

# INTERNAL REVENUE BULLETIN



## HIGHLIGHTS OF THIS ISSUE

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

### EMPLOYMENT TAX

#### **REG-111879-20, page 421.**

Temporary and proposed regulations provide guidance on the recapture of excess employment tax credits. Under the Families First Coronavirus Response Act and Coronavirus Aid, Relief and Economic Security Act, eligible employers may claim refundable paid sick and family leave and employee retention credits up to the total allowable amounts either on their employment tax returns or as an advance payment that is later reconciled on their employment tax returns. Any refund of these credits paid to a taxpayer that exceeds the credit amount the taxpayer is allowed is an erroneous refund. These temporary regulations authorize the assessment and collection of any erroneous refund of the credits in the normal course of processing the applicable employment tax returns. This allows the IRS to efficiently recover any refund, while preserving administrative protections for taxpayers.

#### **T.D. 9904, page 413.**

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credits in the normal course of processing the applicable employment tax returns. This allows the IRS to efficiently recover any refund, while preserving administrative protections for taxpayers.

### EXCISE TAX

#### **REG-112042-19, page 422.**

This document contains proposed regulations relating to the excise taxes imposed on certain amounts paid for transportation of persons and property by air. Specifically, the proposed regulations relate to the exemption for amounts paid for certain aircraft management services. The proposed regulations also amend, revise, redesignate, and remove provisions of existing regulations that are out-of-date or obsolete and generally update the existing regulations to incorporate statutory changes, case law, and other published guidance. In addition, the proposed regulations withdraw a provision that was included in a prior notice of proposed rulemaking that was never finalized and re-propose it. The proposed regulations affect persons that provide air transportation of persons and property, and persons that pay for those services.

### INCOME TAX

#### **Notice 2020-58, page 419.**

In response to the ongoing Coronavirus Disease 2019 (COVID-19) pandemic, this notice provides temporary relief from certain requirements under § 47 of the Internal Revenue Code.

**REG-132766-18, page 436.**

This document contains proposed regulations to implement legislative changes to sections 263A, 448, 460, and 471 of the Internal Revenue Code (Code) that simplify the application of those tax accounting provisions for certain businesses having average annual gross receipts that do not exceed \$25 million, adjusted for inflation. This document also contains proposed regulations regarding certain special accounting rules for long-term contracts under section 460

to implement legislative changes applicable to corporate taxpayers. The proposed regulations generally affect taxpayers with average annual gross receipts of not more than \$25 million (adjusted for inflation). Additionally, this document contains a request for comments regarding the application of section 460 (or other special methods of accounting) to a contract with income that is accounted for in part under section 460 (or other special method) and in part under section 451.

# The IRS Mission

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

## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

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

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

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

against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

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

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

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

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

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

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

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

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

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

# Part I

26 CFR 31.3111-6T & 26 CFR 31.3221-5T: *Recapture of credits under the Families First Coronavirus Response Act and the Coronavirus Aid, Relief, and Economic S*

## T.D. 9904

### DEPARTMENT OF THE TREASURY Internal Revenue Service 26 CFR Part 31

### Recapture of Excess Employment Tax Credits under the Families First Act and the CARES Act

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Temporary regulations.

**SUMMARY:** This document amends the regulations under sections 3111 and 3221 of the Internal Revenue Code with the addition of temporary regulations issued under the regulatory authority granted by the Families First Coronavirus Response Act and the Coronavirus Aid, Relief, and Economic Security Act to prescribe such regulations as may be necessary for reconciling advance payments of refundable employment tax credits provided under these acts and recapturing the benefit of the credits when necessary. Consistent with this authority, these temporary regulations authorize the assessment of any erroneous refund of the credits paid under sections 7001 and 7003 of the Families First Coronavirus Response Act, including any increases in such credits under section 7005 thereof, and section 2301 of the Coronavirus Aid, Relief, and Economic Security Act. The text of these temporary regulations also serves as the text of the proposed regulations (REG-111879-20) set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**.

