenses, taxes, transportation, court-ordered payments, and expenses reasonably necessary to the production of income, but not for the maintenance of an affluent or luxurious standard of living);

(D) Divorce or legal separation under a decree of divorce or separate maintenance; or

(E) Multiple births resulting from the same pregnancy.

(3) *Designation of additional events as unforeseen circumstances.* The Commissioner may designate other events or situations as unforeseen circumstances in published guidance of general applicability and may issue rulings addressed to specific taxpayers identifying other events or situations as unforeseen circumstances with regard to those taxpayers (see § 601.601(d)(2) of this chapter).

(4) *Examples.* The following examples illustrate the rules of this paragraph (e):

#### **Example 1.**

In 2003 A buys a house in California. After A begins to use the house as her principal residence, an earthquake causes damage to A's house. A sells the house in 2004. The sale is within the safe harbor of paragraph (e)(2)(ii) of this section and A is entitled to claim a reduced maximum exclusion under section 121(c)(2).

#### **Example 2.**

H works as a teacher and W works as a pilot. In 2003 H and W buy a house that they use as their principal residence. Later that year W is furloughed from her job for six months. H and W are unable to pay their mortgage and reasonable basic living expenses for their household during the period W is furloughed. H and W sell their house in 2004. The sale is within the safe harbor of paragraph (e)(2)(iii)(C) of this section and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

#### **Example 3.**

In 2003 H and W buy a two-bedroom condominium that they use as their principal residence. In 2004 W gives birth to twins and H and W sell their condominium and buy a four-bedroom house. The sale is within the safe harbor of paragraph (e)(2)(iii)(E) of this section, and H and W are entitled to claim a reduced maximum exclusion under section 121(c)(2).

#### **Example 4.**

In 2003 B buys a condominium in a high-rise building and uses it as his principal residence. B's monthly condominium fee is \$X. Three months after B moves into the condominium, the condominium association replaces the building's roof and heating system. Six months later, B's monthly condominium fee doubles in order to pay for the repairs. B sells the condominium in 2004 because he is unable to afford the new condominium fee along with a monthly mortgage payment. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, the doubling of the condominium fee, is an unforeseen circumstance because B could not reasonably have anticipated that the condominium fee would double at the time he purchased and occupied the property. Consequently, the sale of the condominium is by reason of unforeseen circumstances and B is entitled to claim a reduced maximum exclusion under section 121(c)(2).

#### **Example 5.**

In 2003 C buys a house that he uses as his principal residence. The property is located on a heavily traveled road. C sells the property in 2004 because C is disturbed by the traffic. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale, the traffic, is not an unforeseen circumstance because C could reasonably have anticipated the traffic at the time he purchased and occupied the house. Consequently, the sale of the house is not by reason of unforeseen circumstances and C is not entitled to claim a reduced maximum exclusion under section 121(c)(2).

#### **Example 6.**

In 2003 D and her fiancé E buy a house and live in it as their principal residence. In 2004 D and E cancel their wedding plans and E moves out of the house. Because D cannot afford to make the monthly mortgage payments alone, D and E sell the house in 2004. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, the broken engagement, is an unforeseen circumstance because D and E could not reasonably have anticipated the broken engagement at the time they purchased and occupied the house. Consequently, the sale is by reason of unforeseen circumstances and D and E are each entitled to claim a reduced maximum exclusion under section 121(c)(2).

#### **Example 7.**

In 2003 F buys a small condominium that she uses as her principal residence. In 2005 F receives a promotion and a large increase in her salary. F sells the condominium in 2004 and purchases a house because she can now afford the house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, F's salary increase, is an improvement in F's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen

circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).

**Example 8.**

In April 2003 G buys a house that he uses as his principal residence. G sells his house in October 2004 because the house has greatly appreciated in value, mortgage rates have substantially decreased, and G can afford a bigger house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reasons for the sale of the house, the changes in G's house value and in the mortgage rates, are an improvement in G's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion by reason of unforeseen circumstances under section 121(c)(2).

**Example 9.**

H works as a police officer for City X. In 2003 H buys a condominium that he uses as his principal residence. In 2004 H is assigned to City X's K-9 unit and is required to care for the police service dog at his home. Because H's condominium association does not permit H to have a dog in his condominium, in 2004 he sells the condominium and buys a house. The safe harbors of paragraph (e)(2) of this section do not apply. However, under the facts and circumstances, the primary reason for the sale, H's assignment to the K-9 unit, is an unforeseen circumstance because H could not reasonably have anticipated his assignment to the K-9 unit at the time he purchased and occupied the condominium. Consequently, the sale of the condominium is by reason of unforeseen circumstances and H is entitled to claim a reduced maximum exclusion under section 121(c)(2).

**Example 10.**

In 2003, J buys a small house that she uses as her principal residence. After J wins the lottery, she sells the small house in 2004 and buys a bigger, more expensive house. The safe harbors of paragraph (e)(2) of this section do not apply. Under the facts and circumstances, the primary reason for the sale of the house, winning the lottery, is an improvement in J's financial circumstances. Under paragraph (e)(1) of this section, an improvement in financial circumstances, even if the result of unforeseen circumstances, does not qualify for the reduced maximum exclusion under section 121(c)(2).

## **§1.132-2 NO-ADDITIONAL-COST SERVICES.**

**(a) *In general* -**

(1) *Definition.* Gross income does not include the value of a no-additional-cost service. A “no-additional-cost service” is any service provided by an employer to an employee for the employee's personal use if -

(i) The service is offered for sale by the employer to its customers in the ordinary course of the line of business of the employer in which the employee performs substantial services,

and

(ii) The employer incurs no substantial additional cost in providing the service to the employee (including foregone revenue and excluding any amount paid by or on behalf of the employee for the service).

For rules relating to the line of business limitation, see §1.132-4. For purposes of this section, a service will not be considered to be offered for sale by the employer to its customers if that service is primarily provided to employees and not to the employer's customers.

(2) *Excess capacity services.* Services that are eligible for treatment as no-additional-cost services include excess capacity services such as hotel accommodations; transportation by aircraft, train, bus, subway, or cruise line; and telephone services. Services that are not eligible for treatment as no-additional-cost services are non-excess capacity services such as the facilitation by a stock brokerage firm of the purchase of stock. Employees who receive non-excess capacity services may, however, be eligible for a qualified employee discount of up to 20 percent of the value of the service provided. See §1.132-3.

(3) *Cash rebates.* The exclusion for a no-additional-cost service applies whether the service is provided at no charge or at a reduced price. The exclusion also applies if the benefit is provided through a partial or total cash rebate of an amount paid for the service.

(4) *Applicability of nondiscrimination rules.* The exclusion for a no-additional-cost service applies to highly compensated employees only if the service is available on substantially the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer that does not discriminate in favor of highly compensated employees. See §1.132-8.

(5) *No substantial additional cost -*

(i) *In general.* The exclusion for a no-additional-cost service applies only if the employer does not incur substantial additional cost in providing the service to the employee. For purposes of the preceding sentence, the term “cost” includes revenue that is forgone because the service is provided to an employee rather than a nonemployee. (For purposes of determining whether any revenue is forgone, it is assumed that the employee would not have purchased the service unless it were available to the employee at the actual price charged to the employee.) Whether an employer incurs substantial additional cost must be determined without regard to any amount paid by the employee for the service. Thus, any reimbursement by the employee for the cost of providing the service does not affect the determination of whether the employer incurs substantial additional cost.

(ii) *Labor intensive services.* An employer must include the cost of labor incurred in providing services to employees when determining whether the employer has incurred substantial additional cost. An employer incurs substantial additional cost, whether non-labor costs are incurred, if a substantial amount of time is spent by the employer or its employees in providing the service to employees. This would be the result whether the time

spent by the employer or its employees in providing the services would have been “idle,” or if the services were provided outside normal business hours. An employer generally incurs no substantial additional cost, however, if the services provided to the employee are merely incidental to the primary service being provided by the employer. For example, the in-flight services of a flight attendant and the cost of in-flight meals provided to airline employees traveling on a space-available basis are merely incidental to the primary service being provided (*i.e.*, air transportation). Similarly, maid service provided to hotel employees renting hotel rooms on a space-available basis is merely incidental to the primary service being provided (*i.e.*, hotel accommodations).

(6) *Payments for telephone service.* Payment made by an entity subject to the modified final judgment (as defined in section 559(c)(5) of the Tax Reform Act of 1984) of all or part of the cost of local telephone service provided to an employee by a person other than an entity subject to the modified final judgment shall be treated as telephone service provided to the employee by the entity making the payment for purposes of this section. The preceding sentence also applies to a rebate of the amount paid by the employee for the service and a payment to the person providing the service. This paragraph (a)(6) applies only to services and employees described in §1.132-4 (c). For a special line of business rule relating to such services and employees, see §1.132-4 (c).

(b) *Reciprocal agreements.* For purposes of the exclusion from gross income for a no-additional-cost service, an exclusion is available to an employee of one employer for a no-additional-cost service provided by an unrelated employer only if all of the following requirements are satisfied -

(1) The service provided to such employee by the unrelated employer is the same type of service generally provided to nonemployee customers by both the line of business in which the employee works and the line of business in which the service is provided to such employee (so that the employee would be permitted to exclude from gross income the value of the service if such service were provided directly by the employee's employer);

(2) Both employers are parties to a written reciprocal agreement under which a group of employees of each employer, all of whom perform substantial services in the same line of business, may receive no-additional-cost services from the other employer; and

(3) Neither employer incurs any substantial additional cost (including forgone revenue) in providing such service to the employees of the other employer, or pursuant to such agreement. If one employer receives a substantial payment from the other employer with respect to the reciprocal agreement, the paying employer will be considered to have incurred a substantial additional cost pursuant to the agreement, and consequently services performed under the reciprocal agreement will not qualify for exclusion as no-additional-cost services.

(c) *Example.* The rules of this section are illustrated by the following example:

**Example.**

Assume that a commercial airline permits its employees to take personal flights on the airline at no charge and receive reserved seating. Because the employer forgoes potential revenue by

permitting the employees to reserve seats, employees receiving such free flights are not eligible for the no-additional-cost exclusion.

[T.D. 8256, 54 FR 28602, July 6, 1989]

### §1.132-3 QUALIFIED EMPLOYEE DISCOUNTS.

(e) *Excess discounts.* Unless excludable under a provision of the Internal Revenue Code of 1986 other than section 132(a)(2), an employee discount provided on property is excludable to the extent of the gross profit percentage multiplied by the price at which the property is being offered for sale to customers. If an employee discount exceeds the gross profit percentage, the excess discount is includible in the employee's income. For example, if the discount on employer-purchased property is 30 percent and the employer's gross profit percentage for the period in the relevant line of business is 25 percent, then 5 percent of the price at which the property is being offered for sale to customers is includible in the employee's income. With respect to services, an employee discount of up to 20 percent may be excludable. If an employee discount exceeds 20 percent, the excess discount is includible in the employee's income. For example, assume that a commercial airline provides a pass to each of its employees permitting the employees to obtain a free round-trip coach ticket with a confirmed seat to any destination the airline services. Neither the exclusion of section 132(a)(1) (relating to no-additional-cost services) nor any other statutory exclusion applies to a flight taken primarily for personal purposes by an employee under this program. However, an employee discount of up to 20 percent may be excluded as a qualified employee discount. Thus, if the price charged to customers for the flight taken is \$300 (under restrictions comparable to those actually placed on travel associated with the employee airline ticket), \$60 is excludable from gross income as a qualified employee discount and \$240 is includible in gross income.

### §1.132-4 LINE OF BUSINESS LIMITATION.

(a) *In general -*

(1) *Applicability -*

(i) *General rule.* A no-additional-cost service or a qualified employee discount provided to an employee is only available with respect to property or services that are offered for sale to customers in the ordinary course of the same line of business in which the employee receiving the property or service performs substantial services. Thus, an employee who does not perform substantial services in a particular line of business of the employer may not exclude from income under section 132 (a)(1) or (a)(2) the value of services or employee discounts received on property or services in that line of business. For rules that relax the line of business requirement, see paragraphs (b) through (g) of this section.

(ii) *Property and services sold to employees rather than customers.* Because the property or services must be offered for sale to customers in the ordinary course of the same line of business in which the employee performs substantial services, the line of business limitation

is not satisfied if the employer's products or services are sold primarily to employees of the employer, rather than to customers. Thus, for example, an employer in the banking line of business is not considered in the variety store line of business if the employer establishes an employee store that offers variety store items for sale to the employer's employees. See § 1.132-7 for rules relating to employer-operated eating facilities, and see § 1.132-1(e) for rules relating to employer-operated on-premises athletic facilities.

(iii) *Performance of substantial services in more than one line of business.* An employee who performs services in more than one of the employer's lines of business may only exclude no-additional-cost services and qualified employee discounts in the lines of business in which the employee performs substantial services.

(iv) *Performance of services that directly benefit more than one line of business -*

(A) *In general.* An employee who performs substantial services that directly benefit more than one line of business of an employer is treated as performing substantial services in all such line of business. For example, an employee who maintains accounting records for an employer's three lines of business may receive qualified employee discounts in all three lines of business. Similarly, if an employee of a minor line of business of an employer that is significantly interrelated with a major line of business of the employer performs substantial services that directly benefit both the major and the minor lines of business, the employee is treated as performing substantial services for both the major and the minor lines of business.

(B) *Examples.* The rules provided in this paragraph (a)(1)(iv) are illustrated by the following examples:

#### **Example 1.**

Assume that employees of units of an employer provide repair or financing services, or sell by catalog, with respect to retail merchandise sold by the employer. Such employees may be considered to perform substantial services for the retail merchandise line of business under paragraph (a)(1)(iv)(A) of this section.

#### **Example 2.**

Assume that an employer operates a hospital and a laundry service. Assume further that some of the gross receipts of the laundry service line of business are from laundry services sold to customers other than the hospital employer. Only the employees of the laundry service who perform substantial services which directly benefit the hospital line of business (through the provision of laundry services to the hospital) will be treated as performing substantial services for the hospital line of business. Other employees of the laundry service line of business will not be treated as employees of the hospital line of business.

#### **Example 3.**

Assume the same facts as in example (2), except that the employer also operates a chain of dry cleaning stores. Employees who perform substantial services which directly benefit the dry



cleaning stores but who do not perform substantial services that directly benefit the hospital line of business will not be treated as performing substantial services for the hospital line of business.

(2) *Definition* -

(i) *In general.* An employer's line of business is determined by reference to the Enterprise Standard Industrial Classification Manual (ESIC Manual) prepared by the Statistical Policy Division of the U.S. Office of Management and Budget. An employer is considered to have more than one line of business if the employer offers for sale to customers property or services in more than one two-digit code classification referred to in the ESIC Manual.

(ii) *Examples.* Examples of two-digit classifications are general retail merchandise stores; hotels and other lodging places; auto repair, services, and garages; and food stores.

(3) *Aggregation of two-digit classifications.* If, pursuant to paragraph (a)(2) of this section, an employer has more than one line of business, such lines of business will be treated as a single line of business where and to the extent that one or more of the following aggregation rules apply:

(i) If it is uncommon in the industry of the employer for any of the separate lines of business of the employer to be operated without the others, the separate lines of business are treated as one line of business.

(ii) If it is common for a substantial number of employees (other than those employees who work at the headquarters or main office of the employer) to perform substantial services for more than one line of business of the employer, so that determination of which employees perform substantial services for which line or lines of business would be difficult, then the separate lines of business of the employer in which such employees perform substantial services are treated as one line of business. For example, assume that an employer operates a delicatessen with an attached service counter at which food is sold for consumption on the premises. Assume further that most but not all employees work both at the delicatessen and at the service counter. Under the aggregation rule of this paragraph (a)(3)(ii), the delicatessen and the service counter are treated as one line of business.

(iii) If the retail operations of an employer that are located on the same premises are in separate lines of business but would be considered to be within one line of business under paragraph (a)(2) of this section if the merchandise offered for sale in such lines of business were offered for sale at a department store, then the operations are treated as one line of business. For example, assume that on the same premises an employer sells both women's apparel and jewelry. Because, if sold together at a department store, the operations would be part of the same line of business, the operations are treated as one line of business.

## §1.132-5 WORKING CONDITION FRINGES.

(a) *In general* -

(1) *Definition.* Gross income does not include the value of a working condition fringe. A “working condition fringe” is any property or service provided to an employee of an employer to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under section 162 or 167.

(i) A service or property offered by an employer in connection with a flexible spending account is not excludable from gross income as a working condition fringe. For purposes of the preceding sentence, a flexible spending account is an agreement (whether or not written) entered into between an employer and an employee that makes available to the employee over a time period a certain level of unspecified non-cash benefits with a pre-determined cash value.

(ii) If, under section 274 or any other section, certain substantiation requirements must be met in order for a deduction under section 162 or 167 to be allowable, then those substantiation requirements apply when determining whether a property or service is excludable as a working condition fringe.

(iii) An amount that would be deductible by the employee under a section other than section 162 or 167, such as section 212, is not a working condition fringe.

(iv) A physical examination program provided by the employer is not excludable as a working condition fringe even if the value of such program might be deductible to the employee under section 213. The previous sentence applies without regard to whether the employer makes the program mandatory to some or all employees.

(v) A cash payment made by an employer to an employee will not qualify as a working condition fringe unless the employer requires the employee to -

(A) Use the payment for expenses in connection with a specific or pre-arranged activity or undertaking for which a deduction is allowable under section 162 or 167,

(B) Verify that the payment is actually used for such expenses, and

(C) Return to the employer any part of the payment not so used.

(vi) The limitation of section 67(a) (relating to the two-percent floor on miscellaneous itemized deductions) is not considered when determining the amount of a working condition fringe. For example, assume that an employer provides a \$1,000 cash advance to Employee A and that the conditions of paragraph (a)(1)(v) of this section are not satisfied. Even to the extent A uses the allowance for expenses for which a deduction is allowable under section 162 and 167, because such cash payment is not a working condition fringe, section 67(a) applies. The \$1,000 payment is includible in A's gross income and subject to income and employment tax withholding. If, however, the conditions of paragraph (a)(1)(v) of this section are satisfied with respect to the payment, then the amount of A's working condition fringe is determined without regard to section 67(a). The \$1,000 payment is excludable from A's gross income and not subject to income and employment tax reporting and withholding.

(2) *Trade or business of the employee -*

(i) *General.* If the hypothetical payment for a property or service would be allowable as a deduction with respect to a trade or business of an employee other than the employee's trade or business of being an employee of the employer, it cannot be taken into account for purposes of determining the amount, if any, of the working condition fringe.

(ii) *Examples.* The rule of paragraph (a)(2)(i) of this section may be illustrated by the following examples:

**Example 1.**

Assume that, unrelated to company X's trade or business and unrelated to employee A's trade or business of being an employee of company X, A is a member of the board of directors of company Y. Assume further that company X provides A with air transportation to a company Y board of director's meeting. A may not exclude from gross income the value of the air transportation to the meeting as a working condition fringe. A may, however, deduct such amount under section 162 if the section 162 requirements are satisfied. The result would be the same whether the air transportation was provided in the form of a flight on a commercial airline or a seat on a company X airplane.

**Example 2.**

Assume the same facts as in example (1) except that A serves on the board of directors of company Z and company Z regularly purchases a significant amount of goods and services from company X. Because of the relationship between Company Z and A's employer, A's membership on Company Z's board of directors is related to A's trade or business of being an employee of Company X. Thus, A may exclude from gross income the value of air transportation to board meetings as a working condition fringe.

**Example 3.**

Assume the same facts as in example (1) except that A serves on the board of directors of a charitable organization. Assume further that the service by A on the charity's board is substantially related to company X's trade or business. In this case, A may exclude from gross income the value of air transportation to board meetings as a working condition fringe.

**Example 4.**

Assume the same facts as in example (3) except that company X also provides A with the use of a company X conference room which A uses for monthly meetings relating to the charitable organization. Also assume that A uses company X's copy machine and word processor each month in connection with functions of the charitable organization. Because of the substantial business benefit that company X derives from A's service on the board of the charity, A may exclude as a working condition fringe the value of the use of company X property in connection with the charitable organization.

## §1.132-6 DE MINIMIS FRINGES.

(a) *In general.* Gross income does not include the value of a de minimis fringe provided to an employee. The term “de minimis fringe” means any property or service the value of which is (after taking into account the frequency with which similar fringes are provided by the employer to the employer's employees) so small as to make accounting for it unreasonable or administratively impracticable.

### (b) *Frequency -*

(1) *Employee-measured frequency.* Generally, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the frequency with which the employer provides the fringes to each individual employee. For example, if an employer provides a free meal in kind to one employee on a daily basis, but not to any other employee, the value of the meals is not de minimis with respect to that one employee even though with respect to the employer's entire workforce the meals are provided “infrequently.”