**DATES: Effective Date:** These temporary regulations are effective on July 29, 2020.

**Applicability Date:** For date of applicability, see §§31.3111-6T and 31.3221-5T of these temporary regulations.

**FOR FURTHER INFORMATION CONTACT:** Concerning these temporary regulations, NaLee Park at 202-317-6798.

#### SUPPLEMENTARY INFORMATION:

#### Background

##### *I. The Statutes in General: The Families First Act and the CARES Act*

The Families First Coronavirus Response Act (Families First Act), Public Law 116-127, 134 Stat. 178 (2020), enacted on March 18, 2020, and the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Public Law 116-136, 134 Stat. 281 (2020), enacted on March 27, 2020, provide relief to taxpayers from economic hardships resulting from the Coronavirus Disease 2019 (COVID-19).

The Families First Act, through the enactment of the Emergency Paid Sick Leave Act and the Emergency Family and Medical Leave Expansion Act, generally requires employers with fewer than 500 employees to provide paid leave due to certain circumstances related to COVID-19.

Division E of the Families First Act, the Emergency Paid Sick Leave Act (EPSLA), requires certain employers to provide employees with up to 80 hours of paid sick leave if the employee is unable to work or telework because the employee:

- (1) is subject to a Federal, State, or local quarantine or isolation order related to COVID-19;
- (2) has been advised by a health care provider to self-quarantine due to concerns related to COVID-19;
- (3) is experiencing symptoms of COVID-19 and seeking a medical diagnosis;

- (4) is caring for an individual who is subject to a Federal, State, or local quarantine or isolation order related to COVID-19, or has been advised by a health care provider to self-quarantine due to concerns related to COVID-19;
- (5) is caring for a son or daughter of such employee if the school or place of care of the son or daughter has been closed, or the child care provider of such son or daughter is unavailable, due to COVID-19 precautions; or
- (6) is experiencing any other substantially similar condition specified by the Secretary of Health and Human Services in consultation with the Secretaries of the Treasury and Labor.<sup>1</sup>

An employee who is unable to work or telework for reasons related to COVID-19 described in (1), (2), or (3) above is entitled to paid sick leave at the employee's regular rate of pay or, if higher, the Federal minimum wage or any applicable State or local minimum wage, up to \$511 per day and \$5,110 in the aggregate. An employee who is unable to work or telework for reasons related to COVID-19 described in (4), (5), or (6) above is entitled to paid sick leave at two-thirds the employee's regular rate of pay or, if higher, the Federal minimum wage or any applicable State or local minimum wage, up to \$200 per day and \$2,000 in the aggregate.

Division C of the Families First Act, the Emergency Family and Medical Leave Expansion Act (EFMLEA), amends the Family and Medical Leave Act of 1993 to require certain employers to provide expanded paid family and medical leave to employees who are unable to work or telework for reasons related to COVID-19. An employee can receive up to 10 weeks of paid family and medical leave at two-thirds the employee's regular rate of pay, up to \$200 per day and \$10,000 in the aggregate if the employee is unable to work or telework because the employee is caring for a son or daughter whose school or place of care is closed or whose child care provider is unavailable for reasons related to COVID-19.

<sup>1</sup> The U.S. Department of Health and Human Services has not yet specified any other such conditions as of July 29, 2020.

Sections 7001 and 7003 of the Families First Act generally provide that employers subject to the paid leave requirements under EPSLA and EFMLEA (“eligible employers”) are entitled to fully refundable tax credits to cover the cost of the leave required to be paid for those periods of time during which employees are unable to work or telework for reasons related to COVID-19.<sup>2</sup>

Eligible employers are entitled to receive a refundable credit equal to the amount of the qualified sick leave wages and qualified family leave wages (collectively “qualified leave wages”), plus allocable qualified health plan expenses. Under the respective provisions, qualified leave wages are defined to mean wages (as defined in section 3121(a) of the Internal Revenue Code (Code)) and compensation (as defined in section 3231(e) of the Code) paid by an employer which are required to be paid under the EPSLA and EFMLEA. See section 7001(c) and 7003(c). The credit is allowed against the taxes imposed on employers by section 3111(a) of the Code (the Old-Age, Survivors, and Disability Insurance tax (social security tax)), first reduced by any credits claimed under sections 3111(e) and (f) of the Code, and section 3221(a) of the Code (the Railroad Retirement Tax Act Tier 1 tax), on all wages and compensation paid to all employees. Under section 7005 of the Families First Act, the qualified leave wages are not subject to the taxes imposed on employers by sections 3111(a) and 3221(a) of the Code. In addition, section 7005 provides that the credits under sections 7001 and 7003 of the Families First Act are increased by the amount of the tax imposed by section 3111(b) of the Code (employer’s share of Medicare tax) on qualified leave wages.<sup>3</sup>

The CARES Act provides an additional credit for employers experiencing economic hardship related to COVID-19. Under section 2301 of the CARES Act, certain employers who pay qualified wages to their employees are eligible for an employee retention credit. Employers

eligible for the employee retention credit are employers that carry on a trade or business during calendar year 2020 and tax-exempt organizations that either have a full or partial suspension of operations during any calendar quarter in 2020 due to an order from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to COVID-19, or experience a significant decline in gross receipts during the calendar quarter.

Qualified wages are wages (as defined in section 3121(a) of the Code) and compensation (as defined in section 3231(e) of the Code) paid by an employer to some or all employees after March 12, 2020, and before January 1, 2021, and include the employer’s qualified health plan expenses that are properly allocable to such wages or compensation. For employers that averaged more than 100 full-time employees during 2019, qualified wages are wages and compensation (including allocable qualified health plan expenses), up to \$10,000 per employee, paid to employees that are not providing services because operations were fully or partially suspended due to orders from an appropriate governmental authority or due to a decline in gross receipts. For employers who averaged 100 full-time employees or fewer during 2019, qualified wages are wages and compensation (including allocable qualified health plan expenses), up to \$10,000 per employee, paid to any employee during the period operations were suspended due to orders from an appropriate governmental authority or due to a decline in gross receipts, regardless of whether its employees are providing services.

The employee retention credit is a fully refundable tax credit for employers equal to 50 percent of qualified wages. Because the maximum amount of qualified wages taken into account with respect to each employee is \$10,000, the maximum employee retention credit for an eligible employer for qualified wages paid to any

employee is \$5,000. The credit is allowed against the taxes imposed on employers by section 3111(a) of the Code, first reduced by any credits allowed under sections 3111(e) and (f) of the Code and sections 7001 and 7003 of the Families First Act, and the taxes imposed under section 3221(a) of the Code that are attributable to the rate in effect under section 3111(a) of the Code, first reduced by any credits allowed under sections 7001 and 7003 of the Families First Act, on all wages and compensation paid to all employees. The same wages or compensation cannot be counted for both the Families First Act leave credits and the CARES Act employee retention credit.

## *II. Refundability of Credits*

Sections 7001(b)(4) and 7003(b)(3) of the Families First Act provide that if the amount of the paid sick and family leave credits under these sections exceeds the taxes imposed by section 3111(a) or 3221(a) of the Code for any calendar quarter, such excess shall be treated as an overpayment that shall be refunded under sections 6402(a) and 6413(b) of the Code. Section 2301(b)(3) of the CARES Act provides that if the amount of the employee retention credit exceeds the taxes imposed by section 3111(a) or 3221(a) (limited to the portion attributable to the rate in effect under section 3111(a)) of the Code for any calendar quarter, such excess shall be treated as an overpayment that shall be refunded under sections 6402(a) and 6413(b) of the Code.

Section 6402(a) of the Code provides that, within the applicable period of limitations, overpayments may be credited against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and any remaining balance refunded to such person. Section 6413(b) provides that if more than the correct amount of employment tax imposed by sections 3101, 3111, 3201, 3221, or 3402 is paid or deducted and the overpayment cannot be adjusted under section

<sup>2</sup>Under sections 7001(d)(4) and 7003(d)(4) of the Families First Act, these credits do not apply to the government of the United States, the government of any State or political subdivision thereof, or any agency or instrumentality of any of the foregoing.

<sup>3</sup>The credit for the employer’s share of Medicare tax does not apply to eligible employers that are subject to Railroad Retirement Tax Act (RRTA) because under section 7005(a) of the Families First Act qualified leave wages are not subject to Medicare tax under RRTA due to that section’s reference to section 3221(a) of the Code, which includes both social security tax and Medicare tax.



6413(a)<sup>4</sup>, the amount of the overpayment shall be refunded (subject to the applicable statute of limitations) as the Secretary may prescribe in regulations.