(2) *Employer-measured frequency.* Notwithstanding the rule of paragraph (b)(1) of this section, except for purposes of applying the special rules of paragraph (d)(2) of this section, where it would be administratively difficult to determine frequency with respect to individual employees, the frequency with which similar fringes are provided by the employer to the employer's employees is determined by reference to the frequency with which the employer provides the fringes to the workforce as a whole. Therefore, under this rule, the frequency with which any individual employee receives such a fringe benefit is not relevant and in some circumstances, the de minimis fringe exclusion may apply with respect to a benefit even though a particular employee receives the benefit frequently. For example, if an employer exercises sufficient control and imposes significant restrictions on the personal use of a company copying machine so that at least 85 percent of the use of the machine is for business purposes, any personal use of the copying machine by particular employees is considered to be a de minimis fringe.

(c) *Administrability.* Unless excluded by a provision of chapter 1 of the Internal Revenue Code of 1986 other than section 132(a)(4), the value of any fringe benefit that would not be unreasonable or administratively impracticable to account for is includible in the employee's gross income. Thus, except as provided in paragraph (d)(2) of this section, the provision of any cash fringe benefit is never excludable under section 132(a) as a de minimis fringe benefit. Similarly except as otherwise provided in paragraph (d) of this section, a cash equivalent fringe benefit (such as a fringe benefit provided to an employee through the use of a gift certificate or charge or credit card) is generally not excludable under section 132(a) even if the same property or service acquired (if provided in kind) would be excludable as a de minimis fringe benefit. For example, the provision of cash to an employee for a theatre ticket that would itself be excludable as a de minimis fringe (see paragraph (e)(1) of this section) is not excludable as a de minimis fringe.

### (d) *Special rules -*

(1) *Transit passes.* A public transit pass provided at a discount to defray an employee's commuting costs may be excluded from the employee's gross income as a de minimis fringe if such discount does not exceed \$21 in any month. The exclusion provided in this paragraph (d) (1) also applies to the provision of tokens or fare cards that enable an individual to travel on the public transit system if the value of such tokens and fare cards in any month does not exceed by more than \$21 the amount the employee paid for the tokens and fare cards for such month. Similarly, the exclusion of this paragraph (d)(1) applies to the provision of a voucher or similar instrument that is exchangeable solely for tokens, fare cards, or other instruments that enable the employee to use the public transit system if the value of such vouchers and other instruments in any month does not exceed \$21. The exclusion of this paragraph (d)(1) also applies to reimbursements made by an employer to an employee after December 31, 1988, to cover the cost of commuting on a public transit system, provided the employee does not receive more than \$21 in such reimbursements for commuting costs in any given month. The reimbursement must be made under a bona fide reimbursement arrangement. A reimbursement arrangement will be treated as bona fide if the employer establishes appropriate procedures for verifying on a periodic basis that the employee's use of public transportation for commuting is consistent with the value of the benefit provided by the employer for that purpose. The amount of in-kind public transit commuting benefits and reimbursements provided during any month that are excludible under this paragraph (d)(1) is limited to \$21. For months ending before July 1, 1991, the amount is \$15 per month. The exclusion provided in this paragraph (d)(1) does not apply to the provision of any benefit to defray public transit expenses incurred for personal travel other than commuting.

(2) *Occasional meal money or local transportation fare -*

(i) *General rule.* Meals, meal money or local transportation fare provided to an employee is excluded as a de minimis fringe benefit if the benefit provided is reasonable and is provided in a manner that satisfies the following three conditions:

(A) *Occasional basis.* The meals, meal money or local transportation fare is provided to the employee on an occasional basis. Whether meal money or local transportation fare is provided to an employee on an occasional basis will depend upon the frequency *i.e.*, the availability of the benefit and regularity with which the benefit is provided by the employer to the employee. Thus, meals, meal money, or local transportation fare or a combination of such benefits provided to an employee on a regular or routine basis is not provided on an occasional basis.

(B) *Overtime.* The meals, meal money or local transportation fare is provided to an employee because overtime work necessitates an extension of the employee's normal work schedule. This condition does not fail to be satisfied merely because the circumstances giving rise to the need for overtime work are reasonably foreseeable.

(C) *Meal money.* In the case of a meal or meal money, the meal or meal money is provided to enable the employee to work overtime. Thus, for example, meals provided on the employer's premises that are consumed during the period that the employee works overtime or meal money provided for meals consumed during such period satisfy this condition.

In no event shall meal money or local transportation fare calculated on the basis of the number of hours worked (e.g., \$1.00 per hour for each hour over eight hours) be considered a de minimis fringe benefit.

(ii) *Applicability of other exclusions for certain meals and for transportation provided for security concerns.* The value of meals furnished to an employee, an employee's spouse, or any of the employee's dependents by or on behalf of the employee's employer for the convenience of the employer is excluded from the employee's gross income if the meals are furnished on the business premises of the employer (see section 119). (For purposes of the exclusion under section 119, the definitions of an employee under §1.132-1(b) do not apply.) If, for a bona fide business-oriented security concern, an employer provides an employee vehicle transportation that is specially designed for security (for example, the vehicle is equipped with bulletproof glass and armor plating), and the conditions of §1.132-5(m) are satisfied, the value of the special security design is excludable from gross income as a working condition fringe if the employee would not have had such special security design but for the bona fide business-oriented security concern.

(iii) *Special rule for employer-provided transportation provided in certain circumstances.*

(A) *Partial exclusion of value.* If an employer provides transportation (such as taxi fare to an employee for use in commuting to and/or from work because of unusual circumstances and because, based on the facts and circumstances, it is unsafe for the employee to use other available means of transportation, the excess of the value of each one-way trip over \$1.50 per one-way commute is excluded from gross income. The rule of this paragraph (d)(2)(iii) is not available to a control employee as defined in §1.61-21(f) (5) and (6).

(B) *"Unusual circumstances".* Unusual circumstances are determined with respect to the employee receiving the transportation and are based on all facts and circumstances. An example of unusual circumstances would be when an employee is asked to work outside of his normal work hours (such as being called to the workplace at 1:00 am when the employee normally works from 8:00 am to 4:00 pm). Another example of unusual circumstances is a temporary change in the employee's work schedule (such as working from 12 midnight to 8:00 am rather than from 8:00 am to 4:00 pm for a two-week period).

(C) *"Unsafe conditions".* Factors indicating whether it is unsafe for an employee to use other available means of transportation are the history of crime in the geographic area surrounding the employee's workplace or residence and the time of day during which the employee must commute.

(3) *Use of special rules or examples to establish a general rule.* The special rules provided in this paragraph (d) or examples provided in paragraph (e) of this section may not be used to establish any general rule permitting exclusion as a de minimis fringe. For example, the fact that \$252 (*i.e.*, \$21 per month for 12 months) worth of public transit passes can be excluded from gross income as a de minimis fringe in 1992 does not mean that any fringe benefit with a value equal to or less than \$252 may be excluded as a de minimis fringe. As another example, the fact that the commuting use of an employer-provided vehicle more than one day a month is an example of a benefit not excludable as a de minimis fringe (see paragraph (e)(2) of this

section) does not mean that the commuting use of a vehicle up to 12 times per year is excludable from gross income as a de minimis fringe.

(4) *Benefits exceeding value and frequency limits.* If a benefit provided to an employee is not de minimis because either the value or frequency exceeds a limit provided in this paragraph (d), no amount of the benefit is considered to be a de minimis fringe. For example, if, in 1992, an employer provides a \$50 monthly public transit pass, the entire \$50 must be included in income, not just the excess value over \$21.

(e) *Examples -*

(1) *Benefits excludable from income.* Examples of de minimis fringe benefits are occasional typing of personal letters by a company secretary; occasional personal use of an employer's copying machine, provided that the employer exercises sufficient control and imposes significant restrictions on the personal use of the machine so that at least 85 percent of the use of the machine is for business purposes; occasional cocktail parties, group meals, or picnics for employees and their guests; traditional birthday or holiday gifts of property (not cash) with a low fair market value; occasional theater or sporting event tickets; coffee, doughnuts, and soft drinks; local telephone calls; and flowers, fruit, books, or similar property provided to employees under special circumstances (e.g., on account of illness, outstanding performance, or family crisis).

(2) *Benefits not excludable as de minimis fringes.* Examples of fringe benefits that are not excludable from gross income as de minimis fringes are: season tickets to sporting or theatrical events; the commuting use of an employer-provided automobile or other vehicle more than one day a month; membership in a private country club or athletic facility, regardless of the frequency with which the employee uses the facility; employer-provided group-term life insurance on the life of the spouse or child of an employee; and use of employer-owned or leased facilities (such as an apartment, hunting lodge, boat, etc.) for a weekend. Some amount of the value of certain of these fringe benefits may be excluded from income under other statutory provisions, such as the exclusion for working condition fringes. See §1.132-5.

(f) *Nonapplicability of nondiscrimination rules.* Except to the extent provided in §1.132-7, the nondiscrimination rules of section 132(h)(1) and §1.132-8 do not apply in determining the amount, if any, of a de minimis fringe. Thus, a fringe benefit may be excludable as a de minimis fringe even if the benefit is provided exclusively to highly compensated employees of the employer.

[T.D. 8256, 54 FR 28615, July 6, 1989, as amended by T.D. 8389, 57 FR 1871, Jan. 16, 1992; 57 FR 5982, Feb. 19, 1992]

## §1.162-1 BUSINESS EXPENSES.

(a) *In general.* Business expenses deductible from gross income include the ordinary and necessary expenditures directly connected with or pertaining to the taxpayer's trade or business, except items which are used as the basis for a deduction or a credit under provisions of law other

than section 162. The cost of goods purchased for resale, with proper adjustment for opening and closing inventories, is deducted from gross sales in computing gross income. See paragraph (a) of § 1.161-3. Among the items included in business expenses are management expenses, commissions (but see section 263 and the regulations thereunder), labor, supplies, incidental repairs, operating expenses of automobiles used in the trade or business, traveling expenses while away from home solely in the pursuit of a trade or business (see § 1.162-2), advertising and other selling expenses, together with insurance premiums against fire, storm, theft, accident, or other similar losses in the case of a business, and rental for the use of business property. No such item shall be included in business expenses, however, to the extent that it is used by the taxpayer in computing the cost of property included in its inventory or used in determining the gain or loss basis of its plant, equipment, or other property. See section 1054 and the regulations thereunder. A deduction for an expense paid or incurred after December 30, 1969, which would otherwise be allowable under section 162 shall not be denied on the grounds that allowance of such deduction would frustrate a sharply defined public policy. See section 162(c), (f), and (g) and the regulations thereunder. The full amount of the allowable deduction for ordinary and necessary expenses in carrying on a business is deductible, even though such expenses exceed the gross income derived during the taxable year from such business. In the case of any sports program to which section 114 (relating to sports programs conducted for the American National Red Cross) applies, expenses described in section 114(a)(2) shall be allowable as deductions under section 162(a) only to the extent that such expenses exceed the amount excluded from gross income under section 114(a).

#### **§1.162-4 REPAIRS.**

(a) *In general.* A taxpayer may deduct amounts paid for repairs and maintenance to tangible property if the amounts paid are not otherwise required to be capitalized. Optionally, § 1.263(a)-3(n) provides an election to capitalize amounts paid for repair and maintenance consistent with the taxpayer's books and records.

#### **§1.162-5 EXPENSES FOR EDUCATION.**

(a) *General rule.* Expenditures made by an individual for education (including research undertaken as part of his educational program) which are not expenditures of a type described in paragraph (b) (2) or (3) of this section are deductible as ordinary and necessary business expenses (even though the education may lead to a degree) if the education -

- (1) Maintains or improves skills required by the individual in his employment or other trade or business, or
- (2) Meets the express requirements of the individual's employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the individual of an established employment relationship, status, or rate of compensation.

(b) *Nondeductible educational expenditures -*



(1) *In general.* Educational expenditures described in subparagraphs (2) and (3) of this paragraph are personal expenditures or constitute an inseparable aggregate of personal and capital expenditures and, therefore, are not deductible as ordinary and necessary business expenses even though the education may maintain or improve skills required by the individual in his employment or other trade or business or may meet the express requirements of the individual's employer or of applicable law or regulations.

(2) *Minimum educational requirements.*

(i) The first category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is required of him in order to meet the minimum educational requirements for qualification in his employment or other trade or business. The minimum education necessary to qualify for a position or other trade or business must be determined from a consideration of such factors as the requirements of the employer, the applicable law and regulations, and the standards of the profession, trade, or business involved. The fact that an individual is already performing service in an employment status does not establish that he has met the minimum educational requirements for qualification in that employment. Once an individual has met the minimum educational requirements for qualification in his employment or other trade or business (as in effect when he enters the employment or trade or business), he shall be treated as continuing to meet those requirements even though they are changed.

(ii) The minimum educational requirements for qualification of a particular individual in a position in an educational institution is the minimum level of education (in terms of aggregate college hours or degree) which under the applicable laws or regulations, in effect at the time this individual is first employed in such position, is normally required of an individual initially being employed in such a position. If there are no normal requirements as to the minimum level of education required for a position in an educational institution, then an individual in such a position shall be considered to have met the minimum educational requirements for qualification in that position when he becomes a member of the faculty of the educational institution. The determination of whether an individual is a member of the faculty of an educational institution must be made on the basis of the particular practices of the institution. However, an individual will ordinarily be considered to be a member of the faculty of an institution if

(a) he has tenure or his years of service are being counted toward obtaining tenure;

(b) the institution is making contributions to a retirement plan (other than Social Security or a similar program) in respect of his employment; or

(c) he has a vote in faculty affairs.

(iii) The application of this subparagraph may be illustrated by the following examples:

**Example 1.**

General facts: State X requires a bachelor's degree for beginning secondary school teachers which must include 30 credit hours of professional educational courses. In addition, in order to retain his position, a secondary school teacher must complete a fifth year of preparation within 10 years after beginning his employment. If an employing school official certifies to the State Department of Education that applicants having a bachelor's degree and the required courses in professional education cannot be found, he may hire individuals as secondary school teachers if they have completed a minimum of 90 semester hours of college work. However, to be retained in his position, such an individual must obtain his bachelor's degree and complete the required professional educational courses within 3 years after his employment commences. Under these facts, a bachelor's degree, without regard to whether it includes 30 credit hours of professional educational courses, is considered to be the minimum educational requirement for qualification as a secondary school teacher in State X. This is the case notwithstanding the number of teachers who are actually hired without such a degree. The following are examples of the application of these facts in particular situations:

*Situation 1.* A, at the time he is employed as a secondary school teacher in State X, has a bachelor's degree including 30 credit hours of professional educational courses. After his employment, A completes a fifth college year of education and, as a result, is issued a standard certificate. The fifth college year of education undertaken by A is not education required to meet the minimum educational requirements for qualification as a secondary school teacher. Accordingly, the expenditures for such education are deductible unless the expenditures are for education which is part of a program of study being pursued by A which will lead to qualifying him in a new trade or business.

*Situation 2.* Because of a shortage of applicants meeting the stated requirements, B, who has a bachelor's degree, is employed as a secondary school teacher in State X even though he has only 20 credit hours of professional educational courses. After his employment, B takes an additional 10 credit hours of professional educational courses. Since these courses do not constitute education required to meet the minimum educational requirements for qualification as a secondary school teacher which is a bachelor's degree and will not lead to qualifying B in a new trade or business, the expenditures for such courses are deductible.

*Situation 3.* Because of a shortage of applicants meeting the stated requirements, C is employed as a secondary school teacher in State X although he has only 90 semester hours of college work toward his bachelor's degree. After his employment, C undertakes courses leading to a bachelor's degree. These courses (including any courses in professional education) constitute education required to meet the minimum educational requirements for qualification as a secondary school teacher. Accordingly, the expenditures for such education are not deductible.

*Situation 4.* Subsequent to the employment of A, B, and C, but before they have completed a fifth college year of education, State X changes its requirements affecting secondary school teachers to provide that beginning teachers must have completed 5 college years of preparation. In the cases of A, B, and C, a fifth college year of education is not considered to be education undertaken to meet the minimum educational requirements for qualifications as a secondary school teacher. Accordingly, expenditures for a fifth year of college will be deductible unless the expenditures are for education which is part of a program being pursued by A, B, or C which will lead to qualifying him in a new trade or business.

### Example 2.

D, who holds a bachelor's degree, obtains temporary employment as an instructor at University Y and undertakes graduate courses as a candidate for a graduate degree. D may become a faculty member only if he obtains a graduate degree and may continue to hold a position as instructor only so long as he shows satisfactory progress towards obtaining this graduate degree. The graduate courses taken by D constitute education required to meet the minimum educational requirements for qualification in D's trade or business and, thus, the expenditures for such courses are not deductible.

### Example 3.

E, who has completed 2 years of a normal 3-year law school course leading to a bachelor of laws degree (LL.B.), is hired by a law firm to do legal research and perform other functions on a full-time basis. As a condition to continued employment, E is required to obtain an LL.B. and pass the State bar examination. E completes his law school education by attending night law school, and he takes a bar review course in order to prepare for the State bar examination. The law courses and bar review course constitute education required to meet the minimum educational requirements for qualification in E's trade or business and, thus, the expenditures for such courses are not deductible.

#### *(3) Qualification for new trade or business.*

(i) The second category of nondeductible educational expenses within the scope of subparagraph (1) of this paragraph are expenditures made by an individual for education which is part of a program of study being pursued by him which will lead to qualifying him in a new trade or business. In the case of an employee, a change of duties does not constitute a new trade or business if the new duties involve the same general type of work as is involved in the individual's present employment. For this purpose, all teaching and related duties shall be considered to involve the same general type of work. The following are examples of changes in duties which do not constitute new trades or businesses:

(a) Elementary to secondary school classroom teacher.

(b) Classroom teacher in one subject (such as mathematics) to classroom teacher in another subject (such as science).

(c) Classroom teacher to guidance counselor.

(d) Classroom teacher to principal.

(ii) The application of this subparagraph to individuals other than teachers may be illustrated by the following examples:

### Example 1.

A, a self-employed individual practicing a profession other than law, for example, engineering, accounting, etc., attends law school at night and after completing his law school studies receives

a bachelor of laws degree. The expenditures made by A in attending law school are nondeductible because this course of study qualifies him for a new trade or business.

#### **Example 2.**

Assume the same facts as in example (1) except that A has the status of an employee rather than a self-employed individual, and that his employer requires him to obtain a bachelor of laws degree. A intends to continue practicing his nonlegal profession as an employee of such employer. Nevertheless, the expenditures made by A in attending law school are not deductible since this course of study qualifies him for a new trade or business.

#### **Example 3.**

B, a general practitioner of medicine, takes a 2-week course reviewing new developments in several specialized fields of medicine. B's expenses for the course are deductible because the course maintains or improves skills required by him in his trade or business and does not qualify him for a new trade or business.

#### **Example 4.**

C, while engaged in the private practice of psychiatry, undertakes a program of study and training at an accredited psychoanalytic institute which will lead to qualifying him to practice psychoanalysis. C's expenditures for such study and training are deductible because the study and training maintains or improves skills required by him in his trade or business and does not qualify him for a new trade or business.

#### **(c) *Deductible educational expenditures -***

(1) *Maintaining or improving skills.* The deduction under the category of expenditures for education which maintains or improves skills required by the individual in his employment or other trade or business includes refresher courses or courses dealing with current developments as well as academic or vocational courses provided the expenditures for the courses are not within either category of nondeductible expenditures described in paragraph (b) (2) or (3) of this section.

(2) *Meeting requirements of employer.* An individual is considered to have undertaken education in order to meet the express requirements of his employer, or the requirements of applicable law or regulations, imposed as a condition to the retention by the taxpayer of his established employment relationship, status, or rate of compensation only if such requirements are imposed for a bona fide business purpose of the individual's employer. Only the minimum education necessary to the retention by the individual of his established employment relationship, status, or rate of compensation may be considered as undertaken to meet the express requirements of the taxpayer's employer. However, education in excess of such minimum education may qualify as education undertaken in order to maintain or improve the skills required by the taxpayer in his employment or other trade or business (see subparagraph (1) of this paragraph). In no event, however, is a deduction allowable for expenditures for education which, even though for education required by the employer or applicable law or regulations, are within one of the categories of nondeductible expenditures described in

paragraph (b) (2) and (3) of this section.

## **§1.162-11 RENTALS.**

(a) *Acquisition of a leasehold.* If a leasehold is acquired for business purposes for a specified sum, the purchaser may take as a deduction in his return an aliquot part of such sum each year, based on the number of years the lease has to run. Taxes paid by a tenant to or for a landlord for business property are additional rent and constitute a deductible item to the tenant and taxable income to the landlord, the amount of the tax being deductible by the latter. For disallowance of deduction for income taxes paid by a lessee corporation pursuant to a lease arrangement with the lessor corporation, see section 110 and the regulations thereunder. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in amortizing the costs incurred after July 28, 1958 of acquiring a lease. See § 1.197-2 for rules governing the amortization of costs to acquire limited interests in section 197 intangibles.

## **§1.170A-1 CHARITABLE, ETC., CONTRIBUTIONS AND GIFTS; ALLOWANCE OF DEDUCTION.**

(c) *Value of a contribution in property.*

(1) If a charitable contribution is made in property other than money, the amount of the contribution is the fair market value of the property at the time of the contribution reduced as provided in section 170(e)(1) and paragraph (a) of § 1.170A-4, or section 170(e)(3) and paragraph (c) of § 1.170A-4A.