The IRS has revised Form 941, *Employer's Quarterly Federal Tax Return*, and is revising Form 943, *Employer's Annual Federal Tax Return for Agricultural Employees*, Form 944, *Employer's Annual Federal Tax Return*, and Form CT-1, *Employer's Annual Railroad Retirement Tax Return*, so that employers may use these returns to claim the paid sick and family leave credits under the Families First Act and the employee retention credit under the CARES Act. The revised employment tax returns will provide for any credits in excess of the taxes imposed under sections 3111(a) or 3221(a) (for the employee retention credit, only the taxes imposed under section 3221(a) that are attributable to the rate in effect under section 3111(a)) to be credited against other employment taxes and then for any remaining balance to be refunded to the employer (per section 6402(a) or section 6413(b)).<sup>5</sup>

### III. Advance Payment of Credits and Erroneous Refunds

Section 3606 of the CARES Act amends sections 7001(b)(4) and 7003(b) (3) of the Families First Act to provide that, in anticipation of the paid sick and family leave credits under these sections, including any refundable portions (which would include any increases in the credits under section 7005), these credits may be advanced, according to forms and instructions provided by the Secretary, up to the total allowable amount and subject to applicable limits for the calendar quarter. Section 2301(l)(1) of the CARES Act provides that the Secretary shall issue such forms, instructions, regulations, and guidance as are necessary to allow the advance payment of the employee retention credit under section 2301, subject to the limitations provided in section 2301 and based

on such information as the Secretary shall require.

To implement the advance payment provisions of the Families First Act and the CARES Act, the IRS has created Form 7200, *Advance Payment of Employer Credits Due To COVID-19*, which employers may use to request an advance of the paid sick or family leave credits under the Families First Act, the employee retention credit under the CARES Act, or two or more of them. Employers are required to reconcile any advance payments claimed on Form 7200 with total credits claimed and total taxes due on their employment tax returns. A refund, a credit, or an advance of any portion of these credits to a taxpayer in excess of the amount to which the taxpayer is entitled is an erroneous refund for which the IRS must seek repayment.

### IV. Assessment Authority

Section 6201, in general, authorizes the Secretary to determine and assess tax liabilities including interest, additional amounts, additions to the tax, and assessable penalties. However, the general authority to assess tax liabilities under section 6201(a) does not allow the assessment of any non-rebate<sup>6</sup> portion of an erroneous refund of a refundable credit. Instead, non-rebate refunds are generally recovered or recaptured through voluntary payment or litigation. The government by appropriate action can bring civil litigation to recover funds which its agents have wrongfully, erroneously, or illegally paid, and no statute is necessary to authorize the government to sue in such a case, since the right to sue is independent of statute. *United States v. Wurts*, 303 U.S. 414, 415 (1938), citing *United States v. The Bank of the Metropolis*, 40 U.S. 377 (1841). However, the statutory language of the Families First Act and the CARES Act provides for the administrative recapture of these non-rebate refunds by autho-

rizing the promulgation of regulations or other guidance to do so.

Sections 7001 and 7003 of the Families First Act and section 2301 of the CARES Act grant authority to the Department of the Treasury (Treasury Department) and the IRS to issue regulations or other guidance to recapture an erroneous refund of the credits. Specifically, sections 7001(f) and 7003(f) of the Families First Act and section 2301(l) of the CARES Act authorize the Secretary to issue guidance to allow for the administrative reconciliation and recapture of erroneous refunds. Sections 7001(f) and 7003(f) of the Families First Act provide, in relevant part, that the Secretary (or the Secretary's delegate) shall provide such regulations or other guidance as may be necessary to carry out the purposes of the credit, including regulations or other guidance: (1) to prevent the avoidance of the purposes of the limitations under this provision; (2) to minimize compliance and record-keeping burdens associated with the credit; (3) to provide for a waiver of penalties for failure to deposit amounts in anticipation of the allowance of the credit; (4) to recapture the benefit of the credit in cases where there is a subsequent adjustment to the credit; and (5) to ensure that the wages taken into account for the credit conform with the paid sick leave and paid family leave required to be provided under the Families First Act. Similarly, section 2301(l) of the CARES Act provides in relevant part that the Secretary shall issue such forms, instructions, regulations, and guidance as are necessary to provide for the reconciliation of an advance payment of the employee retention credit with the amount advanced at the time of filing the return of tax for the applicable calendar quarter or taxable year, and to provide for the recapture of the credit under section 2301 of the CARES Act if such credit is allowed to a taxpayer that receives a small business loan under section 1102 of the CARES Act during a subsequent quarter.

<sup>4</sup>Section 6413(a) addresses interest-free adjustments of overpayments. The section provides that if more than the correct amount of employment tax imposed by section 3101, 3111, 3201, 3221, or 3402 is paid with respect to any payment of remuneration, proper adjustments with respect to both the tax and the amount to be deducted, shall be made, without interest, in such manner and at such times as the Secretary may by regulations prescribe.

<sup>5</sup>Employment tax returns have also been revised to provide for reporting of any deferral of employment taxes under the CARES Act. Section 2302 of the CARES Act provides that employers may defer the deposit and payment of the employer's share of social security tax for the payroll tax deferral period of March 27, 2020 through December 31, 2020. The deferral applies in addition to the credits claimed on an employment tax return, but the deferral does not reduce the amount of the employer's share of social security tax against which the credits are applied.

<sup>6</sup>"Non-rebate" refers to the portion of any refund of a credit that exceeds the IRS's determination of the recipient's tax liability (i.e., the remaining portion of the refund that is paid to the recipient after the refund has been applied to the recipient's tax liability).

Accordingly, this document amends the Employment Tax Regulations (26 CFR Part 31) by adding temporary regulations under sections 3111 and 3221 of the Code. Concurrent with the publication of this Treasury decision, the Treasury Department and the IRS are publishing in the Proposed Rules section of this issue of the **Federal Register** a notice of proposed rulemaking (REG-111879-20) on this subject that cross-references the text of these temporary regulations. *See* section 7805(e) (1). Interested persons are directed to the ADDRESSES and COMMENTS AND REQUESTS FOR A PUBLIC HEARING sections of the preamble to REG-111879-20 for information on submitting public comments or requesting a public hearing on the proposed regulations.

### Explanation of Provisions

Sections 7001 and 7003 of the Families First Act and section 2301 of the CARES Act provide that the credits described in these sections are taken against the taxes imposed on employers under sections 3111(a) or 3221(a) of the Code (for the employee retention credit, only the taxes imposed under section 3221(a) that are attributable to the rate in effect under section 3111(a) of the Code). Additionally, if the amount of the credit exceeds the taxes imposed under sections 3111(a) or 3221(a) of the Code (for the employee retention credit, only the taxes imposed under section 3221(a) that are attributable to the rate in effect under section 3111(a) of the Code) for any calendar quarter, such excess shall be treated as an overpayment to be refunded or credited under sections 6402(a) and 6413(b) of the Code. Any credits claimed that exceed the amount to which the employer is entitled and that are actually credited or paid by the IRS are considered to be erroneous refunds of the credits. These temporary regulations provide that erroneous refunds of these credits are treated as underpayments of the taxes imposed under sections 3111(a) or 3221(a) of the Code and authorize the IRS to assess any portion of the credits erroneously credited, paid, or refunded in excess of the amount allowed as if those amounts were tax liabilities under sections 3111(a) and 3221(a) subject to assessment and ad-

ministrative collection procedures. This allows the IRS to efficiently recover the amounts, while also preserving administrative protections afforded to taxpayers with respect to contesting their tax liabilities under the Code and avoiding unnecessary costs and burdens associated with litigation. These assessment and administrative collection procedures will apply in the normal course in processing employment tax returns that report advances in excess of claimed credits and in examining returns for excess claimed credits.

Specifically, these temporary regulations provide that any amount of the credits for qualified leave wages under sections 7001 and 7003 of the Families First Act, plus any amount of credits for qualified health plan expenses under sections 7001 and 7003, and including any increases in these credits under section 7005, and any amount of the employee retention credit for qualified wages under section 2301 of the CARES Act that are erroneously refunded or credited to an employer shall be treated as underpayments of the taxes imposed by section 3111(a) or section 3221(a), as applicable, by the employer and may be administratively assessed and collected in the same manner as the taxes. These temporary regulations provide that the determination of any amount of credits erroneously refunded must take into account any credit amounts advanced to an employer under the process established by the IRS in accordance with sections 7001(b)(4)(A)(ii) and 7003(b)(3)(B) of the Families First Act and section 2301(l) (1) of the CARES Act.

Because in certain situations third party payors claim credits on behalf of their common law employer clients, these temporary regulations also provide that employers against whom an erroneous refund of credits can be assessed as an underpayment include persons treated as the employer under sections 3401(d), 3504, and 3511 of the Code, consistent with their liability for the section 3111(a) and section 3221(a) taxes against which the credit applied.