(2) The fair market value is the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having reasonable knowledge of relevant facts. If the contribution is made in property of a type which the taxpayer sells in the course of his business, the fair market value is the price which the taxpayer would have received if he had sold the contributed property in the usual market in which he customarily sells, at the time and place of the contribution and, in the case of a contribution of goods in quantity, in the quantity contributed. The usual market of a manufacturer or other producer consists of the wholesalers or other distributors to or through whom he customarily sells, but if he sells only at retail the usual market consists of his retail customers.

(3) If a donor makes a charitable contribution of property, such as stock in trade, at a time when he could not reasonably have been expected to realize its usual selling price, the value of the gift is not the usual selling price but is the amount for which the quantity of property contributed would have been sold by the donor at the time of the contribution.

(4) Any costs and expenses pertaining to the contributed property which were incurred in taxable years preceding the year of contribution and are properly reflected in the opening inventory for the year of contribution must be removed from inventory and are not a part of the cost of goods sold for purposes of determining gross income for the year of contribution. Any

costs and expenses pertaining to the contributed property which are incurred in the year of contribution and would, under the method of accounting used, be properly reflected in the cost of goods sold for such year are to be treated as part of the costs of goods sold for such year. If costs and expenses incurred in producing or acquiring the contributed property are, under the method of accounting used, properly deducted under section 162 or other section of the Code, such costs and expenses will be allowed as deductions for the taxable year in which they are paid or incurred whether or not such year is the year of the contribution. Any such costs and expenses which are treated as part of the cost of goods sold for the year of contribution, and any such costs and expenses which are properly deducted under section 162 or other section of the Code, are not to be treated under any section of the Code as resulting in any basis for the contributed property. Thus, for example, the contributed property has no basis for purposes of determining under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4 the amount of gain which would have been recognized if such property had been sold by the donor at its fair market value at the time of its contribution. The amount of any charitable contribution for the taxable year is not to be reduced by the amount of any costs or expenses pertaining to the contributed property which was properly deducted under section 162 or other section of the Code for any taxable year preceding the year of the contribution. This subparagraph applies only to property which was held by the taxpayer for sale in the course of a trade or business. The application of this subparagraph may be illustrated by the following examples:

#### **Example 1.**

In 1970, A, an individual using the calendar year as the taxable year and the accrual method of accounting, contributed to a church property from inventory having a fair market value of \$600. The closing inventory at the end of 1969 properly included \$400 of costs attributable to the acquisition of such property, and in 1969 A properly deducted under section 162 \$50 of administrative and other expenses attributable to such property. Under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4, the amount of the charitable contribution allowed for 1970 is \$400 (\$600-[\$600-\$400]). Pursuant to this subparagraph, the cost of goods sold to be used in determining gross income for 1970 may not include the \$400 which was included in opening inventory for that year.

#### **Example 2.**

The facts are the same as in *Example 1* except that the contributed property was acquired in 1970 at a cost of \$400. The \$400 cost of the property is included in determining the cost of goods sold for 1970, and \$50 is allowed as a deduction for that year under section 162. A is not allowed any deduction under section 170 for the contributed property, since under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4 the amount of the charitable contribution is reduced to zero (\$600-[\$600-\$0]).

#### **Example 3.**

In 1970, B, an individual using the calendar year as the taxable year and the accrual method of accounting, contributed to a church property from inventory having a fair market value of \$600. Under § 1.471-3(c), the closing inventory at the end of 1969 properly included \$450 costs attributable to the production of such property, including \$50 of administrative and other indirect expenses which, under his method of accounting, was properly added to inventory rather than

deducted as a business expense. Under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4, the amount of the charitable contribution allowed for 1970 is \$450 (\$600-[\$600-\$450]). Pursuant to this subparagraph, the cost of goods sold to be used in determining gross income for 1970 may not include the \$450 which was included in opening inventory for that year.

#### Example 4.

The facts are the same as in *Example 3* except that the contributed property was produced in 1970 at a cost of \$450, including \$50 of administrative and other indirect expenses. The \$450 cost of the property is included in determining the cost of goods sold for 1970. B is not allowed any deduction under section 170 for the contributed property, since under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4 the amount of the charitable contribution is reduced to zero (\$600-[\$600-\$0]).

#### Example 5.

In 1970, C, a farmer using the cash method of accounting and the calendar year as the taxable year, contributed to a church a quantity of grain which he had raised having a fair market value of \$600. In 1969, C paid expenses of \$450 in raising the property which he properly deducted for such year under section 162. Under section 170(e)(1)(A) and paragraph (a) of § 1.170A-4, the amount of the charitable contribution in 1970 is reduced to zero (\$600-[\$600-\$0]). Accordingly, C is not allowed any deduction under section 170 for the contributed property.

#### Example 6.

The facts are the same as in *Example 5* except that the \$450 expenses incurred in raising the contributed property were paid in 1970. The result is the same as in *Example 5*, except the amount of \$450 is deductible under section 162 for 1970.

(5) For payments or transfers to an entity described in section 170(c) by a taxpayer carrying on a trade or business, see § 1.162-15(a).

(g) *Contributions of services.* No deduction is allowable under section 170 for a contribution of services. However, unreimbursed expenditures made incident to the rendition of services to an organization contributions to which are deductible may constitute a deductible contribution. For example, the cost of a uniform without general utility which is required to be worn in performing donated services is deductible. Similarly, out-of-pocket transportation expenses necessarily incurred in performing donated services are deductible. Reasonable expenditures for meals and lodging necessarily incurred while away from home in the course of performing donated services also are deductible. For the purposes of this paragraph, the phrase *while away from home* has the same meaning as that phrase is used for purposes of section 162 and the regulations thereunder.

### §1.263(A)-1 CAPITAL EXPENDITURES; IN GENERAL.

(a) *General rule for capital expenditures.* Except as provided in chapter 1 of the Internal Revenue Code, no deduction is allowed for -

- (1) Any amount paid for new buildings or for permanent improvements or betterments made to increase the value of any property or estate; or
- (2) Any amount paid in restoring property or in making good the exhaustion thereof for which an allowance is or has been made.

## **§1.263(A)-4 AMOUNTS PAID TO ACQUIRE OR CREATE INTANGIBLES.**

### **(b) Capitalization with respect to intangibles -**

(1) *In general.* Except as otherwise provided in this section, a taxpayer must capitalize -

- (i) An amount paid to acquire an intangible (see paragraph (c) of this section);
- (ii) An amount paid to create an intangible described in paragraph (d) of this section;
- (iii) An amount paid to create or enhance a separate and distinct intangible asset within the meaning of paragraph (b)(3) of this section;
- (iv) An amount paid to create or enhance a future benefit identified in published guidance in the Federal Register or in the Internal Revenue Bulletin (*see* § 601.601(d)(2)(ii) of this chapter) as an intangible for which capitalization is required under this section; and
- (v) An amount paid to facilitate (within the meaning of paragraph (e)(1) of this section) an acquisition or creation of an intangible described in paragraph (b)(1)(i), (ii), (iii) or (iv) of this section.

(2) *Published guidance.* Any published guidance identifying a future benefit as an intangible for which capitalization is required under paragraph (b)(1)(iv) of this section applies only to amounts paid on or after the date of publication of the guidance.

### **(3) Separate and distinct intangible asset -**

- (i) *Definition.* The term *separate and distinct intangible asset* means a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business. In addition, for purposes of this section, a fund (or similar account) is treated as a separate and distinct intangible asset of the taxpayer if amounts in the fund (or account) may revert to the taxpayer. The determination of whether a payment creates a separate and distinct intangible asset is made based on all of the facts and circumstances existing during the taxable year in which the payment is made.
- (ii) *Creation or termination of contract rights.* Amounts paid to another party to create, originate, enter into, renew or renegotiate an agreement with that party that produces rights or benefits for the taxpayer (and amounts paid to facilitate the creation, origination,



enhancement, renewal or renegotiation of such an agreement) are treated as amounts that do not create (or facilitate the creation of) a separate and distinct intangible asset within the meaning of this paragraph (b)(3). Further, amounts paid to another party to terminate (or facilitate the termination of) an agreement with that party are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). See paragraphs (d)(2), (d)(6), and (d)(7) of this section for rules that specifically require capitalization of amounts paid to create or terminate certain agreements.

(iii) *Amounts paid in performing services.* Amounts paid in performing services under an agreement are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3), regardless of whether the amounts result in the creation of an income stream under the agreement.

(iv) *Creation of computer software.* Except as otherwise provided in the Internal Revenue Code, the regulations thereunder, or other published guidance in the Federal Register or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii) of this chapter), amounts paid to develop computer software are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3).

(v) *Creation of package design.* Amounts paid to develop a package design are treated as amounts that do not create a separate and distinct intangible asset within the meaning of this paragraph (b)(3). For purposes of this section, the term *package design* means the specific graphic arrangement or design of shapes, colors, words, pictures, lettering, and other elements on a given product package, or the design of a container with respect to its shape or function.

#### (4) *Coordination with other provisions of the Internal Revenue Code -*

(i) *In general.* Nothing in this section changes the treatment of an amount that is specifically provided for under any other provision of the Internal Revenue Code (other than section 162(a) or 212) or the regulations thereunder.

(ii) *Example.* The following example illustrates the rule of this paragraph (b)(4):

#### **Example.**

On January 1, 2004, G enters into an interest rate swap agreement with unrelated counterparty H under which, for a term of five years, G is obligated to make annual payments at 11% and H is obligated to make annual payments at LIBOR on a notional principal amount of \$100 million. At the time G and H enter into this swap agreement, the rate for similar on-market swaps is LIBOR to 10%. To compensate for this difference, on January 1, 2004, H pays G a yield adjustment fee of \$3,790,786. This yield adjustment fee constitutes an amount paid to create an intangible and would be capitalized under paragraph (d)(2) of this section. However, because the yield adjustment fee is a nonperiodic payment on a notional principal contract as defined in § 1.446-3(c), the treatment of this fee is governed by § 1.446-3 and not this section.

#### (c) *Acquired intangibles -*

(1) *In general.* A taxpayer must capitalize amounts paid to another party to acquire any intangible from that party in a purchase or similar transaction. Examples of intangibles within the scope of this paragraph (c) include, but are not limited to, the following (if acquired from another party in a purchase or similar transaction):

- (i) An ownership interest in a corporation, partnership, trust, estate, limited liability company, or other entity.
- (ii) A debt instrument, deposit, stripped bond, stripped coupon (including a servicing right treated for federal income tax purposes as a stripped coupon), regular interest in a REMIC or FASIT, or any other intangible treated as debt for federal income tax purposes.
- (iii) A financial instrument, such as -
  - (A) A notional principal contract;
  - (B) A foreign currency contract;
  - (C) A futures contract;
  - (D) A forward contract (including an agreement under which the taxpayer has the right and obligation to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property));
  - (E) An option (including an agreement under which the taxpayer has the right to provide or to acquire property (or to be compensated for such property, regardless of whether the taxpayer provides or acquires the property)); and
  - (F) Any other financial derivative.
- (iv) An endowment contract, annuity contract, or insurance contract.
- (v) Non-functional currency.
- (vi) A lease.
- (vii) A patent or copyright.
- (viii) A franchise, trademark or tradename (as defined in § 1.197-2(b)(10)).
- (ix) An assembled workforce (as defined in § 1.197-2(b)(3)).
- (x) Goodwill (as defined in § 1.197-2(b)(1)) or going concern value (as defined in § 1.197-2(b)(2)).
- (xi) A customer list.

(xii) A servicing right (for example, a mortgage servicing right that is not treated for Federal income tax purposes as a stripped coupon).

(xiii) A customer-based intangible (as defined in § 1.197-2(b)(6)) or supplier-based intangible (as defined in § 1.197-2(b)(7)).

(xiv) Computer software.

(xv) An agreement providing either party the right to use, possess or sell an intangible described in paragraphs (c)(1)(i) through (v) of this section.

(2) *Readily available software.* An amount paid to obtain a nonexclusive license for software that is (or has been) readily available to the general public on similar terms and has not been substantially modified (within the meaning of § 1.197-2(c)(4)) is treated for purposes of this paragraph (c) as an amount paid to another party to acquire an intangible from that party in a purchase or similar transaction.

(3) *Intangibles acquired from an employee.* Amounts paid to an employee to acquire an intangible from that employee are not required to be capitalized under this section if the amounts are includible in the employee's income in connection with the performance of services under section 61 or 83. For purposes of this section, whether an individual is an employee is determined in accordance with the rules contained in section 3401(c) and the regulations thereunder.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

#### **Example 1.**

Debt instrument. X corporation, a commercial bank, purchases a portfolio of existing loans from Y corporation, another financial institution. X pays Y \$2,000,000 in exchange for the portfolio. The \$2,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

#### **Example 2.**

Option. W corporation owns all of the outstanding stock of X corporation. Y corporation holds a call option entitling it to purchase from W all of the outstanding stock of X at a certain price per share. Z corporation acquires the call option from Y in exchange for \$5,000,000. The \$5,000,000 paid to Y constitutes an amount paid to acquire an intangible from Y and must be capitalized.

#### **Example 3. Ownership interest in a corporation.**

Same as *Example 2*, but assume Z exercises its option and purchases from W all of the outstanding stock of X in exchange for \$100,000,000. The \$100,000,000 paid to W constitutes an amount paid to acquire an intangible from W and must be capitalized.

#### **Example 4.**

Customer list. N corporation, a retailer, sells its products through its catalog and mail order system. N purchases a customer list from R corporation. N pays R \$100,000 in exchange for the customer list. The \$100,000 paid to R constitutes an amount paid to acquire an intangible from R and must be capitalized.

#### Example 5.

Goodwill. Z corporation pays W corporation \$10,000,000 to purchase all of the assets of W in a transaction that constitutes an applicable asset acquisition under section 1060(c). Of the \$10,000,000 consideration paid in the transaction, \$9,000,000 is allocable to tangible assets purchased from W and \$1,000,000 is allocable to goodwill. The \$1,000,000 allocable to goodwill constitutes an amount paid to W to acquire an intangible from W and must be capitalized.

#### (f) 12-month rule -

(1) *In general.* Except as otherwise provided in this paragraph (f), a taxpayer is not required to capitalize under this section amounts paid to create (or to facilitate the creation of) any right or benefit for the taxpayer that does not extend beyond the earlier of -

(i) 12 months after the first date on which the taxpayer realizes the right or benefit; or

(ii) The end of the taxable year following the taxable year in which the payment is made.

(2) *Duration of benefit for contract terminations.* For purposes of this paragraph (f), amounts paid to terminate a contract or other agreement described in paragraph (d)(7)(i) of this section prior to its expiration date (or amounts paid to facilitate such termination) create a benefit for the taxpayer that lasts for the unexpired term of the agreement immediately before the date of the termination. If the terms of a contract or other agreement described in paragraph (d)(7)(i) of this section permit the taxpayer to terminate the contract or agreement after a notice period, amounts paid by the taxpayer to terminate the contract or agreement before the end of the notice period create a benefit for the taxpayer that lasts for the amount of time by which the notice period is shortened.

(3) *Inapplicability to created financial interests and self-created amortizable section 197 intangibles.* Paragraph (f)(1) of this section does not apply to amounts paid to create (or facilitate the creation of) an intangible described in paragraph (d)(2) of this section (relating to amounts paid to create financial interests) or to amounts paid to create (or facilitate the creation of) an intangible that constitutes an amortizable section 197 intangible within the meaning of section 197(c).

(4) *Inapplicability to rights of indefinite duration.* Paragraph (f)(1) of this section does not apply to amounts paid to create (or facilitate the creation of) an intangible of indefinite duration. A right has an indefinite duration if it has no period of duration fixed by agreement or by law, or if it is not based on a period of time, such as a right attributable to an agreement to provide or receive a fixed amount of goods or services. For example, a license granted by a governmental agency that permits the taxpayer to operate a business conveys a right of indefinite duration if the license may be revoked only upon the taxpayer's violation of the terms

of the license.

(5) *Rights subject to renewal* -

(i) *In general*. For purposes of paragraph (f)(1) of this section, the duration of a right includes any renewal period if all of the facts and circumstances in existence during the taxable year in which the right is created indicate a reasonable expectancy of renewal.

(ii) *Reasonable expectancy of renewal*. The following factors are significant in determining whether there exists a reasonable expectancy of renewal:

(A) *Renewal history*. The fact that similar rights are historically renewed is evidence of a reasonable expectancy of renewal. On the other hand, the fact that similar rights are rarely renewed is evidence of a lack of a reasonable expectancy of renewal. Where the taxpayer has no experience with similar rights, or where the taxpayer holds similar rights only occasionally, this factor is less indicative of a reasonable expectancy of renewal.

(B) *Economics of the transaction*. The fact that renewal is necessary for the taxpayer to earn back its investment in the right is evidence of a reasonable expectancy of renewal. For example, if a taxpayer pays \$14,000 to enter into a renewable contract with an initial 9-month term that is expected to generate income to the taxpayer of \$1,000 per month, the fact that renewal is necessary for the taxpayer to earn back its \$14,000 payment is evidence of a reasonable expectancy of renewal.

(C) *Likelihood of renewal by other party*. Evidence that indicates a likelihood of renewal by the other party to a right, such as a bargain renewal option or similar arrangement, is evidence of a reasonable expectancy of renewal. However, the mere fact that the other party will have the opportunity to renew on the same terms as are available to others is not evidence of a reasonable expectancy of renewal.

(D) *Terms of renewal*. The fact that material terms of the right are subject to renegotiation at the end of the initial term is evidence of a lack of a reasonable expectancy of renewal. For example, if the parties to an agreement must renegotiate price or amount, the renegotiation requirement is evidence of a lack of a reasonable expectancy of renewal.

(E) *Terminations*. The fact that similar rights are typically terminated prior to renewal is evidence of a lack of a reasonable expectancy of renewal.

(iii) *Safe harbor pooling method*. In lieu of applying the reasonable expectancy of renewal test described in paragraph (f)(5)(ii) of this section to each separate right created during a taxable year, a taxpayer that reasonably expects to enter into at least 25 similar rights during the taxable year may establish a pool of similar rights for which the initial term does not extend beyond the period prescribed in paragraph (f)(1) of this section and may elect to apply the reasonable expectancy of renewal test to that pool. See paragraph (h) of this section for additional rules relating to pooling. The application of paragraph (f)(1) of this section to each pool is determined in the following manner:

(A) All amounts (except *de minimis* costs described in paragraph (d)(6)(v) of this section) paid to create the rights included in the pool and all amounts paid to facilitate the creation of the rights included in the pool are aggregated.

(B) If less than 20 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, all rights in the pool are treated as having a duration that does not extend beyond the period prescribed in paragraph (f)(1) of this section, and the taxpayer is not required to capitalize under this section any portion of the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(C) If more than 80 percent of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, all rights in the pool are treated as having a duration that extends beyond the period prescribed in paragraph (f)(1) of this section, and the taxpayer is required to capitalize under this section the aggregate amount described in paragraph (f)(5)(iii)(A) of this section.

(D) If 20 percent or more, but 80 percent or less, of the rights in the pool are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section, the aggregate amount described in paragraph (f)(5)(iii)(A) of this section is multiplied by the percentage of the rights in the pool that are reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section and the taxpayer must capitalize the resulting amount under this section by treating such amount as creating a separate intangible. The amount determined by multiplying the aggregate amount described in paragraph (f)(5)(iii)(A) of this section by the percentage of rights in the pool that are not reasonably expected to be renewed beyond the period prescribed in paragraph (f)(1) of this section is not required to be capitalized under this section.

(6) *Coordination with section 461.* In the case of a taxpayer using an accrual method of accounting, the rules of this paragraph (f) do not affect the determination of whether a liability is incurred during the taxable year, including the determination of whether economic performance has occurred with respect to the liability. See § 1.461-4 for rules relating to economic performance.

(7) *Election to capitalize.* A taxpayer may elect not to apply the rule contained in paragraph (f)(1) of this section. An election made under this paragraph (f)(7) applies to all similar transactions during the taxable year to which paragraph (f)(1) of this section would apply (but for the election under this paragraph (f)(7)). For example, a taxpayer may elect under this paragraph (f)(7) to capitalize its costs of prepaying insurance contracts for 12 months, but may continue to apply the rule in paragraph (f)(1) to its costs of entering into non-renewable, 12-month service contracts. A taxpayer makes the election by treating the amounts as capital expenditures in its timely filed original federal income tax return (including extensions) for the taxable year during which the amounts are paid. In the case of an affiliated group of corporations filing a consolidated return, the election is made separately with respect to each member of the group, and not with respect to the group as a whole. In the case of an S corporation or partnership, the election is made by the S corporation or by the partnership, and not by the shareholders or partners. An election made under this paragraph (f)(7) is revocable with respect to each taxable year for which made only with the consent of the Commissioner.