Finally, these temporary regulations apply to all credit refunds under section 7001 and 7003 of the Families First Act advanced or paid on or after April 1, 2020, and all credit refunds under section 2301 of the CARES Act advanced or paid on or

after March 13, 2020. These applicability dates correspond to the effective dates of the statutory sections that provide for these credits and that authorize guidance to allow for the administrative reconciliation and recapture of erroneous refunds of these credits.

Sections 7001(g) and 7003(g) of the Families First Act provide that sections 7001 and 7003 apply to wages paid with respect to the period beginning on a date selected by the Secretary of the Treasury which is during the 15-day period beginning on the date of the enactment of the Families First Act (March 18, 2020). In Notice 2020-21, 2020-16 I.R.B. 660, the IRS provided that the tax credits for qualified sick leave wages and qualified family leave wages under sections 7001 and 7003 of the Families First Act apply to wages paid for the period beginning on April 1, 2020, and ending on December 31, 2020. Section 2301(m) of the CARES Act provides that section 2301 applies to wages paid on or after March 13, 2020, and before January 1, 2021.

Pursuant to section 7805(b)(2) of the Code, these temporary regulations are permitted to apply before the dates provided under section 7805(b)(1), including the date on which these temporary regulations are filed with the Federal Register, because these temporary regulations are being issued within 18 months of the date of the enactment of the relevant statutory provisions under the Families First Act and the CARES Act. Accordingly, these temporary regulations apply to all credits under sections 7001 and 7003 of the Families First Act, as modified by section 3606 of the CARES Act, including any increases in the credits under section 7005 of the Families First Act, refunded on or after April 1, 2020, including advanced refunds, as well as all credits under section 2301 of the CARES Act that are refunded on or after March 13, 2020, including advanced refunds.

### Special Analyses

The Office of Management and Budget's Office of Information and Regulatory Analysis has determined that these temporary regulations are not significant and not subject to review under section 6(b) of Executive Order 12866.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), the Secretary certifies that these temporary regulations will not have a significant economic impact on a substantial number of small entities because these temporary regulations impose no compliance burden on any business entities, including small entities. Although these temporary regulations will apply to all employers eligible for the credits under the Families First Act and the CARES Act, including small businesses and tax-exempt organizations with fewer than 500 employees, and will therefore be likely to affect a substantial number of small entities, the economic impact will not be significant. These temporary regulations do not affect the employer's employment tax reporting or the necessary information to substantiate entitlement to the credits. Rather, these temporary regulations merely implement the statutory authority granted under sections 7001(f) and 7003(f) of the Families First Act and section 2301(l) of the CARES Act that authorize the IRS to assess, reconcile, and recapture any portion of the credits erroneously credited, paid, or refunded in excess of the actual amount allowed as if the amounts were tax liabilities under sections 3111(a) and 3221(a) subject to assessment and administrative collection procedures. Notwithstanding this certification, the Treasury Department and the IRS invite comments on any impact these temporary regulations would have on small entities.

Pursuant to section 7805(f), these temporary regulations have been submitted to the Chief Counsel of the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

The Treasury Department and the IRS have determined that good cause exists under section 553(b)(B) of the Administrative Procedure Act (APA) (5 U.S.C. 551 *et seq.*). Section 553(b)(B) provides that an agency is not required to publish a notice of proposed rulemaking in the **Federal Register** when the agency, for good cause, finds that notice and public comment thereon are impracticable, unnecessary, or contrary to the public interest. Employers must file Form 941, *Employer's Quarterly Federal Tax Return*, for the second

quarter of calendar year 2020 by July 31, 2020, as required by section 6071 of the Code and Treas. Reg. § 31.6071(a)-1. Employers use Form 941 to claim qualified leave credits under the Families First Act and the employee retention credit under the CARES Act, as well as to report any advance of these credits they received during the quarter. In filing their second quarter 2020 Form 941, some employers will report and receive, or will have already received as an advance, refund amounts in excess of the refund to which they are entitled. These temporary regulations authorize the assessment of any such erroneous refunds. Without these temporary regulations, in some instances the IRS may not be able to avoid bringing costly and burdensome litigation to recover such reported erroneous refunds. Further, comments are being solicited in the cross-referenced notice of proposed rulemaking that is in this issue of the Federal Register, and any comments will be considered before final regulations are issued.