(8) *Examples.* The rules of this paragraph (f) are illustrated by the following examples, in which it is assumed (unless otherwise stated) that the taxpayer is a calendar year, accrual method taxpayer that does not have a short taxable year in any taxable year and has not made an election under paragraph (f)(7) of this section:

**Example 1. Prepaid expenses.**

On December 1, 2005, N corporation pays a \$10,000 insurance premium to obtain a property insurance policy (with no cash value) with a 1-year term that begins on February 1, 2006. The amount paid by N is a prepaid expense described in paragraph (d)(3) of this section and not paragraph (d)(2) of this section. Because the right or benefit attributable to the \$10,000 payment extends beyond the end of the taxable year following the taxable year in which the payment is made, the 12-month rule provided by this paragraph (f) does not apply. N must capitalize the \$10,000 payment.

**Example 2. Prepaid expenses.**

(i) Assume the same facts as in *Example 1*, except that the policy has a term beginning on December 15, 2005. The 12-month rule of this paragraph (f) applies to the \$10,000 payment because the right or benefit attributable to the payment neither extends more than 12 months beyond December 15, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, N is not required to capitalize the \$10,000 payment.

(ii) Alternatively, assume N capitalizes prepaid expenses for financial accounting and reporting purposes and elects under paragraph (f)(7) of this section not to apply the 12-month rule contained in paragraph (f)(1) of this section. N must capitalize the \$10,000 payment for Federal income tax purposes.

**Example 3. Financial interests.**

On October 1, 2005, X corporation makes a 9-month loan to B in the principal amount of \$250,000. The principal amount of the loan to B constitutes an amount paid to create or originate a financial interest under paragraph (d)(2)(i)(B) of this section. The 9-month term of the loan does not extend beyond the period prescribed by paragraph (f)(1) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, X must capitalize the \$250,000 loan amount.

**Example 4. Financial interests.**

X corporation owns all of the outstanding stock of Z corporation. On December 1, 2005, Y corporation pays X \$1,000,000 in exchange for X's grant of a 9-month call option to Y permitting Y to purchase all of the outstanding stock of Z. Y's payment to X constitutes an amount paid to create or originate an option with X under paragraph (d)(2)(i)(C)(7) of this section. The 9-month term of the option does not extend beyond the period prescribed by paragraph (f)(1) of this section. However, as provided by paragraph (f)(3) of this section, the rules of this paragraph (f) do not apply to intangibles described in paragraph (d)(2) of this section. Accordingly, Y must

capitalize the \$1,000,000 payment.

#### **Example 5. License.**

(i) On July 1, 2005, R corporation pays \$10,000 to state X to obtain a license to operate a business in state X for a period of 5 years. The terms of the license require R to pay state X an annual fee of \$500 due on July 1, 2005, and each of the succeeding four years. R pays the \$500 fee on July 1 as required by the license.

(ii) R's payment of \$10,000 is an amount paid to a governmental agency for a license granted by that agency to which paragraph (d)(5) of this section applies. Because R's payment creates rights or benefits for R that extend beyond 12 months after the first date on which R realizes the rights or benefits attributable to the payment and beyond the end of 2006 (the taxable year following the taxable year in which the payment is made), the rules of this paragraph (f) do not apply to R's payment. Accordingly, R must capitalize the \$10,000 payment.

(iii) R's payment of each \$500 annual fee is a prepaid expense described in paragraph (d)(3) of this section. R is not required to capitalize the \$500 fee in each taxable year. The rules of this paragraph (f) apply to each such payment because each payment provides a right or benefit to R that does not extend beyond 12 months after the first date on which R realizes the rights or benefits attributable to the payment and does not extend beyond the end of the taxable year following the taxable year in which the payment is made.

#### **Example 6. Lease.**

On December 1, 2005, W corporation enters into a lease agreement with X corporation under which W agrees to lease property to X for a period of 9 months, beginning on December 1, 2005. W pays its outside counsel \$7,000 for legal services rendered in drafting the lease agreement and negotiating with X. The agreement between W and X is an agreement providing W the right to be compensated for the use of property, as described in paragraph (d)(6)(i)(A) of this section. W's \$7,000 payment to its outside counsel is an amount paid to facilitate W's creation of the lease as described in paragraph (e)(1)(i) of this section. The 12-month rule of this paragraph (f) applies to the \$7,000 payment because the right or benefit that the \$7,000 payment facilitates the creation of neither extends more than 12 months beyond December 1, 2005 (the first date the benefit is realized by the taxpayer) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, W is not required to capitalize its payment to its outside counsel.

#### **Example 7. Certain contract terminations.**

V corporation owns real property that it has leased to A for a period of 15 years. When the lease has a remaining unexpired term of 5 years, V and A agree to terminate the lease, enabling V to use the property in its trade or business. V pays A \$100,000 in exchange for A's agreement to terminate the lease. V's payment to A to terminate the lease is described in paragraph (d)(7)(i)(A) of this section. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 5 years, the remaining unexpired term of the lease as of the date of the termination. Because the benefit attributable to the expenditure extends beyond 12 months after the first date on which V realizes the rights or benefits attributable to the payment and beyond the end of the



taxable year following the taxable year in which the payment is made, the rules of this paragraph (f) do not apply to the payment. V must capitalize the \$100,000 payment.

**Example 8. Certain contract terminations.**

Assume the same facts as in *Example 7*, except that the lease is terminated when it has a remaining unexpired term of 10 months. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 10 months. The 12-month rule of this paragraph (f) applies to the payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, V is not required to capitalize the \$100,000 payment.

**Example 9. Certain contract terminations.**

Assume the same facts as in *Example 7*, except that either party can terminate the lease upon 12 months notice. When the lease has a remaining unexpired term of 5 years, V wants to terminate the lease, however, V does not want to wait another 12 months. V pays A \$50,000 for the ability to terminate the lease with one month's notice. V's payment to A to terminate the lease is described in paragraph (d)(7)(i)(A) of this section. Under paragraph (f)(2) of this section, V's payment creates a benefit for V with a duration of 11 months, the time by which the notice period is shortened. The 12-month rule of this paragraph (f) applies to V's \$50,000 payment because the benefit attributable to the payment neither extends more than 12 months beyond the date of termination (the first date the benefit is realized by V) nor beyond the end of the taxable year following the taxable year in which the payment is made. Accordingly, V is not required to capitalize the \$50,000 payment.

**Example 10. Coordination with section 461.**

(i) U corporation leases office space from W corporation at a monthly rental rate of \$2,000. On August 1, 2005, U prepays its office rent expense for the first six months of 2006 in the amount of \$12,000. For purposes of this example, it is assumed that the recurring item exception provided by § 1.461-5 does not apply and that the lease between W and U is not a section 467 rental agreement as defined in section 467(d).

(ii) Under § 1.461-4(d)(3), U's prepayment of rent is a payment for the use of property by U for which economic performance occurs ratably over the period of time U is entitled to use the property. Accordingly, because economic performance with respect to U's prepayment of rent does not occur until 2006, U's prepaid rent is not incurred in 2005 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2005. Thus, the rules of this paragraph (f) do not apply to U's prepayment of its rent.

(iii) Alternatively, assume that U uses the cash method of accounting and the economic performance rules in § 1.461-4 therefore do not apply to U. The 12-month rule of this paragraph (f) applies to the \$12,000 payment because the rights or benefits attributable to U's prepayment of its rent do not extend beyond December 31, 2006. Accordingly, U is not required to capitalize its prepaid rent.

### Example 11. Coordination with section 461.

N corporation pays R corporation, an advertising and marketing firm, \$40,000 on August 1, 2005, for advertising and marketing services to be provided to N throughout calendar year 2006. For purposes of this example, it is assumed that the recurring item exception provided by § 1.461-5 does not apply. Under § 1.461-4(d)(2), N's payment arises out of the provision of services to N by R for which economic performance occurs as the services are provided. Accordingly, because economic performance with respect to N's prepaid advertising expense does not occur until 2006, N's prepaid advertising expense is not incurred in 2005 and therefore is not properly taken into account through capitalization, deduction, or otherwise in 2005. Thus, the rules of this paragraph (f) do not apply to N's payment.

## §1.446-1 GENERAL RULE FOR METHODS OF ACCOUNTING.

### (a) *General rule.*

(1) Section 446(a) provides that taxable income shall be computed under the method of accounting on the basis of which a taxpayer regularly computes his income in keeping his books. The term “method of accounting” includes not only the overall method of accounting of the taxpayer but also the accounting treatment of any item. Examples of such over-all methods are the cash receipts and disbursements method, an accrual method, combinations of such methods, and combinations of the foregoing with various methods provided for the accounting treatment of special items. These methods of accounting for special items include the accounting treatment prescribed for research and experimental expenditures, soil and water conservation expenditures, depreciation, net operating losses, etc. Except for deviations permitted or required by such special accounting treatment, taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books. For requirement respecting the adoption or change of accounting method, see section 446(e) and paragraph (e) of this section.

(2) It is recognized that no uniform method of accounting can be prescribed for all taxpayers. Each taxpayer shall adopt such forms and systems as are, in his judgment, best suited to his needs. However, no method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. A method of accounting which reflects the consistent application of generally accepted accounting principles in a particular trade or business in accordance with accepted conditions or practices in that trade or business will ordinarily be regarded as clearly reflecting income, provided all items of gross income and expense are treated consistently from year to year.

(3) Items of gross income and expenditures which are elements in the computation of taxable income need not be in the form of cash. It is sufficient that such items can be valued in terms of money. For general rules relating to the taxable year for inclusion of income and for taking deductions, see sections 451 and 461, and the regulations thereunder.

(4) Each taxpayer is required to make a return of his taxable income for each taxable year and must maintain such accounting records as will enable him to file a correct return. See section

6001 and the regulations thereunder. Accounting records include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on his books of account and on his return, as for example, a reconciliation of any differences between such books and his return. The following are among the essential features that must be considered in maintaining such records:

(i) Except in the case of a taxpayer qualifying as a small business taxpayer for the taxable year under section 471(c), in all cases in which the production, purchase or sale of merchandise of any kind is an income-producing factor, merchandise on hand (including finished goods, work in progress, raw materials, and supplies) at the beginning and end of the year shall be taken into account in computing the taxable income of the year. (For rules relating to computation of inventories, see section 263A, 471, and 472 and the regulations thereunder.)

(ii) Expenditures made during the year shall be properly classified as between capital and expense. For example, expenditures for such items as plant and equipment, which have a useful life extending substantially beyond the taxable year, shall be charged to a capital account and not to an expense account.

(iii) In any case in which there is allowable with respect to an asset a deduction for depreciation, amortization, or depletion, any expenditures (other than ordinary repairs) made to restore the asset or prolong its useful life shall be added to the asset account or charged against the appropriate reserve.

(b) *Exceptions.*

(1) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation of taxable income shall be made in a manner which, in the opinion of the Commissioner, does clearly reflect income.

(2) A taxpayer whose sole source of income is wages need not keep formal books in order to have an accounting method. Tax returns, copies thereof, or other records may be sufficient to establish the use of the method of accounting used in the preparation of the taxpayer's income tax returns.

(c) *Permissible methods -*

(1) In general. Subject to the provisions of paragraphs (a) and (b) of this section, a taxpayer may compute his taxable income under any of the following methods of accounting:

(i) *Cash receipts and disbursements method.* Generally, under the cash receipts and disbursements method in the computation of taxable income, all items which constitute gross income (whether in the form of cash, property, or services) are to be included for the taxable year in which actually or constructively received. Expenditures are to be deducted for the taxable year in which actually made. For rules relating to constructive receipt, see § 1.451-2. For treatment of an expenditure attributable to more than one taxable year, see section 461(a) and paragraph (a)(1) of § 1.461-1.

(ii) *Accrual method.* (A) Generally, under an accrual method, income is to be included for the taxable year when all the events have occurred that fix the right to receive the income and the amount of the income can be determined with reasonable accuracy. (See § 1.451-1 for rules relating to the taxable year of inclusion.) Under such a method, a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of § 1.461-1 for examples of liabilities that may not be taken into account until after the taxable year incurred, and see §§ 1.461-4 through 1.461-6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that a deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of § 1.263A-1(c)(3)) and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and related guidance.

(B) The term “liability” includes any item allowable as a deduction, cost, or expense for Federal income tax purposes. In addition to allowable deductions, the term includes any amount otherwise allowable as a capitalized cost, as a cost taken into account in computing cost of goods sold, as a cost allocable to a long-term contract, or as any other cost or expense. Thus, for example, an amount that a taxpayer expends or will expend for capital improvements to property must be incurred before the taxpayer may take the amount into account in computing its basis in the property. The term “liability” is not limited to items for which a legal obligation to pay exists at the time of payment. Thus, for example, amounts prepaid for goods or services and amounts paid without a legal obligation to do so may not be taken into account by an accrual basis taxpayer any earlier than the taxable year in which those amounts are incurred.

(C) No method of accounting is acceptable unless, in the opinion of the Commissioner, it clearly reflects income. The method used by the taxpayer in determining when income is to be accounted for will generally be acceptable if it accords with generally accepted accounting principles, is consistently used by the taxpayer from year to year, and is consistent with the Income Tax Regulations. For example, a taxpayer engaged in a manufacturing business may account for sales of the taxpayer's product when the goods are shipped, when the product is delivered or accepted, or when title to the goods passes to the customers, whether or not billed, depending on the method regularly employed in keeping the taxpayer's books.

(iii) *Other permissible methods.* Special methods of accounting are described elsewhere in chapter 1 of the Code and the regulations thereunder. For example, see the following sections and the regulations thereunder: Sections 61 and 162, relating to the crop method of accounting; section 453, relating to the installment method; section 460, relating to the long-

term contract methods. In addition, special methods of accounting for particular items of income and expense are provided under other sections of chapter 1. For example, see section 174, relating to research and experimental expenditures, and section 175, relating to soil and water conservation expenditures.

(iv) *Combinations of the foregoing methods.*

(a) In accordance with the following rules, any combination of the foregoing methods of accounting will be permitted in connection with a trade or business if such combination clearly reflects income and is consistently used. Where a combination of methods of accounting includes any special methods, such as those referred to in subdivision (iii) of this subparagraph, the taxpayer must comply with the requirements relating to such special methods. A taxpayer using an accrual method of accounting with respect to purchases and sales may use the cash method in computing all other items of income and expense. However, a taxpayer who uses the cash method of accounting in computing gross income from his trade or business shall use the cash method in computing expenses of such trade or business. Similarly, a taxpayer who uses an accrual method of accounting in computing business expenses shall use an accrual method in computing items affecting gross income from his trade or business.

(b) A taxpayer using one method of accounting in computing items of income and deductions of his trade or business may compute other items of income and deductions not connected with his trade or business under a different method of accounting.

(2) *Special rules.*

(i) In any case in which it is necessary to use an inventory, the accrual method of accounting must be used with regard to purchases and sales unless:

(A) The taxpayer qualifies as a small business taxpayer for the taxable year under section 471(c), or

(B) Otherwise authorized under paragraph (c)(2)(ii) of this section.

(ii) No method of accounting will be regarded as clearly reflecting income unless all items of gross profit and deductions are treated with consistency from year to year. The Commissioner may authorize a taxpayer to adopt or change to a method of accounting permitted by this chapter although the method is not specifically described in the regulations in this part if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. Further, the Commissioner may authorize a taxpayer to continue the use of a method of accounting consistently used by the taxpayer, even though not specifically authorized by the regulations in this part, if, in the opinion of the Commissioner, income is clearly reflected by the use of such method. See section 446(a) and paragraph (a) of this section, which require that taxable income shall be computed under the method of accounting on the basis of which the taxpayer regularly computes his income in keeping his books, and section 446(e) and paragraph (e) of this section, which require the prior approval of the Commissioner in the case of changes in accounting method.

(iii) The timing rules of § 1.1502-13 are a method of accounting for intercompany transactions (as defined in § 1.1502-13(b)(1)(i)), to be applied by each member of a consolidated group in addition to the member's other methods of accounting. See § 1.1502-13(a)(3)(i). This paragraph (c)(2)(iii) is applicable to consolidated return years beginning on or after November 7, 2001.

(3) *Applicability date.* The first sentence of paragraph (a)(4)(i) of this section and paragraph (c)(2)(i) of this section apply to taxable years beginning on or after January 5, 2021. However, for a taxable year beginning after December 31, 2017, and before January 5, 2021, a taxpayer may apply the rules provided in the first sentence of this paragraph (c)(3), provided that the taxpayer follows all the applicable rules contained in the regulations under section 446 for such taxable year and all subsequent taxable years.

## §1.451-1 GENERAL RULE FOR TAXABLE YEAR OF INCLUSION.

(a) *General rule.* Gains, profits, and income are to be included in gross income for the taxable year in which they are actually or constructively received by the taxpayer unless includible for a different year in accordance with the taxpayer's method of accounting. Under an accrual method of accounting, income is includible in gross income when all the events have occurred which fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (all events test). Therefore, under such a method of accounting if, in the case of compensation for services, no determination can be made as to the right to such compensation or the amount thereof until the services are completed, the amount of compensation is ordinarily income for the taxable year in which the determination can be made. Under the cash receipts and disbursements method of accounting, such an amount is includible in gross income when actually or constructively received. Where an amount of income is properly accrued on the basis of a reasonable estimate and the exact amount is subsequently determined, the difference, if any, shall be taken into account for the taxable year in which such determination is made. To the extent that income is attributable to the recovery of bad debts for accounts charged off in prior years, it is includible in the year of recovery in accordance with the taxpayer's method of accounting, regardless of the date when the amounts were charged off. For treatment of bad debts and bad debt recoveries, see sections 166 and 111 and the regulations thereunder. For rules relating to the treatment of amounts received in crop shares, see section 61 and the regulations thereunder. For the year in which a partner must include his distributive share of partnership income, see section 706(a) and paragraph (a) of § 1.706-1. If a taxpayer ascertains that an item should have been included in gross income in a prior taxable year, he should, if within the period of limitation, file an amended return and pay any additional tax due. Similarly, if a taxpayer ascertains that an item was improperly included in gross income in a prior taxable year, he should, if within the period of limitation, file claim for credit or refund of any overpayment of tax arising therefrom.

## §1.451-2 CONSTRUCTIVE RECEIPT OF INCOME.

(a) *General rule.* Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year during which it is credited to his account, set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he

could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. Thus, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt. In the case of interest, dividends, or other earnings (whether or not credited) payable in respect of any deposit or account in a bank, building and loan association, savings and loan association, or similar institution, the following are not substantial limitations or restrictions on the taxpayer's control over the receipt of such earnings:

- (1) A requirement that the deposit or account, and the earnings thereon, must be withdrawn in multiples of even amounts;
- (2) The fact that the taxpayer would, by withdrawing the earnings during the taxable year, receive earnings that are not substantially less in comparison with the earnings for the corresponding period to which the taxpayer would be entitled had he left the account on deposit until a later date (for example, if an amount equal to three months' interest must be forfeited upon withdrawal or redemption before maturity of a one year or less certificate of deposit, time deposit, bonus plan, or other deposit arrangement then the earnings payable on premature withdrawal or redemption would be substantially less when compared with the earnings available at maturity);
- (3) A requirement that the earnings may be withdrawn only upon a withdrawal of all or part of the deposit or account. However, the mere fact that such institutions may pay earnings on withdrawals, total or partial, made during the last three business days of any calendar month ending a regular quarterly or semiannual earnings period at the applicable rate calculated to the end of such calendar month shall not constitute constructive receipt of income by any depositor or account holder in any such institution who has not made a withdrawal during such period;
- (4) A requirement that a notice of intention to withdraw must be given in advance of the withdrawal. In any case when the rate of earnings payable in respect of such a deposit or account depends on the amount of notice of intention to withdraw that is given, earnings at the maximum rate are constructively received during the taxable year regardless of how long the deposit or account was held during the year or whether, in fact, any notice of intention to withdraw is given during the year. However, if in the taxable year of withdrawal the depositor or account holder receives a lower rate of earnings because he failed to give the required notice of intention to withdraw, he shall be allowed an ordinary loss in such taxable year in an amount equal to the difference between the amount of earnings previously included in gross income and the amount of earnings actually received. See section 165 and the regulations thereunder.

(b) *Examples of constructive receipt.* Amounts payable with respect to interest coupons which have matured and are payable but which have not been cashed are constructively received in the taxable year during which the coupons mature, unless it can be shown that there are no funds available for payment of the interest during such year. Dividends on corporate stock are constructively received when unqualifiedly made subject to the demand of the shareholder. However, if a dividend is declared payable on December 31 and the corporation followed its usual practice of paying the dividends by checks mailed so that the shareholders would not

receive them until January of the following year, such dividends are not considered to have been constructively received in December. Generally, the amount of dividends or interest credited on savings bank deposits or to shareholders of organizations such as building and loan associations or cooperative banks is income to the depositors or shareholders for the taxable year when credited. However, if any portion of such dividends or interest is not subject to withdrawal at the time credited, such portion is not constructively received and does not constitute income to the depositor or shareholder until the taxable year in which the portion first may be withdrawn. Accordingly, if, under a bonus or forfeiture plan, a portion of the dividends or interest is accumulated and may not be withdrawn until the maturity of the plan, the crediting of such portion to the account of the shareholder or depositor does not constitute constructive receipt. In this case, such credited portion is income to the depositor or shareholder in the year in which the plan matures. However, in the case of certain deposits made after December 31, 1970, in banks, domestic building and loan associations, and similar financial institutions, the ratable inclusion rules of section 1232(a)(3) apply. See §1.1232-3A. Accrued interest on unwithdrawn insurance policy dividends is gross income to the taxpayer for the first taxable year during which such interest may be withdrawn by him.

[T.D. 6723, 29 FR 5342, Apr. 21, 1964, as amended by T.D. 7154, 36 FR 24997, Dec. 28, 1971; T.D. 7663, 44 FR 76782, Dec. 28, 1979]

## **§15A.453-1 INSTALLMENT METHOD REPORTING FOR SALES OF REAL PROPERTY AND CASUAL SALES OF PERSONAL PROPERTY.**

(a) *In general.* Unless the taxpayer otherwise elects in the manner prescribed in paragraph (d)(3) of this section, income from a sale of real property or a casual sale of personal property, where any payment is to be received in a taxable year after the year of sale, is to be reported on the installment method.

(b) *Installment sale defined -*

(1) *In general.* The term “installment sale” means a disposition of property (except as provided in paragraph (b)(4) of this section) where at least one payment is to be received after the close of the taxable year in which the disposition occurs. The term “installment sale” includes dispositions from which payment is to be received in a lump sum in a taxable year subsequent to the year of sale. For purposes of this paragraph, the taxable year in which payments are to be received is to be determined without regard to section 453(e) (relating to related party sales), section (f)(3) (relating to the definition of a “payment”) and section (g) (relating to sales of depreciable property to a spouse or 80-percent-owned entity).

(2) *Installment method defined -*

(i) *In general.* Under the installment method, the amount of any payment which is income to the taxpayer is that portion of the installment payment received in that year which the gross profit realized or to be realized bears to the total contract price (the “gross profit ratio”). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.



(ii) *Selling price defined.* The term “selling price” means the gross selling price without reduction to reflect any existing mortgage or other encumbrance on the property (whether assumed or taken subject to by the buyer) and, for installment sales in taxable years ending after October 19, 1980, without reduction to reflect any selling expenses. Neither interest, whether stated or unstated, nor original issue discount is considered to be a part of the selling price. See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(iii) *Contract price defined.* The term “contract price” means the total contract price equal to selling price reduced by that portion of any qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section), assumed or taken subject to by the buyer, which does not exceed the seller's basis in the property (adjusted, for installment sales in taxable years ending after October 19, 1980, to reflect commissions and other selling expenses as provided in paragraph (b)(2)(v) of this section). See paragraph (c) of this section for rules describing installment method reporting of contingent payment sales.

(iv) *Qualifying indebtedness.* The term “qualifying indebtedness” means a mortgage or other indebtedness encumbering the property and indebtedness, not secured by the property but incurred or assumed by the purchaser incident to the purchaser's acquisition, holding, or operation in the ordinary course of business or investment, of the property. The term “qualifying indebtedness” does not include an obligation of the taxpayer incurred incident to the disposition of the property (*e.g.*, legal fees relating to the taxpayer's sale of the property) or an obligation functionally unrelated to the acquisition, holding, or operating of the property (*e.g.*, the taxpayer's medical bill). Any obligation created subsequent to the taxpayer's acquisition of the property and incurred or assumed by the taxpayer or placed as an encumbrance on the property in contemplation of disposition of the property is not qualifying indebtedness if the arrangement results in accelerating recovery of the taxpayer's basis in the installment sale.

(v) *Gross profit defined.* The term “gross profit” means the selling price less the adjusted basis as defined in section 1011 and the regulations thereunder. For sales in taxable years ending after October 19, 1980, in the case of sales of real property by a person other than a dealer and casual sales of personal property, commissions and other selling expenses shall be added to basis for purposes of determining the proportion of payments which is gross profit attributable to the disposition. Such additions to basis will not be deemed to affect the taxpayer's holding period in the transferred property.

### (3) *Payment -*

(i) *In general.* Except as provided in paragraph (e) of this section (relating to purchaser evidences of indebtedness payable on demand or readily tradable), the term “payment” does not include the receipt of evidences of indebtedness of the person acquiring the property (“installment obligation”), whether or not payment of such indebtedness is guaranteed by a third party (including a government agency). For special rules regarding the receipt of an evidence of indebtedness of a transferee of a qualified intermediary, see §§ 1.1031(b)-2(b) and 1.1031(k)-1(j)(2)(iii) of this chapter. A standby letter of credit (as defined in paragraph (b)(3)(iii) of this section) shall be treated as a third party guarantee. Payments include

amounts actually or constructively received in the taxable year under an installment obligation. For a special rule regarding a transfer of property to a qualified intermediary followed by the sale of such property by the qualified intermediary, see § 1.1031(k)-1(j)(2)(ii) of this chapter. Receipt of an evidence of indebtedness which is secured directly or indirectly by cash or a cash equivalent, such as a bank certificate of deposit or a treasury note, will be treated as the receipt of payment. For a special rule regarding a transfer of property in exchange for an obligation that is secured by cash or a cash equivalent held in a qualified escrow account or a qualified trust, see § 1.1031(k)-1(j)(2)(i) of this chapter. Payment may be received in cash or other property, including foreign currency, marketable securities, and evidences of indebtedness which are payable on demand or readily tradable. However, for special rules relating to the receipt of certain property with respect to which gain is not recognized, see paragraph (f) of this section (relating to transactions described in sections 351, 356(a) and 1031). Except as provided in § 15a.453-2 of these regulations (relating to distributions of installment obligations in corporate liquidations described in section 337), payment includes receipt of an evidence of indebtedness of a person other than the person acquiring the property from the taxpayer. For purposes of determining the amount of payment received in the taxable year, the amount of qualifying indebtedness (as defined in paragraph (b)(2)(iv) of this section) assumed or taken subject to by the person acquiring the property shall be included only to the extent that it exceeds the basis of the property (determined after adjustment to reflect selling expenses). For purposes of the preceding sentence, an arrangement under which the taxpayer's liability on qualifying indebtedness is eliminated incident to the disposition (*e.g.*, a novation) shall be treated as an assumption of the qualifying indebtedness. If the taxpayer sells property to a creditor of the taxpayer and indebtedness of the taxpayer is cancelled in consideration of the sale, such cancellation shall be treated as payment. To the extent that cancellation is not in consideration of the sale, see §§ 1.61-12(b)(1) and 1.1001-2(a)(2) relating to discharges of indebtedness. If the taxpayer sells property which is encumbered by a mortgage or other indebtedness on which the taxpayer is not personally liable, and the person acquiring the property is the obligee, the taxpayer shall be treated as having received payment in the amount of such indebtedness.

(ii) *Wrap-around mortgage.* This paragraph (b)(3)(ii) shall apply generally to any installment sale after March 4, 1981 unless the installment sale was completed before June 1, 1981 pursuant to a written obligation binding on the seller that was executed on or before March 4, 1981. A “wrap-around mortgage” means an agreement in which the buyer initially does not assume and purportedly does not take subject to part or all of the mortgage or other indebtedness encumbering the property (“wrapped indebtedness”) and, instead, the buyer issues to the seller an installment obligation the principal amount of which reflects such wrapped indebtedness. Ordinarily, the seller will use payments received on the installment obligation to service the wrapped indebtedness. The wrapped indebtedness shall be deemed to have been taken subject to even though title to the property has not passed in the year of sale and even though the seller remains liable for payments on the wrapped indebtedness. In the hands of the seller, the wrap-around installment obligation shall have a basis equal to the seller's basis in the property which was the subject of the installment sale, increased by the amount of gain recognized in the year of sale, and decreased by the amount of cash and the fair market value of other nonqualifying property received in the year of sale. For purposes of this paragraph (b)(3)(ii), the amount of any indebtedness assumed or taken subject to by the buyer (other than wrapped indebtedness) is to be treated as cash received by the seller in

the year of sale. Therefore, except as otherwise required by section 483 or 1232, the gross profit ratio with respect to the wrap-around installment obligation is a fraction, the numerator of which is the face value of the obligation less the taxpayer's basis in the obligation and the denominator of which is the face value of the obligation.

(iii) *Standby letter of credit.* The term “standby letter of credit” means a non-negotiable, non-transferable (except together with the evidence of indebtedness which it secures) letter of credit, issued by a bank or other financial institution, which serves as a guarantee of the evidence of indebtedness which is secured by the letter of credit. Whether or not the letter of credit explicitly states it is non-negotiable and nontransferable, it will be treated as non-negotiable and nontransferable if applicable local law so provides. The mere right of the secured party (under applicable local law) to transfer the proceeds of a letter of credit shall be disregarded in determining whether the instrument qualifies as a standby letter of credit. A letter of credit is not a standby letter of credit if it may be drawn upon in the absence of default in payment of the underlying evidence of indebtedness.

(4) *Exceptions.* The term “installment sale” does not include, and the provisions of section 453 do not apply to, dispositions of personal property on the installment plan by a person who regularly sells or otherwise disposes of personal property on the installment plan, or to dispositions of personal property of a kind which is required to be included in the inventory of the taxpayer if on hand at the close of the taxable year. See section 453A and the regulations thereunder for rules relating to installment sales by dealers in personal property. A dealer in real property or a farmer who is not required under his method of accounting to maintain inventories may report the gain on the installment method under section 453.

(5) *Examples.* The following examples illustrate installment method reporting under this section:

#### Example (1).

In 1980, A, a calendar year taxpayer, sells Blackacre, an unencumbered capital asset in A's hands, to B for \$100,000: \$10,000 down and the remainder payable in equal annual installments over the next 9 years, together with adequate stated interest. A's basis in Blackacre, exclusive of selling expenses, is \$38,000. Selling expenses paid by A are \$2,000. Therefore, the gross profit is \$60,000 (\$100,000 selling price—\$40,000 basis inclusive of selling expenses). The gross profit ratio is  $\frac{3}{5}$  (gross profit of \$60,000 divided by \$100,000 contract price). Accordingly,  $\frac{3}{5}$  of \$10,000) of each \$10,000 payment received is gain attributable to the sale and \$4,000 (\$10,000—\$6,000) is recovery of basis. The interest received in addition to principal is ordinary income to A.

#### Example (2).

C sells Whiteacre to D for a selling price of \$160,000. Whiteacre is encumbered by a longstanding mortgage in the principal amount of \$60,000. D will assume or take subject to the \$60,000 mortgage and pay the remaining \$100,000 in 10 equal annual installments together with adequate stated interest. C's basis in Whiteacre is \$90,000. There are no selling expenses. The contract price is \$100,000, the \$160,000 selling price reduced by the mortgage of \$60,000 assumed or taken subject to. Gross profit is \$70,000 (\$160,000 selling price less C's basis of

\$90,000). C's gross profit ratio is 7/10 (gross profit of \$70,000 divided by \$100,000 contract price). Thus, \$7,000 (7/10 of \$10,000) of each \$10,000 annual payment is gain attributable to the sale, and \$3,000 (\$10,000–\$7,000) is recovery of basis.

#### **Example (3).**

The facts are the same as in example (2), except that C's basis in the land is \$40,000. In the year of the sale C is deemed to have received payment of \$20,000 (\$60,000–\$40,000, the amount by which the mortgage D assumed or took subject to exceeds C's basis). Since basis is fully recovered in the year of sale, the gross profit ratio is 1 (\$120,000/\$120,000) and C will report 100% of the \$20,000 deemed payment in the year of sale and each \$10,000 annual payment as gain attributable to the sale.

#### **Example (4).**

E sells Blackacre, an unencumbered capital gain property in E's hands, to F on January 2, 1981. F makes a cash down payment of \$500,000 and issues a note to E obliging F to pay an additional \$500,000 on the fifth anniversary date. The note does not require a payment of interest. In determining selling price, section 483 will apply to recharacterize as interest a portion of the \$500,000 future payment. Assume that under section 483 and the applicable regulations \$193,045 is treated as total unstated interest, and the selling price is \$806,955 (\$1 million less unstated interest). Assuming E's basis (including selling expenses) in Blackacre is \$200,000) gross profit is \$606,955 (\$806,955–\$200,000) and the gross profit ratio is 75.21547%. Accordingly, of the \$500,000 cash down payment received by E in 1981, \$376,077 (75.21547% of \$500,000) is gain attributable to the sale and \$123,923 is recovery of basis (\$500,000–\$376,077).

#### **Example (5).**

In 1982, G sells to H Blackacre, which is encumbered by a first mortgage with a principal amount of \$500,000 and a second mortgage with a principal amount of \$400,000, for a selling price of \$2 million. G's basis in Blackacre is \$700,000. Under the agreement between G and H, passage of title is deferred and H does not assume and purportedly does not take subject to either mortgage in the year of sale. H pays G \$200,000 in cash and issues a wrap-around mortgage note with a principal amount of \$1,800,000 bearing adequate stated interest. H is deemed to have acquired Blackacre subject to the first and second mortgages (wrapped indebtedness) totalling \$900,000. The contract price is \$1,300,000 (selling price of \$2 million less \$700,000 mortgages within the seller's basis assumed or taken subject to). Gross profit is also \$1,300,000 (selling price of \$2 million less \$700,000 basis). Accordingly in the year of sale, the gross profit ratio is 1 (\$1,300,000/\$1,300,000). Payment in the year of sale is \$400,000 (\$200,000 cash received plus \$200,000 mortgage in excess of basis (\$900,000–\$700,000)). Therefore, G recognizes \$400,000 gain in the year of sale (\$400,000 × 1). In the hands of G the wrap-around installment obligation has a basis of \$900,000, equal to G's basis in Blackacre (\$700,000) increased by the gain recognized by G in the year of sale (\$400,000) reduced by the cash received by G in the year of sale (\$200,000). G's gross profit with respect to the note is \$900,000 (\$1,800,000 face amount less \$900,000 basis in the note) and G's contract price with respect to the note is its face amount of \$1,800,000. Therefore, the gross profit ratio with respect to the note is 1/2 (\$900,000/\$1,800,000).

### Example (6).

The facts are the same as example (5) except that under the terms of the agreement H assumes the \$500,000 first mortgage on Blackacre. H does not assume and purportedly does not take subject to the \$400,000 second mortgage on Blackacre. The wrap-around installment obligation issued by H to G has a face amount of \$1,300,000. The tax results in the year of sale to G are the same as example (5) (\$400,000 payment received and gain recognized). In the hands of G, basis in the wrap-around installment obligation is \$400,000 (\$700,000 basis in Blackacre plus \$400,000 gain recognized in the year of sale minus \$700,000 (\$200,000 cash received and \$500,000 treated as cash received as a result of H's assumption of the first mortgage)). G's gross profit with respect to the note is \$900,000 (\$1,300,000 face amount of the wrap-around installment obligation less \$400,000 basis in that note) and G's contract price with respect to the note is its face value of \$1,300,000. Therefore, the gross profit ratio with respect to the note is 9/13 (\$900,000/\$1,300,000).

### Example (7).

A sells the stock of X corporation to B for a \$1 million installment obligation payable in equal annual installments over the next 10 years with adequate stated interest. The installment obligation is secured by a standby letter of credit (within the meaning of paragraph (b)(3)(iii) of this section) issued by M bank. Under the agreement between B and M bank, B is required to maintain a compensating balance in an account B maintains with M bank and is required by the M bank to post additional collateral, which may include cash or a cash equivalent, with M bank. Under neither the standby letter of credit nor any other agreement or arrangement is A granted a direct lien upon or other security interest in such cash or cash equivalent collateral. Receipt of B's installment obligation secured by the standby letter of credit will not be treated as the receipt of payment by A.

### Example (8).

The facts are the same as in example (7) except that the standby letter of credit is in the drawable sum of \$600,000. To secure fully its \$1 million note issued to A, B deposits in escrow \$400,000 in cash and Treasury bills. Under the escrow agreement, upon default in payment of the note A may look directly to the escrowed collateral. Receipt of B's installment obligation will be treated as the receipt payment by A in the sum of \$400,000.

## §1.461-1 GENERAL RULE FOR TAXABLE YEAR OF DEDUCTION.

### (a) *General rule* -

(1) *Taxpayer using cash receipts and disbursements method.* Under the cash receipts and disbursements method of accounting, amounts representing allowable deductions shall, as a general rule, be taken into account for the taxable year in which paid. Further, a taxpayer using this method may also be entitled to certain deductions in the computation of taxable income which do not involve cash disbursements during the taxable year, such as the deductions for depreciation, depletion, and losses under sections 167, 611, and 165, respectively. If an expenditure results in the creation of an asset having a useful life which extends substantially

beyond the close of the taxable year, such an expenditure may not be deductible, or may be deductible only in part, for the taxable year in which made. An example is an expenditure for the construction of improvements by the lessee on leased property where the estimated life of the improvements is in excess of the remaining period of the lease. In such a case, in lieu of the allowance for depreciation provided by section 167, the basis shall be amortized ratably over the remaining period of the lease. See section 178 and the regulations thereunder for rules governing the effect to be given renewal options in determining whether the useful life of the improvements exceeds the remaining term of the lease where a lessee begins improvements on leased property after July 28, 1958, other than improvements which on such date and at all times thereafter, the lessee was under a binding legal obligation to make. See section 263 and the regulations thereunder for rules relating to capital expenditures. See section 467 and the regulations thereunder for rules under which a liability arising out of the use of property pursuant to a section 467 rental agreement is taken into account.

(2) *Taxpayer using an accrual method -*

(i) *In general.* Under an accrual method of accounting, a liability (as defined in § 1.446-1(c)(1)(ii)(B)) is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. (See paragraph (a)(2)(iii)(A) of this section for examples of liabilities that may not be taken into account until a taxable year subsequent to the taxable year incurred, and see §§ 1.461-4 through 1.461-6 for rules relating to economic performance.) Applicable provisions of the Code, the Income Tax Regulations, and other guidance published by the Secretary prescribe the manner in which a liability that has been incurred is taken into account. For example, section 162 provides that the deductible liability generally is taken into account in the taxable year incurred through a deduction from gross income. As a further example, under section 263 or 263A, a liability that relates to the creation of an asset having a useful life extending substantially beyond the close of the taxable year is taken into account in the taxable year incurred through capitalization (within the meaning of § 1.263A-1(c)(3)), and may later affect the computation of taxable income through depreciation or otherwise over a period including subsequent taxable years, in accordance with applicable Internal Revenue Code sections and guidance published by the Secretary. The principles of this paragraph (a)(2) also apply in the calculation of earnings and profits and accumulated earnings and profits.

(ii) *Uncertainty as to the amount of a liability.* While no liability shall be taken into account before economic performance and all of the events that fix the liability have occurred, the fact that the exact amount of the liability cannot be determined does not prevent a taxpayer from taking into account that portion of the amount of the liability which can be computed with reasonable accuracy within the taxable year. For example, A renders services to B during the taxable year for which A charges \$10,000. B admits a liability to A for \$6,000 but contests the remainder. B may take into account only \$6,000 as an expense for the taxable year in which the services were rendered.

(iii) *Alternative timing rules.* (A) If any provision of the Code requires a liability to be taken into account in a taxable year later than the taxable year provided in paragraph (a)(2)(i) of

this section, the liability is taken into account as prescribed in that Code provision. See, for example, section 267 (transactions between related parties) and section 464 (farming syndicates).

(B) If the liability of a taxpayer is subject to section 170 (charitable contributions), section 192 (black lung benefit trusts), section 194A (employer liability trusts), section 468 (mining and solid waste disposal reclamation and closing costs), or section 468A (certain nuclear decommissioning costs), the liability is taken into account as determined under that section and not under section 461 or the regulations thereunder. For special rules relating to certain loss deductions, see sections 165(e), 165(i), and 165(l), relating to theft losses, disaster losses, and losses from certain deposits in qualified financial institutions.

(C) Section 461 and the regulations thereunder do not apply to any amount allowable under a provision of the Code as a deduction for a reserve for estimated expenses.

(D) Except as otherwise provided in any Internal Revenue regulations, revenue procedure, or revenue ruling, the economic performance requirement of section 461(h) and the regulations thereunder is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation), section 404A (certain foreign deferred compensation plans), or section 419 (welfare benefit funds). See § 1.461-4(d)(2)(iii).

(E) Except as otherwise provided by regulations or other published guidance issued by the Commissioner (See § 601.601(b)(2) of this chapter), in the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, the all events test (including economic performance) is considered met in the taxable year in which the liability is to be taken into account under section 467 and the regulations thereunder.

(3) *Effect in current taxable year of improperly accounting for a liability in a prior taxable year.* Each year's return should be complete in itself, and taxpayers shall ascertain the facts necessary to make a correct return. The expenses, liabilities, or loss of one year generally cannot be used to reduce the income of a subsequent year. A taxpayer may not take into account in a return for a subsequent taxable year liabilities that, under the taxpayer's method of accounting, should have been taken into account in a prior taxable year. If a taxpayer ascertains that a liability should have been taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file a claim for credit or refund of any overpayment of tax arising therefrom. Similarly, if a taxpayer ascertains that a liability was improperly taken into account in a prior taxable year, the taxpayer should, if within the period of limitation, file an amended return and pay any additional tax due. However, except as provided in section 905(c) and the regulations thereunder, if a liability is properly taken into account in an amount based on a computation made with reasonable accuracy and the exact amount of the liability is subsequently determined in a later taxable year, the difference, if any, between such amounts shall be taken into account for the later taxable year.