#### **Statement of Availability of IRS Documents**

IRS notices and other guidance cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

#### **Drafting Information**

The principal author of these temporary regulations is NaLee Park, Office of the Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the Treasury Department and the IRS participated in the development of these temporary regulations.

#### **List of Subjects in 26 CFR 31**

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

#### **Adoption of Amendments to the Regulations**

Accordingly, 26 CFR part 31 is amended as follows:

#### **PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE**

Paragraph 1. The authority citation for part 31 is amended by adding entries for §§31.3111-6T and 31.3221-5T in numerical order to read in part as follows:

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

Section 31.3111-6T also issued under sec. 7001 and sec. 7003 of the Families First Coronavirus Response Act of 2020 and sec. 2301 of the Coronavirus Aid, Relief, and Economic Security Act of 2020.

\* \* \* \* \*

Section 31.3221-5T also issued under sec. 7001 and sec. 7003 of the Families First Coronavirus Response Act of 2020 and sec. 2301 of the Coronavirus Aid, Relief, and Economic Security Act of 2020.

\* \* \* \* \*

Par. 2. Section 31.3111-6T is added to read as follows:

*§31.3111-6T Recapture of credits under the Families First Coronavirus Response Act and the Coronavirus Aid, Relief, and Economic Security Act.*

(a) *Recapture of erroneously refunded credits under the Families First Coronavirus Response Act.* Any amount of credits for qualified sick leave wages or qualified family leave wages under sections 7001 and 7003, respectively, of the Families First Coronavirus Response Act (Families First Act), Public Law 116-127, 134 Stat. 178 (2020), as modified by section 3606 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Public Law 116-136, 134 Stat. 281 (2020), plus any amount of credits for qualified health plan expenses under sections 7001 and 7003, and including any increases in those credits under section 7005 of the Families First Act, that are treated as overpayments and refunded or credited to an employer under section 6402(a) or section 6413(b) of the Internal Revenue Code (Code) and to which the employer is not entitled, resulting in an erroneous refund to the



employer, shall be treated as an underpayment of the taxes imposed by section 3111(a) of the Code and may be assessed and collected by the Secretary in the same manner as the taxes.

(b) *Recapture of erroneously refunded credits under the Coronavirus Aid, Relief, and Economic Security Act.* Any amount of credits for qualified wages under section 2301 of the CARES Act that is treated as an overpayment and refunded or credited to an employer under section 6402(a) or section 6413(b) of the Code and to which the employer is not entitled, resulting in an erroneous refund to the employer, shall be treated as an underpayment of the taxes imposed by section 3111(a) of the Code and may be assessed and collected by the Secretary in the same manner as the taxes.

(c) *Advance credit amounts erroneously refunded.* The determination of any amount of credits erroneously refunded as described in paragraphs (a) and (b) of this section must take into account any amount of credits advanced to an employer under the process established by the Internal Revenue Service in accordance with sections 7001(b)(4)(A)(ii) and 7003(b)(3)(B) of the Families First Act, as modified by section 3606 of the CARES Act, and section 2301(l)(1) of the CARES Act.

(d) *Third party payors.* For purposes of this section, employers against whom an erroneous refund of the credits under sections 7001 and 7003 of the Families First Act (including any increases in those credits under section 7005 of the Families First Act), as modified by section 3606 of the CARES Act, and the credits under section 2301 of the CARES Act can be assessed as an underpayment of the taxes imposed by section 3111(a) include persons treated as the employer under sections 3401(d), 3504, and 3511 of the Code, consistent with their liability for the section 3111(a) taxes against which the credit applied.

(e) *Applicability date.* This regulation applies to all credit refunds under sections 7001 and 7003 of the Families First Act

(including any increases in those credits under section 7005 of the Families First Act), as modified by section 3606 of the CARES Act, advanced or paid on or after April 1, 2020, and all credit refunds under section 2301 of the CARES Act advanced or paid on or after March 13, 2020.