(4) *Deductions attributable to certain foreign income.* In any case in which, owing to monetary, exchange, or other restrictions imposed by a foreign country, an amount otherwise constituting gross income for the taxable year from sources without the United States is not includible in

gross income of the taxpayer for that year, the deductions and credits properly chargeable against the amount so restricted shall not be deductible in such year but shall be deductible proportionately in any subsequent taxable year in which such amount or portion thereof is includible in gross income. See paragraph (g) of § 1.905-1 for rules relating to credit for foreign income taxes when foreign income is subject to exchange controls.

## §1.461-4 ECONOMIC PERFORMANCE.

### (a) *Introduction* -

(1) *In general.* For purposes of determining whether an accrual basis taxpayer can treat the amount of any liability (as defined in § 1.446-1(c)(1)(ii)(B)) as incurred, the all events test is not treated as met any earlier than the taxable year in which economic performance occurs with respect to the liability.

(2) *Overview.* Paragraph (b) of this section lists exceptions to the economic performance requirement. Paragraph (c) of this section provides cross-references to the definitions of certain terms for purposes of section 461 (h) and the regulations thereunder. Paragraphs (d) through (m) of this section and § 1.461-6 provide rules for determining when economic performance occurs. Section 1.461-5 provides rules relating to an exception under which certain recurring items may be incurred for the taxable year before the year during which economic performance occurs.

(b) *Exceptions to the economic performance requirement.* Paragraph (a)(2)(iii)(B) of § 1.461-1 provides examples of liabilities that are taken into account under rules that operate without regard to the all events test (including economic performance).

(c) *Definitions.* The following cross-references identify certain terms defined for purposes of section 461(h) and the regulations thereunder:

(1) *Liability.* See paragraph (c)(1)(ii)(B)d of § 1.446-1 for the definition of “liability.”

(2) *Payment.* See paragraph (g)(1)(ii) of this section for the definition of “payment.”

### (d) *Liabilities arising out of the provision of services, property, or the use of property* -

(1) *In general.* The principles of this paragraph (d) determine when economic performance occurs with respect to liabilities arising out of the performance of services, the transfer of property, or the use of property. This paragraph (d) does not apply to liabilities described in paragraph (e) (relating to interest expense) or paragraph (g) (relating to breach of contract, workers compensation, tort, etc.) of this section. In addition, except as otherwise provided in Internal Revenue regulations, revenue procedures, or revenue rulings this paragraph (d) does not apply to amounts paid pursuant to a notional principal contract. The Commissioner may provide additional rules in regulations, revenue procedures, or revenue rulings concerning the time at which economic performance occurs for items described in this paragraph (d).



(2) *Services or property provided to the Taxpayer -*

(i) *In general.* Except as otherwise provided in paragraph (d)(5) of this section, if the liability of a taxpayer arises out of the providing of services or property to the taxpayer by another person, economic performance occurs as the services or property is provided.

(ii) *Long-term contracts.* In the case of any liability of a taxpayer described in paragraph (d)(2)(i) of this section that is an expense attributable to a long-term contract with respect to which the taxpayer uses the percentage of completion method, economic performance occurs -

(A) As the services or property is provided; or, if earlier,

(B) As the taxpayer makes payment (as defined in paragraph (g)(1)(ii) of this section) in satisfaction of the liability to the person providing the services or property. See paragraph (k)(2) of this section for the effective date of this paragraph (d)(2)(ii).

(iii) *Employee benefits -*

(A) *In general.* Except as otherwise provided in any Internal Revenue regulation, revenue procedure, or revenue ruling, the economic performance requirement is satisfied to the extent that any amount is otherwise deductible under section 404 (employer contributions to a plan of deferred compensation), section 404A (certain foreign deferred compensation plans), and section 419 (welfare benefit funds). See § 1.461-1(a)(2)(iii)(D).

(B) *Property transferred in connection with performance of services.* [Reserved]

(iv) *Cross-references.* See *Examples 4* through *6* of paragraph (d)(7) of this section. See paragraph (d)(6) of this section for rules relating to when a taxpayer may treat services or property as provided to the taxpayer.

(3) *Use of property provided to the taxpayer -*

(i) *In general.* Except as otherwise provided in this paragraph (d)(3)d and paragraph (d)(5) of this section, if the liability of a taxpayer arises out of the use of property by the taxpayer, economic performance occurs ratably over the period of time the taxpayer is entitled to the use of the property (taking into account any reasonably expected renewal periods when necessary to carry out the purposes of section 461(h)). See *Examples 6* through *9* of paragraph (d)(7) of this section.

(ii) *Exceptions -*

(A) *Volume, frequency of use, or income.* If the liability of a taxpayer arises out of the use of property by the taxpayer and all or a portion of the liability is determined by reference to the frequency or volume of use of the property or the income from the property, economic performance occurs for the portion of the liability determined by reference to the frequency or volume of use of the property or the income from the property as the taxpayer uses the

property or includes income from the property. See *Examples 8 and 9* of paragraph (d)(7) of this section. This paragraph (d)(3)(ii) shall not apply if the District Director determines, that based on the substance of the transaction, the liability of the taxpayer for use of the property is more appropriately measured ratably over the period of time the taxpayer is entitled to the use of the property.

(B) *Section 467 rental agreements.* In the case of a liability arising out of the use of property pursuant to a section 467 rental agreement, economic performance occurs as provided in § 1.461-1(a)(2)(iii)(E).

(4) *Services or property provided by the taxpayer -*

(i) *In general.* Except as otherwise provided in paragraph (d)(5) of this section, if the liability of a taxpayer requires the taxpayer to provide services or property to another person, economic performance occurs as the taxpayer incurs costs (within the meaning of § 1.446-1(c)(1)(ii)) in connection with the satisfaction of the liability. See *Examples 1 through 3* of paragraph (d)(7) of this section.

(ii) *Barter transactions.* If the liability of a taxpayer requires the taxpayer to provide services, property, or the use of property, and arises out of the use of property by the taxpayer, or out of the provision of services or property to the taxpayer by another person, economic performance occurs to the extent of the lesser of -

(A) The cumulative extent to which the taxpayer incurs costs (within the meaning of § 1.446-1(c)(1)(ii)) in connection with its liability to provide the services or property; or

(B) The cumulative extent to which the services or property is provided to the taxpayer.

(5) *Liabilities that are assumed in connection with the sale of a trade or business -*

(i) *In general.* If, in connection with the sale or exchange of a trade or business by a taxpayer, the purchaser expressly assumes a liability arising out of the trade or business that the taxpayer but for the economic performance requirement would have been entitled to incur as of the date of the sale, economic performance with respect to that liability occurs as the amount of the liability is properly included in the amount realized on the transaction by the taxpayer. See § 1.1001-2 for rules relating to the inclusion in amount realized from a discharge of liabilities resulting from a sale or exchange.

(ii) *Trade or business.* For purposes of this paragraph (d)(5), a trade or business is a specific group of activities carried on by the taxpayer for the purpose of earning income or profit if every operation that is necessary to the process of earning income or profit is included in the group. Thus, for example, the group of activities generally must include the collection of income and the payment of expenses.

(iii) *Tax avoidance.* This paragraph (d)(5) does not apply if the District Director determines that tax avoidance is one of the taxpayer's principal purposes for the sale or exchange.

(6) *Rules relating to the provision of services or property to a taxpayer.* The following rules apply for purposes of this paragraph (d):

(i) Services or property provided to a taxpayer include services or property provided to another person at the direction of the taxpayer.

(ii) A taxpayer is permitted to treat services or property as provided to the taxpayer as the taxpayer makes payment to the person providing the services or property (as defined in paragraph (g)(1)(ii) of this section), if the taxpayer can reasonably expect the person to provide the services or property within 31/2 months after the date of payment.

(iii) A taxpayer is permitted to treat property as provided to the taxpayer when the property is delivered or accepted, or when title to the property passes. The method used by the taxpayer to determine when property is provided is a method of accounting that must comply with the rules of § 1.446-1(e). Thus, the method of determining when property is provided must be used consistently from year to year, and cannot be changed without the consent of the Commissioner.

(iv) If different services or items of property are required to be provided to a taxpayer under a single contract or agreement, economic performance generally occurs over the time each service is provided and as each item of property is provided. However, if a service or item of property to be provided to the taxpayer is incidental to other services or property to be provided under a contract or agreement, the taxpayer is not required to allocate any portion of the total contract price to the incidental service or property. For purposes of this paragraph (d)(6)(iv), services or property is treated as incidental only if -

(A) The cost of the services or property is treated on the taxpayer's books and records as part of the cost of the other services or property provided under the contract; and

(B) The aggregate cost of the services or property does not exceed 10 percent of the total contract price.

(7) *Examples.* The following examples illustrate the principles of this paragraph (d). For purposes of these examples, it is assumed that the requirements of the all events test other than economic performance have been met, and that the recurring item exception is not used. Assume further that the examples do not involve section 467 rental agreements and, therefore, section 467 is not applicable. The examples are as follows:

**Example 1. Services or property provided by the taxpayer.**

(i) X corporation, a calendar year, accrual method taxpayer, is an oil company. During March 1990, X enters into an oil and gas lease with Y. In November 1990, X installs a platform and commences drilling. The lease obligates X to remove its offshore platform and well fixtures upon abandonment of the well or termination of the lease. During 1998, X removes the platform and well fixtures at a cost of \$200,000.

(ii) Under paragraph (d)(4)(i) of this section, economic performance with respect to X's liability

to remove the offshore platform and well fixtures occurs as X incurs costs in connection with that liability. X incurs these costs in 1998 as, for example, X's employees provide X with removal services (see paragraph (d)(2) of this section). Consequently, X incurs \$200,000 for the 1998 taxable year. Alternatively, assume that during 1990 X pays Z \$130,000 to remove the platform and fixtures, and that Z performs these removal services in 1998. Under paragraph (d)(2) of this section, X does not incur this cost until Z performs the services. Thus, economic performance with respect to the \$130,000 X pays Z occurs in 1998.

**Example 2. Services or property provided by the taxpayer.**

- (i) W corporation, a calendar year, accrual method taxpayer, sells tractors under a three-year warranty that obligates W to make any reasonable repairs to each tractor it sells. During 1990, W sells ten tractors. In 1992 W repairs, at a cost of \$5,000, two tractors sold during 1990.
- (ii) Under paragraph (d)(4)(i) of this section, economic performance with respect to W's liability to perform services under the warranty occurs as W incurs costs in connection with that liability. W incurs these costs in 1992 as, for example, replacement parts are provided to W (see paragraph (d)(2) of this section). Consequently, \$5,000 is incurred by W for the 1992 taxable year.

**Example 3. Services or property provided by the taxpayer; Long-term contracts.**

- (i) W corporation, a calendar year, accrual method taxpayer, manufactures machine tool equipment. In November 1992, W contracts to provide X corporation with certain equipment. The contract is not a long-term contract under section 460 or § 1.451-3. In 1992, W pays Z corporation \$50,000 to lease from Z, for the one-year period beginning on January 1, 1993, testing equipment to perform quality control tests required by the agreement with X. In 1992, pursuant to the terms of a contract, W pays Y corporation \$100,000 for certain parts necessary to manufacture the equipment. The parts are provided to W in 1993. W's employees provide W with services necessary to manufacture the equipment during 1993, for which W pays \$150,000 in 1993.
- (ii) Under paragraph (d)(4) of this section, economic performance with respect to W's liability to provide the equipment to X occurs as W incurs costs in connection with that liability. W incurs these costs during 1993, as services, property, and the use of property necessary to manufacture the equipment are provided to W (see paragraphs (d)(2) and (d)(3) of this section). Thus, \$300,000 is incurred by W for the 1993 taxable year. See section 263A and the regulations thereunder for rules relating to the capitalization and inclusion in inventory of these incurred costs.
- (iii) Alternatively, assume that the agreement with X is a long-term contract as defined in section 460(f), and that W takes into account all items with respect to such contracts under the percentage of completion method as described in section 460(b)(1). Under paragraph (d)(2)(ii) of this section, the \$100,000 W pays in 1992 for parts is incurred for the 1992 taxable year, for purposes of determining the percentage of completion under section 460(b)(1)(A). W's other costs under the agreement are incurred for the 1993 taxable year for this purpose.

**Example 4. Services or property provided to the taxpayers.**

(i) LP1, a calendar year, accrual method limited partnership, owns the working interest in a parcel of property containing oil and gas. During December 1990, LP1 enters into a turnkey contract with Z corporation pursuant to which LP1 pays Z \$200,000 and Z is required to provide a completed well by the close of 1992. In May 1992, Z commences drilling the well, and, in December 1992, the well is completed.

(ii) Under paragraph (d)(2) of this section, economic performance with respect to LP1's liability for drilling and development services provided to LP1 by Z occurs as the services are provided. Consequently, \$200,000 is incurred by LP1 for the 1992 taxable year.

**Example 5. Services or property provided to the taxpayer.**

(i) X corporation, a calendar year, accrual method taxpayer, is an automobile dealer. On January 15, 1990, X agrees to pay an additional \$10 to Y, the manufacturer of the automobiles, for each automobile purchased by X from Y. Y agrees to provide advertising and promotional activities to X.

(ii) During 1990, X purchases from Y 1,000 new automobiles and pays to Y an additional \$10,000 as provided in the agreement. Y, in turn, uses this \$10,000 to provide advertising and promotional activities during 1992.

(iii) Under paragraph (d)(2) of this section, economic performance with respect to X's liability for advertising and promotional services provided to X by Y occurs as the services are provided. Consequently, \$10,000 is incurred by X for the 1992 taxable year.

**Example 6. Use of property provided to the taxpayer; services or property provided to the taxpayer.**

(i) V corporation, a calendar year, accrual method taxpayer, charts aircrafts. On December 20, 1990, V leases a jet aircraft from L for the four-year period that begins on January 1, 1991. The lease obligates V to pay L a base rental of \$500,000 per year. In addition, the lease requires V to pay \$25 to an escrow account for each hour that the aircraft is flown. The escrow account funds are held by V and are to be used by L to make necessary repairs to the aircraft. Any amount remaining in the escrow account upon termination of the lease is payable to V. During 1991, the aircraft is flown 1,000 hours and V pays \$25,000 to the escrow account. The aircraft is repaired by L in 1993. In 1994, \$20,000 is released from the escrow account to pay L for the repairs.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to V's base rental liability occurs ratably over the period of time V is entitled to use the jet aircraft. Consequently, the \$500,000 rent is incurred by V for the 1991 taxable year and for each of the next three taxable years. Under paragraph (d)(2) of this section, economic performance with respect to the liability to place amounts in escrow occurs as the aircraft is repaired. Consequently, V incurs \$20,00 for the 1993 taxable year.

**Example 7. Use of property provided to the taxpayer.**

(i) X corporation, a calendar year, accrual method taxpayer, manufactures and sells electronic circuitry. On November 15, 1990, X enters into a contract with Y that entitles X to the exclusive

use of a product owned by Y for the five-year period beginning on January 1, 1991. Pursuant to the contract, X pays Y \$100,000 on December 30, 1990.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to X's liability for the use of property occurs ratably over the period of time X is entitled to use the product. Consequently, \$20,000 is incurred by X for 1991 and for each of the succeeding four taxable years.

**Example 8. Use of property provided to the taxpayer.**

(i) Y corporation, a calendar year, accrual method taxpayer, enters into a five-year lease with Z for the use of a copy machine on July 1, 1991. Y also receives delivery of the copy machine on July 1, 1991. The lease obligates Y to pay Z a base rental payment of \$6,000 per year at the beginning of each lease year and an additional charge of 5 cents per copy 30 days after the end of each lease year. The machine is used to make 50,000 copies during the first lease year: 20,000 copies in 1991 and 30,000 copies from January 1, 1992, to July 1, 1992. Y pays the \$6,000 base rental payment to Z on July 1, 1991, and the \$2,500 variable use payment on July 30, 1992.

(ii) under paragraph (d)(3)(i) of this section, economic performance with respect to Y's base rental liability occurs ratably over the period of time Y is entitled to use the copy machine. Consequently, \$3,000 rent is incurred by Y for the 1991 taxable year. Under paragraph (d)(3)(ii) of this section, economic performance with respect to Y's variable use portion of the liability occurs as Y uses the machine. Thus, the \$1,000 of the \$2,500 variable-use liability that relates to the 20,000 copies made in 1991 is incurred by Y for the 1991 taxable year.

**Example 9. Use of property provided to the taxpayer.**

(i) X corporation, a calendar year, accrual method taxpayer, enters into a five-year product distribution agreement with Y, on January 1, 1992. The agreement provides for a payment of \$100,000 on January 1, 1992, plus 10 percent of the gross profits earned by X from distribution of the product. The variable income portion of X's liability is payable on April 1 of each subsequent year. On January 1, 1992, X pays Y \$100,000. On April 1, 1993, X pays Y \$3 million representing 10 percent of X's gross profits from January 1 through December 31, 1992.

(ii) Under paragraph (d)(3)(i) of this section, economic performance with respect to X's \$100,000 payment occurs ratably over the period of time X is entitled to use the product. Consequently, \$20,000 is incurred by X for each year of the agreement beginning with 1992. Under paragraph (d)(3)(ii) of this section, economic performance with respect to X's variable income portion of the liability occurs as the income is earned by X. Thus, the \$3 million variable-income liability is incurred by X for the 1992 taxable year.

(e) *Interest.* In the case of interest, economic performance occurs as the interest cost economically accrues, in accordance with the principles of relevant provisions of the Code.

(f) *Timing of deductions from notional principal contracts.* Economic performance on a notional principal contract occurs as provided under § 1.446-3.

(g) *Certain liabilities for which payment is economic performance -*

(1) *In general* -

(i) *Person to which payment must be made.* In the case of liabilities described in paragraphs (g) (2) through (7) of this section, economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed. Thus, except as otherwise provided in paragraph (g)(1)(iv) of this section and § 1.461-6, economic performance does not occur as a taxpayer makes payments in connection with such a liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed under paragraph (g)(1)(ii)(B) of this section. Instead, economic performance occurs as payments are made from that other person or fund to the person to which the liability is owed. The amount of economic performance that occurs as payment is made from the other person or fund to the person to which the liability is owed may not exceed the amount the taxpayer transferred to the other person or fund. For special rules relating to the taxation of amounts transferred to “qualified settlement funds,” see section 468B and the regulations thereunder. The Commissioner may provide additional rules in regulations, revenue procedures, and revenue rulings concerning the time at which economic performance occurs for items described in this paragraph (g).

(ii) *Payment to person to which liability is owed.* Paragraph (d)(6) of this section provides that for purposes of paragraph (d) of this section (relating to the provision of services or property to the taxpayer) in certain cases a taxpayer may treat services or property as provided to the taxpayer as the taxpayer makes payments to the person providing the services or property. In addition, this paragraph (g) provides that in the case of certain liabilities of a taxpayer, economic performance occurs as the taxpayer makes payment to persons specified therein. For these and all other purposes of section 461(h) and the regulations thereunder:

(A) *Payment.* The term *payment* has the same meaning as is used when determining whether a taxpayer using the cash receipts and disbursements method of accounting has made a payment. Thus, for example, payment includes the furnishing of cash or cash equivalents and the netting of offsetting accounts. Payment does not include the furnishing of a note or other evidence of indebtedness of the taxpayer, whether or not the evidence is guaranteed by any other instrument (including a standby letter of credit) or by any third party (including a government agency). As a further example, payment does not include a promise of the taxpayer to provide services or property in the future (whether or not the promise is evidenced by a contract or other written agreement). In addition, payment does not include an amount transferred as a loan, refundable deposit, or contingent payment.

(B) *Person to which payment is made.* Payment to a particular person is accomplished if paragraph (g)(1)(ii)(A) of this section is satisfied and a cash basis taxpayer in the position of that person would be treated as having actually or constructively received the amount of the payment as gross income under the principles of section 451 (without regard to section 104(a) or any other provision that specifically excludes the amount from gross income). Thus, for example, the purchase of an annuity contract or any other asset generally does not constitute payment to the person to which a liability is owed unless the ownership of the contract or other asset is transferred to that person.

(C) *Liabilities that are assumed in connection with the sale of a trade or business.*

Paragraph (d)(5) of this section provides rules that determine when economic performance occurs in the case of liabilities that are assumed in connection with the sale of a trade or business. The provisions of paragraph (d)(5) of this section also apply to any liability described in paragraph (g) (2) through (7) of this section that the purchaser expressly assumes in connection with the sale or exchange of a trade or business by a taxpayer, provided the taxpayer (but for the economic performance requirement) would have been entitled to incur the liability as of the date of the sale.

(iii) *Person.* For purposes of this paragraph (g), “person” has the same meaning as in section 7701(a)(1), except that it also includes any foreign state, the United States, any State or political subdivision thereof, any possession of the United States, and any agency or instrumentality of any of the foregoing.

(iv) *Assignments.* If a person that has a right to receive payment in satisfaction of a liability described in paragraphs (g) (2) through (7) of this section makes a valid assignment of that right to a second person, or if the right is assigned to the second person through operation of law, then payment to the second person in satisfaction of that liability constitutes payment to the person to which the liability is owed.

(2) *Liabilities arising under a workers compensation act or out of any tort, breach of contract, or violation of law.* If the liability of a taxpayer requires a payment or series of payments to another person and arises under any workers compensation act or out of any tort, breach of contract, or violation of law, economic performance occurs as payment is made to the person to which the liability is owed. See *Example 1* of paragraph (g)(8) of this section. For purposes of this paragraph (g)(2) -

(i) A liability to make payments for services, property, or other consideration provided under a contract is not a liability arising out of a breach of that contract unless the payments are in the nature of incidental, consequential, or liquidated damages; and

(ii) A liability arising out of a tort, breach of contract, or violation of law includes a liability arising out of the settlement of a dispute in which a tort, breach of contract, or violation of law, respectively, is alleged.

(3) *Rebates and refunds.* If the liability of a taxpayer is to pay a rebate, refund, or similar payment to another person (whether paid in property, money, or as a reduction in the price of goods or services to be provided in the future by the taxpayer), economic performance occurs as payment is made to the person to which the liability is owed. This paragraph (g)(3) applies to all rebates, refunds, and payments or transfers in the nature of a rebate or refund regardless of whether they are characterized as a deduction from gross income, an adjustment to gross receipts or total sales, or an adjustment or addition to cost of goods sold. In the case of a rebate or refund made as a reduction in the price of goods or services to be provided in the future by the taxpayer, “payment” is deemed to occur as the taxpayer would otherwise be required to recognize income resulting from a disposition at an unreduced price. See *Example 2* of paragraph (g)(8) of this section. For purposes of determining whether the recurring item exception of § 1.461-5 applies, a liability that arises out of a tort, breach of contract, or



violation of law is not considered a rebate or refund.

(4) *Awards, prizes, and jackpots.* If the liability of a taxpayer is to provide an award, prize, jackpot, or other similar payment to another person, economic performance occurs as payment is made to the person to which the liability is owed. See *Examples 3 and 4* of paragraph (g)(8) of this section.

(5) *Insurance, warranty, and service contracts.* If the liability of a taxpayer arises out of the provision to the taxpayer of insurance, or a warranty or service contract, economic performance occurs as payment is made to the person to which the liability is owed. See *Examples 5 through 7* of paragraph (g)(8) of this section. For purposes of this paragraph (g)(5) -

(i) A warranty or service contract is a contract that a taxpayer enters into in connection with property bought or leased by the taxpayer, pursuant to which the other party to the contract promises to replace or repair the property under specified circumstances.

(ii) The term “insurance” has the same meaning as is used when determining the deductibility of amounts paid or incurred for insurance under section 162.

(6) *Taxes -*

(i) *In general.* Except as otherwise provided in this paragraph (g)(6), if the liability of a taxpayer is to pay a tax, economic performance occurs as the tax is paid to the governmental authority that imposed the tax. For purposes of this paragraph (g)(6), payment includes payments of estimated income tax and payments of tax where the taxpayer subsequently files a claim for credit or refund. In addition, for purposes of this paragraph (g)(6), a tax does not include a charge collected by a governmental authority for specific extraordinary services or property provided to a taxpayer by the governmental authority. Examples of such a charge include the purchase price of a parcel of land sold to a taxpayer by a governmental authority and a charge for labor engaged in by government employees to improve that parcel. In certain cases, a liability to pay a tax is permitted to be taken into account in the taxable year before the taxable year during which economic performance occurs under the recurring item exception of § 1.461-5. See *Example 8* of paragraph (g)(8) of this section.

(ii) *Licensing fees.* If the liability of a taxpayer is to pay a licensing or permit fee required by a governmental authority, economic performance occurs as the fee is paid to the governmental authority, or as payment is made to any other person at the direction of the governmental authority.

(iii) *Exceptions -*

(A) *Real property taxes.* If a taxpayer has made a valid election under section 461 (c), the taxpayer's accrual for real property taxes is determined under section 461 (c). Otherwise, economic performance with respect to a property tax liability occurs as the tax is paid, as specified in paragraph (g)(6)(i) of this section.

(B) *Certain foreign taxes.* If the liability of a taxpayer is to pay an income, war profits, or

excess profits tax that is imposed by the authority of any foreign country or possession of the United States and is creditable under section 901 (including a creditable tax described in section 903 that is paid in lieu of such a tax), economic performance occurs when the requirements of the all events test (as described in § 1.446-1 (c)(1)(ii)) other than economic performance are met, whether or not the taxpayer elects to credit such taxes under section 901 (a).

(7) *Other liabilities.* In the case of a taxpayer's liability for which economic performance rules are not provided elsewhere in this section or in any other Internal Revenue regulation, revenue ruling or revenue procedure, economic performance occurs as the taxpayer makes payments in satisfaction of the liability to the person to which the liability is owed. This paragraph (g)(7) applies only if the liability cannot properly be characterized as a liability covered by rules provided elsewhere in this section. If a liability may properly be characterized as, for example, a liability arising from the provision of services or property to, or by, a taxpayer, the determination as to when economic performance occurs with respect to that liability is made under paragraph (d) of this section and not under this paragraph (g)(7).

(8) *Examples.* The following examples illustrate the principles of this paragraph (g). For purposes of these examples, it is assumed that the requirements of the all events test other than economic performance have been met and, except as otherwise provided, that the recurring item exception is not used.

#### **Example 1. Liabilities arising out of a tort.**

(i) During the period 1970 through 1975, Z corporation, a calendar year, accrual method taxpayer, manufactured and distributed industrial products that contained carcinogenic substances. In 1992, a number of lawsuits are filed against Z alleging damages due to exposure to these products. In settlement of a lawsuit maintained by A, Z agrees to purchase an annuity contract that will provide annual payments to A of \$50,000 for a period of 25 years. On December 15, 1992, Z pays W, an unrelated life insurance company, \$491,129 for such an annuity contract. Z retains ownership of the annuity contract.

(ii) Under paragraph (g)(2) of this section, economic performance with respect to Z's liability to A occurs as each payment is made to A. Consequently, \$50,000 is incurred by Z for each taxable year that a payment is made to A under the annuity contract. (Z must also include in income a portion of amounts paid under the annuity, pursuant to section 72.) The result is the same if in 1992 Z secures its obligation with a standby letter of credit.

(iii) If Z later transfers ownership of the annuity contract to A, an amount equal to the fair market value of the annuity on the date of transfer is incurred by Z in the taxable year of the transfer (see paragraph (g)(1)(ii)(B) of this section). In addition, the transfer constitutes a transaction to which section 1001 applies.

#### **Example 2. Rebates and refunds.**

(i) X corporation, a calendar year, accrual method taxpayer, manufactures and sells hardware products. X enters into agreements that entitle each of its distributors to a rebate (or discount on future purchases) from X based on the amount of purchases made by the distributor from X

during any calendar year. During the 1992 calendar year, X becomes liable to pay a \$2,000 rebate to distributor A. X pays A \$1,200 of the rebate on January 15, 1993, and the remaining \$800 on October 15, 1993. Assume the rebate is deductible (or allowable as an adjustment to gross receipts or cost of goods sold) when incurred.

(ii) If X does not adopt the recurring item exception described in § 1.461-5 with respect to rebates and refunds, then under paragraph (g)(3) of this section, economic performance with respect to the \$2,000 rebate liability occurs in 1993. However, if X has made a proper election under § 1.461-5, and as of December 31, 1992, all events have occurred that determine the fact of the rebate liability, X incurs \$1,200 for the 1992 taxable year. Because economic performance (payment) with respect to the remaining \$800 does not occur until October 15, 1993 (more than 8½ months after the end of 1992), X cannot use the recurring item exception for this portion of the liability (see § 1.461-5). Thus, the \$800 is not incurred by X until the 1993 taxable year. If, instead of making the cash payments to A during 1993, X adjusts the price of hardware purchased by A that is delivered to A during 1993, X's "payment" occurs as X would otherwise be required to recognize income resulting from a disposition at an unreduced price.

### **Example 3. Awards, prizes, and jackpots.**

(i) W corporation, a calendar year, accrual method taxpayer, produces and sells breakfast cereal. W conducts a contest pursuant to which the winner is entitled to \$10,000 per year for a period of 20 years. On December 1, 1992, A is declared the winner of the contest and is paid \$10,000 by W. In addition, on December 1 of each of the next nineteen years, W pays \$10,000 to A.

(ii) Under paragraph (g)(4) of this section, economic performance with respect to the \$200,000 contest liability occurs as each of the \$10,000 payments is made by W to A. Consequently, \$10,000 is incurred by W for the 1992 taxable year and for each of the succeeding nineteen taxable years.

### **Example 4. Awards, prizes, and jackpots.**

(i) Y corporation, a calendar year, accrual method taxpayer, owns a casino that contains progressive slot machines. A progressive slot machine provides a guaranteed jackpot amount that increases as money is gambled through the machine until the jackpot is won or until a maximum predetermined amount is reached. On July 1, 1993, the guaranteed jackpot amount on one of Y's slot machines reaches the maximum predetermined amount of \$50,000. On October 1, 1994, the \$50,000 jackpot is paid to B.

(ii) Under paragraph (g)(4) of this section, economic performance with respect to the \$50,000 jackpot liability occurs on the date the jackpot is paid to B. Consequently, \$50,000 is incurred by Y for the 1994 taxable year.

### **Example 5. Insurance, warranty, and service contracts.**

(i) V corporation, a calendar year, accrual method taxpayer, manufactures toys. V enters into a contract with W, an unrelated insurance company, on December 15, 1992. The contract obligates V to pay W a premium of \$500,000 before the end of 1995. The contract obligates W to satisfy any liability of V resulting from claims made during 1993 or 1994 against V by any third party

for damages attributable to defects in toys manufactured by V. Pursuant to the contract, V pays W a premium of \$500,000 on October 1, 1995.

(ii) Assuming the arrangement constitutes insurance, under paragraph (g)(5) of this section economic performance occurs as the premium is paid. Thus, \$500,000 is incurred by V for the 1995 taxable year.

**Example 6. Insurance, warranty, and service contracts.**

(i) Y corporation, a calendar year, accrual method taxpayer, is a common carrier. On December 15, 1992, Y enters into a contract with Z, an unrelated insurance company, under which Z must satisfy any liability of Y that arises during the succeeding 5 years for damages under a workers compensation act or out of any tort, provided the event that causes the damages occurs during 1993 or 1994. Under the contract, Y pays \$360,000 to Z on December 31, 1993.

(ii) Assuming the arrangement constitutes insurance, under paragraph (g)(5) of this section economic performance occurs as the premium is paid. Consequently, \$360,000 is incurred by Y for the 1993 taxable year. The period for which the \$360,000 amount is permitted to be taken into account is determined under the capitalization rules because the insurance contract is an asset having a useful life extending substantially beyond the close of the taxable year.

**Example 7. Insurance, warranty, and service contracts.**

Assume the same facts as in *Example 6*, except that Y is obligated to pay the first \$5,000 of any damages covered by the arrangement with Z. Y is, in effect, self-insured to the extent of this \$5,000 “deductible.” Thus, under paragraph (g)(2) of this section, economic performance with respect to the \$5,000 liability does not occur until the amount is paid to the person to which the tort or workers compensation liability is owed.

**Example 8. Taxes.**

(i) The laws of State A provide that every person owning personal property located in State A on the first day of January shall be liable for tax thereon and that a lien for the tax shall attach as of that date. In addition, the laws of State A provide that 60% of the tax is due on the first day of December following the lien date and the remaining 40% is due on the first day of July of the succeeding year. On January 1, 1992, X corporation, a calendar year, accrual method taxpayer, owns personal property located in State A. State A imposes a \$10,000 tax on S with respect to that property on January 1, 1992. X pays State A \$6,000 of the tax on December 1, 1992, and the remaining \$4,000 on July 1, 1993.

(ii) Under paragraph (g)(6) of this section, economic performance with respect to \$6,000 of the tax liability occurs on December 1, 1992. Consequently, \$6,000 is incurred by X for the 1992 taxable year. Economic performance with respect to the remaining \$4,000 of the tax liability occurs on July 1, 1993. If X has adopted the recurring item exception described in § 1.461-5 as a method of accounting for taxes, and as of December 31, 1992, all events have occurred that determine the liability of X for the remaining \$4,000, X also incurs \$4,000 for the 1992 taxable year. If X does not adopt the recurring item exception method, the \$4,000 is not incurred by X until the 1993 taxable year.

## §1.1001-1 COMPUTATION OF GAIN OR LOSS.

### *(e) Transfers in part a sale and in part a gift.*

(1) Where a transfer of property is in part a sale and in part a gift, the transferor has a gain to the extent that the amount realized by him exceeds his adjusted basis in the property. However, no loss is sustained on such a transfer if the amount realized is less than the adjusted basis. For the determination of basis of property in the hands of the transferee, see § 1.1015-4. For the allocation of the adjusted basis of property in the case of a bargain sale to a charitable organization, see § 1.1011-2.

(2) *Examples.* The provisions of subparagraph (1) may be illustrated by the following examples:

#### **Example 1.**

A transfers property to his son for \$60,000. Such property in the hands of A has an adjusted basis of \$30,000 (and a fair market value of \$90,000). A's gain is \$30,000, the excess of \$60,000, the amount realized, over the adjusted basis, \$30,000. He has made a gift of \$30,000, the excess of \$90,000, the fair market value, over the amount realized, \$60,000.

#### **Example 2.**

A transfers property to his son for \$30,000. Such property in the hands of A has an adjusted basis of \$60,000 (and a fair market value of \$90,000). A has no gain or loss, and has made a gift of \$60,000, the excess of \$90,000, the fair market value, over the amount realized, \$30,000.

#### **Example 3.**

A transfers property to his son for \$30,000. Such property in A's hands has an adjusted basis of \$30,000 (and a fair market value of \$60,000). A has no gain and has made a gift of \$30,000, the excess of \$60,000, the fair market value, over the amount realized, \$30,000.

#### **Example 4.**

A transfers property to his son for \$30,000. Such property in A's hands has an adjusted basis of \$90,000 (and a fair market value of \$60,000). A has sustained no loss, and has made a gift of \$30,000, the excess of \$60,000, the fair market value, over the amount realized, \$30,000.

## §1.1001-2 DISCHARGE OF LIABILITIES.

### *(a) Inclusion in amount realized -*

(1) *In general.* Except as provided in paragraph (a) (2) and (3) of this section, the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.

(2) *Discharge of indebtedness.* The amount realized on a sale or other disposition of property that secures a recourse liability does not include amounts that are (or would be if realized and recognized) income from the discharge of indebtedness under section 61(a)(12). For situations where amounts arising from the discharge of indebtedness are not realized and recognized, see section 108 and § 1.61-12(b)(1).

(3) *Liability incurred on acquisition.* In the case of a liability incurred by reason of the acquisition of the property, this section does not apply to the extent that such liability was not taken into account in determining the transferor's basis for such property.

(4) *Special rules.* For purposes of this section -

(i) The sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability;

(ii) The sale or other disposition of property that secures a recourse liability discharges the transferor from the liability if another person agrees to pay the liability (whether or not the transferor is in fact released from liability);

(iii) A disposition of property includes a gift of the property or a transfer of the property in satisfaction of liabilities to which it is subject;

(iv) Contributions and distributions of property between a partner and a partnership are not sales or other dispositions of property; and

(v) The liabilities from which a transferor is discharged as a result of the sale or disposition of a partnership interest include the transferor's share of the liabilities of the partnership.

(b) *Effect of fair market value of security.* The fair market value of the security at the time of sale or disposition is not relevant for purposes of determining under paragraph (a) of this section the amount of liabilities from which the taxpayer is discharged or treated as discharged. Thus, the fact that the fair market value of the property is less than the amount of the liabilities it secures does not prevent the full amount of those liabilities from being treated as money received from the sale or other disposition of the property. However, see paragraph (a)(2) of this section for a rule relating to certain income from discharge of indebtedness.

(c) *Examples.* The provisions of this section may be illustrated by the following examples. In each example assume the taxpayer uses the cash receipts and disbursements method of accounting, makes a return on the basis of the calendar year, and sells or disposes of all property which is security for a given liability.

#### **Example 1.**

In 1976 A purchases an asset for \$10,000. A pays the seller \$1,000 in cash and signs a note payable to the seller for \$9,000. A is personally liable for repayment with the seller having full recourse in the event of default. In addition, the asset which was purchased is pledged as security. During the years 1976 and 1977, A takes depreciation deductions on the asset in the amount of

\$3,100. During this same time period A reduces the outstanding principal on the note to \$7,600. At the beginning of 1978 A sells the asset. The buyer pays A \$1,600 in cash and assumes personal liability for the \$7,600 outstanding liability. A becomes secondarily liable for repayment of the liability. A's amount realized is \$9,200 (\$1,600 + \$7,600). Since A's adjusted basis in the asset is \$6,900 (\$10,000 – \$3,100) A realizes a gain of \$2,300 (\$9,200 – \$6,900).

#### **Example 2.**

Assume the same facts as in example (1) except that A is not personally liable on the \$9,000 note given to the seller and in the event of default the seller's only recourse is to the asset. In addition, on the sale of the asset by A, the purchaser takes the asset subject to the liability. Nevertheless, A's amount realized is \$9,200 and A's gain realized is \$2,300 on the sale.

#### **Example 3.**

In 1975 L becomes a limited partner in partnership GL. L contributes \$10,000 in cash to GL and L's distributive share of partnership income and loss is 10 percent. L is not entitled to receive any guaranteed payments. In 1978 M purchases L's entire interest in partnership GL. At the time of the sale L's adjusted basis in the partnership interest is \$20,000. At that time L's proportionate share of liabilities, of which no partner has assumed personal liability, is \$15,000. M pays \$10,000 in cash for L's interest in the partnership. Under section 752(d) and this section, L's share of partnership liabilities, \$15,000, is treated as money received. Accordingly, L's amount realized on the sale of the partnership interest is \$25,000 (\$10,000 + \$15,000). L's gain realized on the sale is \$5,000 (\$25,000 – \$20,000).

#### **Example 4.**

In 1976 B becomes a limited partner in partnership BG. In 1978 B contributes B's entire interest in BG to a charitable organization described in section 170(c). At the time of the contribution all of the partnership liabilities are liabilities for which neither B nor G has assumed any personal liability and B's proportionate share of which is \$9,000. The charitable organization does not pay any cash or other property to B, but takes the partnership interest subject to the \$9,000 of liabilities. Assume that the contribution is treated as a bargain sale to a charitable organization and that under section 1011(b) \$3,000 is determined to be the portion of B's basis in the partnership interest allocable to the sale. Under section 752(d) and this section, the \$9,000 of liabilities is treated by B as money received, thereby making B's amount realized \$9,000. B's gain realized is \$6,000 (\$9,000 – \$3,000).

#### **Example 5.**

In 1975 C, an individual, creates T, an irrevocable trust. Due to certain powers expressly retained by C, T is a "grantor trust" for purposes of subpart E of part 1 of subchapter J of the code and therefore C is treated as the owner of the entire trust. T purchases an interest in P, a partnership. C, as owner of T, deducts the distributive share of partnership losses attributable to the partnership interest held by T. In 1978, when the adjusted basis of the partnership interest held by T is \$1,200, C renounces the powers previously and expressly retained that initially resulted in T being classified as a grantor trust. Consequently, T ceases to be a grantor trust and C is no longer considered to be the owner of the trust. At the time of the renunciation all of P's liabilities are

liabilities on which none of the partners have assumed any personal liability and the proportionate share of which of the interest held by T is \$11,000. Since prior to the renunciation C was the owner of the entire trust, C was considered the owner of all the trust property for Federal income tax purposes, including the partnership interest. Since C was considered to be the owner of the partnership interest, C not T, was considered to be the partner in P during the time T was a “grantor trust”. However, at the time C renounced the powers that gave rise to T's classification as a grantor trust, T no longer qualified as a grantor trust with the result that C was no longer considered to be the owner of the trust and trust property for Federal income tax purposes. Consequently, at that time, C is considered to have transferred ownership of the interest in P to T, now a separate taxable entity, independent of its grantor C. On the transfer, C's share of partnership liabilities (\$11,000) is treated as money received. Accordingly, C's amount realized is \$11,000 and C's gain realized is \$9,800 ( $\$11,000 - \$1,200$ ).

#### **Example 6.**

In 1977 D purchases an asset for \$7,500. D pays the seller \$1,500 in cash and signs a note payable to the seller for \$6,000. D is not personally liable for repayment but pledges as security the newly purchased asset. In the event of default, the seller's only recourse is to the asset. During the years 1977 and 1978 D takes depreciation deductions on the asset totaling \$4,200 thereby reducing D's basis in the asset to \$3,300 ( $\$7,500 - \$4,200$ ). In 1979 D transfers the asset to a trust which is not a “grantor trust” for purposes of subpart E of part 1 of subchapter J of the Code. Therefore D is not treated as the owner of the trust. The trust takes the asset subject to the liability and in addition pays D \$750 in cash. Prior to the transfer D had reduced the amount outstanding on the liability to \$4,700. D's amount realized on the transfer is \$5,450 ( $\$4,700 + \$750$ ). Since D's adjusted basis is \$3,300, D's gain realized is \$2,150 ( $\$5,450 - \$3,300$ ).

#### **Example 7.**

In 1974 E purchases a herd of cattle for breeding purposes. The purchase price is \$20,000 consisting of \$1,000 cash and a \$19,000 note. E is not personally liable for repayment of the liability and the seller's only recourse in the event of default is to the herd of cattle. In 1977 E transfers the herd back to the original seller thereby satisfying the indebtedness pursuant to a provision in the original sales agreement. At the time of the transfer the fair market value of the herd is \$15,000 and the remaining principal balance on the note is \$19,000. At that time E's adjusted basis in the herd is \$16,500 due to a deductible loss incurred when a portion of the herd died as a result of disease. As a result of the indebtedness being satisfied, E's amount realized is \$19,000 notwithstanding the fact that the fair market value of the herd was less than \$19,000. E's realized gain is \$2,500 ( $\$19,000 - \$16,500$ ).

#### **Example 8.**

In 1980, F transfers to a creditor an asset with a fair market value of \$6,000 and the creditor discharges \$7,500 of indebtedness for which F is personally liable. The amount realized on the disposition of the asset is its fair market value (\$6,000). In addition, F has income from the discharge of indebtedness of \$1,500 ( $\$7,500 - \$6,000$ ).

### **§1.1015-1 BASIS OF PROPERTY ACQUIRED BY GIFT AFTER DECEMBER**



31, 1920.

(a) *General rule.*

(1) In the case of property acquired by gift after December 31, 1920 (whether by a transfer in trust or otherwise), the basis of the property for the purpose of determining gain is the same as it would be in the hands of the donor or the last preceding owner by whom it was not acquired by gift. The same rule applies in determining loss unless the basis (adjusted for the period prior to the date of gift in accordance with sections 1016 and 1017) is greater than the fair market value of the property at the time of the gift. In such case, the basis for determining loss is the fair market value at the time of the gift.

(2) The provisions of subparagraph (1) of this paragraph may be illustrated by the following example.

**Example:**

A acquires by gift income-producing property which has an adjusted basis of \$100,000 at the date of gift. The fair market value of the property at the date of gift is \$90,000. A later sells the property for \$95,000. In such case there is neither gain nor loss. The basis for determining loss is \$90,000; therefore, there is no loss. Furthermore, there is no gain, since the basis for determining gain is \$100,000.

(3) If the facts necessary to determine the basis of property in the hands of the donor or the last preceding owner by whom it was not acquired by gift are unknown to the donee, the district director shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the district director finds it impossible to obtain such facts, the basis in the hands of such donor or last preceding owner shall be the fair market value of such property as found by the district director as of the date or approximate date at which, according to the best information the district director is able to obtain, such property was acquired by such donor or last preceding owner. See paragraph (e) of this section for rules relating to fair market value.

(b) *Uniform basis; proportionate parts of.* Property acquired by gift has a single or uniform basis although more than one person may acquire an interest in such property. The uniform basis of the property remains fixed subject to proper adjustment for items under sections 1016 and 1017. However, the value of the proportionate parts of the uniform basis represented, for instance, by the respective interests of the life tenant and remainderman are adjustable to reflect the change in the relative values of such interest on account of the lapse of time. The portion of the basis attributable to an interest at the time of its sale or other disposition shall be determined under the rules provided in § 1.1014-5. In determining gain or loss from the sale or other disposition after October 9, 1969, of a term interest in property (as defined in § 1.1001-1(f)(2)) the adjusted basis of which is determined pursuant, or by reference, to section 1015, that part of the adjusted uniform basis assignable under the rules of § 1.1014-5(a) to the interest sold or otherwise disposed of shall be disregarded to the extent and in the manner provided by section 1001(e) and § 1.1001-1(f).

## §1.1015-4 TRANSFERS IN PART A GIFT AND IN PART A SALE.

(a) *General rule.* Where a transfer of property is in part a sale and in part a gift, the unadjusted basis of the property in the hands of the transferee is the sum of -

(1) Whichever of the following is the greater:

(i) The amount paid by the transferee for the property, or

(ii) The transferor's adjusted basis for the property at the time of the transfer, and

(2) The amount of increase, if any, in basis authorized by section 1015(d) for gift tax paid (see §1.1015-5).

For determining loss, the unadjusted basis of the property in the hands of the transferee shall not be greater than the fair market value of the property at the time of such transfer. For determination of gain or loss of the transferor, see §1.1001-1(e) and §1.1011-2. For special rule where there has been a charitable contribution of less than a taxpayer's entire interest in property, see section 170(e)(2) and §1.170A-4(c).

(b) *Examples.* The rule of paragraph (a) of this section is illustrated by the following examples:

### Example 1.

If A transfers property to his son for \$30,000, and such property at the time of the transfer has an adjusted basis of \$30,000 in A's hands (and a fair market value of \$60,000), the unadjusted basis of the property in the hands of the son is \$30,000.

### Example 2.

If A transfers property to his son for \$60,000, and such property at the time of transfer has an adjusted basis of \$30,000 in A's hands (and a fair market value of \$90,000), the unadjusted basis of such property in the hands of the son is \$60,000.

### Example 3.

If A transfers property to his son for \$30,000, and such property at the time of transfer has an adjusted basis in A's hands of \$60,000 (and a fair market value of \$90,000), the unadjusted basis of such property in the hands of the son is \$60,000.

### Example 4.

If A transfers property to his son for \$30,000 and such property at the time of transfer has an adjusted basis of \$90,000 in A's hands (and a fair market value of \$60,000), the unadjusted basis of the property in the hands of the son is \$90,000. However, since the adjusted basis of the property in A's hands at the time of the transfer was greater than the fair market value at that time, for the purpose of determining any loss on a later sale or other disposition of the property

by the son its unadjusted basis in his hands is \$60,000.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6693, 28 FR 12818, Dec. 3, 1963; T.D. 7207, 37 FR 20799, Oct. 5, 1972]

## **§1.1031(A)-1 PROPERTY HELD FOR PRODUCTIVE USE IN TRADE OR BUSINESS OR FOR INVESTMENT.**

### **(a) *In general* -**

(1) *Exchanges of property solely for property of a like kind.* Section 1031(a)(1) provides an exception from the general rule requiring the recognition of gain or loss upon the sale or exchange of property. Under section 1031(a)(1), no gain or loss is recognized if property held for productive use in a trade or business or for investment is exchanged solely for property of a like kind to be held either for productive use in a trade or business or for investment. Under section 1031(a)(1), property held for productive use in a trade or business may be exchanged for property held for investment. Similarly, under section 1031(a)(1), property held for investment may be exchanged for property held for productive use in a trade or business. However, section 1031(a)(2) provides that section 1031(a)(1) does not apply to any exchange of -

- (i) Stock in trade or other property held primarily for sale;
- (ii) Stocks, bonds, or notes;
- (iii) Other securities or evidences of indebtedness or interest;
- (iv) Interests in a partnership;
- (v) Certificates of trust or beneficial interests; or
- (vi) Choses in action.

Section 1031(a)(1) does not apply to any exchange of interests in a partnership regardless of whether the interests exchanged are general or limited partnership interests or are interests in the same partnership or in different partnerships. An interest in a partnership that has in effect a valid election under section 761(a) to be excluded from the application of all of subchapter K is treated as an interest in each of the assets of the partnership and not as an interest in a partnership for purposes of section 1031(a)(2)(D) and paragraph (a)(1)(iv) of this section. An exchange of an interest in such a partnership does not qualify for nonrecognition of gain or loss under section 1031 with respect to any asset of the partnership that is described in section 1031(a)(2) or to the extent the exchange of assets of the partnership does not otherwise satisfy the requirements of section 1031(a).

(2) *Exchanges of property not solely for property of a like kind.* A transfer is not within the provisions of section 1031(a) if, as part of the consideration, the taxpayer receives money or

property which does not meet the requirements of section 1031(a), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). Similarly, a transfer is not within the provisions of section 1031(a) if, as part of the consideration, the other party to the exchange assumes a liability of the taxpayer (or acquires property from the taxpayer that is subject to a liability), but the transfer, if otherwise qualified, will be within the provisions of either section 1031 (b) or (c). A transfer of property meeting the requirements of section 1031(a) may be within the provisions of section 1031(a) even though the taxpayer transfers in addition property not meeting the requirements of section 1031(a) or money. However, the nonrecognition treatment provided by section 1031(a) does not apply to the property transferred which does not meet the requirements of section 1031(a).

(3) *Exchanges after 2017.* Pursuant to section 13303 of Public Law 115-97 (131 Stat. 2054), for exchanges beginning after December 31, 2017, section 1031 and §§1.1031(a)-1, 1.1031(b)-2, 1.1031(d)-1T, 1.1031(d)-2, 1.1031(j)-1, 1.1031(k)-1, and references to section 1031 in §§1.1031(b)-1, 1.1031(c)-1, and 1.1031(d)-1, apply only to qualifying exchanges of real property (within the meaning of §1.1031(a)-3) that is held for productive use in a trade or business, or for investment, and that is not held primarily for sale.

(b) *Definition of “like kind.”* As used in section 1031(a), the words *like kind* have reference to the nature or character of the property and not to its grade or quality. One kind or class of property may not, under that section, be exchanged for property of a different kind or class. The fact that any real estate involved is improved or unimproved is not material, for that fact relates only to the grade or quality of the property and not to its kind or class. Unproductive real estate held by one other than a dealer for future use or future realization of the increment in value is held for investment and not primarily for sale. For additional rules for exchanges of personal property, see §1.1031 (a)-2.

(c) *Examples of exchanges of property of a “like kind.”* No gain or loss is recognized if

(1) a taxpayer exchanges property held for productive use in his trade or business, together with cash, for other property of like kind for the same use, such as a truck for a new truck or a passenger automobile for a new passenger automobile to be used for a like purpose; or

(2) a taxpayer who is not a dealer in real estate exchanges city real estate for a ranch or farm, or exchanges a leasehold of a fee with 30 years or more to run for real estate, or exchanges improved real estate for unimproved real estate; or

(3) a taxpayer exchanges investment property and cash for investment property of a like kind.

(d) *Examples of exchanges not solely in kind.* Gain or loss is recognized if, for instance, a taxpayer exchanges

(1) Treasury bonds maturing March 15, 1958, for Treasury bonds maturing December 15, 1968, unless section 1037(a) (or so much of section 1031 as relates to section 1037(a)) applies to such exchange, or

(2) a real estate mortgage for consolidated farm loan bonds.

(e) *Applicability dates* -

(1) *Exchanges of partnership interests.* The provisions of paragraph (a)(1) of this section relating to exchanges of partnership interests apply to transfers of property made by taxpayers on or after April 25, 1991.

(2) *Exchanges after 2017.* The provisions of paragraph (a)(3) of this section apply to exchanges beginning after December 2, 2020.

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15822, Nov. 17, 1967; T.D. 8343, 56 FR 14854, Apr. 12, 1991; T.D. 8346, 56 FR 19937, May 1, 1991; T.D. 9935, 85 FR 77378, Dec. 2, 2020]

## **§1.1031(D)-1 PROPERTY ACQUIRED UPON A TAX-FREE EXCHANGE.**

(a) If, in an exchange of property solely of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), no part of the gain or loss was recognized under the law applicable to the year in which the exchange was made, the basis of the property acquired is the same as the basis of the property transferred by the taxpayer with proper adjustments to the date of the exchange. If additional consideration is given by the taxpayer in the exchange, the basis of the property acquired shall be the same as the property transferred increased by the amount of additional consideration given (see section 1016 and the regulations thereunder).

(b) If, in an exchange of properties of the type indicated in section 1031, section 1035(a), section 1036(a), or section 1037(a), gain to the taxpayer was recognized under the provisions of section 1031(b) or a similar provision of a prior revenue law, on account of the receipt of money in the transaction, the basis of the property acquired is the basis of the property transferred (adjusted to the date of the exchange), decreased by the amount of money received and increased by the amount of gain recognized on the exchange. The application of this paragraph may be illustrated by the following example:

**Example:**

A, an individual in the moving and storage business, in 1954 transfers one of his moving trucks with an adjusted basis in his hands of \$2,500 to B in exchange for a truck (to be used in A's business) with a fair market value of \$2,400 and \$200 in cash. A realizes a gain of \$100 upon the exchange, all of which is recognized under section 1031(b). The basis of the truck acquired by A is determined as follows:

Adjusted basis of A's former truck	\$2,500
Less: Amount of money received	200
Difference	2,300
Plus: Amount of gain recognized	100
Basis of truck acquired by A	2,400

(c) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer received other property (not permitted to be received without the recognition of gain) and gain from the transaction was recognized as required under section 1031(b), or a similar provision of a prior revenue law, the basis (adjusted to the date of the exchange) of the property transferred by the taxpayer, decreased by the amount of any money received and increased by the amount of gain recognized, must be allocated to and is the basis of the properties (other than money) received on the exchange. For the purpose of the allocation of the basis of the properties received, there must be assigned to such other property an amount equivalent to its fair market value at the date of the exchange. The application of this paragraph may be illustrated by the following example:

**Example:**

A, who is not a dealer in real estate, in 1954 transfers real estate held for investment which he purchased in 1940 for \$10,000 in exchange for other real estate (to be held for investment) which has a fair market value of \$9,000, an automobile which has a fair market value of \$2,000, and \$1,500 in cash. A realizes a gain of \$2,500, all of which is recognized under section 1031(b). The basis of the property received in exchange is the basis of the real estate A transfers (\$10,000) decreased by the amount of money received (\$1,500) and increased in the amount of gain that was recognized (\$2,500), which results in a basis for the property received of \$11,000. This basis of \$11,000 is allocated between the automobile and the real estate received by A, the basis of the automobile being its fair market value at the date of the exchange, \$2,000, and the basis of the real estate received being the remainder, \$9,000.

(d) Section 1031(c) and, with respect to section 1031 and section 1036(a), similar provisions of prior revenue laws provide that no loss may be recognized on an exchange of properties of a type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), although the taxpayer receives other property or money from the transaction. However, the basis of the property or properties (other than money) received by the taxpayer is the basis (adjusted to the date of the exchange) of the property transferred, decreased by the amount of money received. This basis must be allocated to the properties received, and for this purpose there must be allocated to such other property an amount of such basis equivalent to its fair market value at the date of the exchange.

(e) If, upon an exchange of properties of the type described in section 1031, section 1035(a), section 1036(a), or section 1037(a), the taxpayer also exchanged other property (not permitted to be transferred without the recognition of gain or loss) and gain or loss from the transaction is recognized under section 1002 or a similar provision of a prior revenue law, the basis of the property acquired is the total basis of the properties transferred (adjusted to the date of the exchange) increased by the amount of gain and decreased by the amount of loss recognized on the other property. For purposes of this rule, the taxpayer is deemed to have received in exchange for such other property an amount equal to its fair market value on the date of the exchange. The application of this paragraph may be illustrated by the following example:

**Example:**

A exchanges real estate held for investment plus stock for real estate to be held for investment.

The real estate transferred has an adjusted basis of \$10,000 and a fair market value of \$11,000. The stock transferred has an adjusted basis of \$4,000 and a fair market value of \$2,000. The real estate acquired has a fair market value of \$13,000. A is deemed to have received a \$2,000 portion of the acquired real estate in exchange for the stock, since \$2,000 is the fair market value of the stock at the time of the exchange. A \$2,000 loss is recognized under section 1002 on the exchange of the stock for real estate. No gain or loss is recognized on the exchange of the real estate since the property received is of the type permitted to be received without recognition of gain or loss. The basis of the real estate acquired by A is determined as follows:

Adjusted basis of real estate transferred	\$10,000
Adjusted basis of stock transferred	4,000
	14,000
Less: Loss recognized on transfer of stock	2,000
Basis of real estate acquired upon the exchange	12,000

[T.D. 6500, 25 FR 11910, Nov. 26, 1960, as amended by T.D. 6935, 32 FR 15823, Nov. 17, 1967]

## §1.1031(D)-2 TREATMENT OF ASSUMPTION OF LIABILITIES.

For the purposes of section 1031(d), the amount of any liabilities of the taxpayer assumed by the other party to the exchange (or of any liabilities to which the property exchanged by the taxpayer is subject) is to be treated as money received by the taxpayer upon the exchange, whether or not the assumption resulted in a recognition of gain or loss to the taxpayer under the law applicable to the year in which the exchange was made. The application of this section may be illustrated by the following examples:

### Example 1.

B, an individual, owns an apartment house which has an adjusted basis in his hands of \$500,000, but which is subject to a mortgage of \$150,000. On September 1, 1954, he transfers the apartment house to C, receiving in exchange therefor \$50,000 in cash and another apartment house with a fair market value on that date of \$600,000. The transfer to C is made subject to the \$150,000 mortgage. B realizes a gain of \$300,000 on the exchange, computed as follows:

Value of property received	\$600,000
Cash	50,000
Liabilities subject to which old property was transferred	150,000
Total consideration received	800,000
Less: Adjusted basis of property transferred	500,000
Gain realized	300,000

Under section 1031(b), \$200,000 of the \$300,000 gain is recognized. The basis of the apartment house acquired by B upon the exchange is \$500,000, computed as follows: Adjusted basis of property transferred

Less: Amount of money received:

Cash	\$50,000	
Amount of liabilities subject to which property was transferred	150,000	
	—	200,000
Difference		300,000
Plus: Amount of gain recognized upon the exchange		200,000
Basis of property acquired upon the exchange		500,000

#### Example 2.

(a) D, an individual, owns an apartment house. On December 1, 1955, the apartment house owned by D has an adjusted basis in his hands of \$100,000, a fair market value of \$220,000, but is subject to a mortgage of \$80,000. E, an individual, also owns an apartment house. On December 1, 1955, the apartment house owned by E has an adjusted basis of \$175,000, a fair market value of \$250,000, but is subject to a mortgage of \$150,000. On December 1, 1955, D transfers his apartment house to E, receiving in exchange therefore \$40,000 in cash and the apartment house owned by E. Each apartment house is transferred subject to the mortgage on it.

(b) D realizes a gain of \$120,000 on the exchange, computed as follows:

Value of property received	\$250,000	
Cash	40,000	
Liabilities subject to which old property was transferred	80,000	
Total consideration received	370,000	
Less:		
Adjusted basis of property transferred	\$100,000	
Liabilities to which new property is subject	150,000	
	—	250,000
Gain realized		120,000



For purposes of section 1031(b), the amount of *other property or money* received by D is \$40,000. (Consideration received by D in the form of a transfer subject to a liability of \$80,000 is offset by consideration given in the form of a receipt of property subject to a \$150,000 liability. Thus, only the consideration received in the form of cash, \$40,000, is treated as *other property or money* for purposes of section 1031(b).) Accordingly, under section 1031(b), \$40,000 of the \$120,000 gain is recognized. The basis of the apartment house acquired by D is \$170,000, computed as follows:

Adjusted basis of property transferred	\$100,000
Liabilities to which new property is subject	150,000
Total	250,000
Less: Amount of money received: Cash	\$40,000
Amount of liabilities subject to which property was transferred	80,000
	120,000
Difference	130,000
Plus: Amount of gain recognized upon the exchange	40,000
Basis of property acquired upon the exchange	170,000

(c) E realizes a gain of \$75,000 on the exchange, computed as follows:

Value of property received	\$220,000
Liabilities subject to which old property was transferred	150,000
Total consideration received	370,000
Less:	
Adjusted basis of property transferred	\$175,000
Cash	40,000
Liabilities to which new property is subject	80,000
	295,000
Gain realized	75,000

For purposes of section 1031(b), the amount of *other property or money* received by E is \$30,000. (Consideration received by E in the form of a transfer subject to a liability of \$150,000 is offset by consideration given in the form of a receipt of property subject to an \$80,000 liability and by the \$40,000 cash paid by E. Although consideration received in the form of cash or other property is not offset by consideration given in the form of an assumption of liabilities or a

receipt of property subject to a liability, consideration given in the form of cash or other property is offset against consideration received in the form of an assumption of liabilities or a transfer of property subject to a liability.) Accordingly, under section 1031(b), \$30,000 of the \$75,000 gain is recognized. The basis of the apartment house acquired by E is \$175,000, computed as follows:

Adjusted basis of property transferred	\$175,000
Cash	40,000
Liabilities to which new property is subject	80,000
Total	295,000
Less: Amount of money received: Amount of liabilities subject to which property was transferred	\$150,000
	150,000
Difference	145,000
Plus: Amount of gain recognized upon the exchange	30,000
Basis of property acquired upon the exchange	175,000