Par. 3. Section 31.3221-5T is added to read as follows:

*§31.3221-5T Recapture of credits under the Families First Coronavirus Response Act and the Coronavirus Aid, Relief, and Economic Security Act.*

(a) *Recapture of erroneously refunded credits under the Families First Coronavirus Response Act.* Any amount of credits for qualified sick leave wages or qualified family leave wages under sections 7001 and 7003, respectively, of the Families First Coronavirus Response Act (Families First Act), Public Law 116-127, 134 Stat. 178 (2020), as modified by section 3606 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Public Law 116-136, 134 Stat. 281 (2020), plus any amount of credits for qualified health plan expenses under sections 7001 and 7003, that are treated as overpayments and refunded or credited to an employer under section 6402(a) or section 6413(b) of the Internal Revenue Code (Code) and to which the employer is not entitled, resulting in an erroneous refund to the employer, shall be treated as an underpayment of the taxes imposed by section 3221(a) of the Code and may be assessed and collected by the Secretary in the same manner as the taxes.

(b) *Recapture of erroneously refunded credits under the Coronavirus Aid, Relief, and Economic Security Act.* Any amount of credits for qualified wages under section 2301 of the CARES Act that is treated as an overpayment and refunded or credited to an employer under section 6402(a) or section 6413(b) of the Code and to which the employer is not entitled, resulting in an erroneous refund to the employer, shall

be treated as an underpayment of the taxes imposed by section 3221(a) of the Code and may be assessed and collected by the Secretary in the same manner as the taxes.

(c) *Advance credit amounts erroneously refunded.* The determination of any amount of credits erroneously refunded as described in paragraphs (a) and (b) of this section must take into account any amount of credits advanced to an employer under the process established by the Internal Revenue Service in accordance with sections 7001(b)(4)(A)(ii) and 7003(b)(3)(B) of the Families First Act, as modified by section 3606 of the CARES Act, and section 2301(l)(1) of the CARES Act.

(d) *Third party payors.* For purposes of this section, employers against whom an erroneous refund of the credits under sections 7001 and 7003 of the Families First Act, as modified by section 3606 of the CARES Act, and the credits under section 2301 of the CARES Act can be assessed as an underpayment of the taxes imposed by section 3221(a) include persons treated as the employer under sections 3401(d), 3504, and 3511 of the Code, consistent with their liability for the section 3221(a) taxes against which the credit applied.

(e) *Applicability date.* This regulation applies to all credit refunds under sections 7001 and 7003 of the Families First Act, as modified by section 3606 of the CARES Act, advanced or paid on or after April 1, 2020, and all credit refunds under section 2301 of the CARES Act advanced or paid on or after March 13, 2020.

Sunita Lough,  
*Deputy Commissioner for Services  
and Enforcement.*

Approved: July 14, 2020.

David J. Kautter,  
*Assistant Secretary of the Treasury  
(Tax Policy).*

(Filed by the Office of the Federal Register on July 24, 2020, 4:15 p.m., and published in the issue of the Federal Register for July 29, 2020, 85 F.R. 45514)

# Part III

## Notice 2020-58

### I. PURPOSE

On March 13, 2020, the President of the United States issued an emergency declaration under the Robert T. Stafford Disaster Relief and Emergency Assistance Act in response to the ongoing Coronavirus Disease 2019 (COVID-19) pandemic. The emergency declaration instructed the Secretary of the Treasury “to provide relief from tax deadlines to Americans who have been adversely affected by the COVID-19 emergency, as appropriate, pursuant to 26 U.S.C. 7508A(a).” Section III of this notice describes the relief provided pursuant to § 7508A(a) of the Internal Revenue Code (Code) for certain requirements of the rehabilitation credit under § 47 of the Code.

### II. BACKGROUND

Section 38(b)(1) of the Code provides that the current year general business credit includes the investment credit determined under § 46 of the Code. The investment credit under § 46 includes the rehabilitation credit under § 47.

On December 22, 2017, former § 47 was amended by section 13402 of Public Law No. 115-97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Prior to the TCJA, former § 47(a) provided for the purposes of § 46 a two-tier credit for qualified rehabilitation expenditures (QREs) incurred in connection with the rehabilitation of a qualified rehabilitated building (QRB). Former § 47(a)(2) allowed a 20-percent credit for QREs with respect to a certified historic structure, and former § 47(a)(1) allowed a 10-percent credit for QREs with respect to a QRB other than a certified historic structure (for certain buildings first placed in service before 1936 (pre-1936 buildings)). Under former § 47, both the 20-percent and 10-percent credits were fully allowed in the taxable year the QRB was placed in service.

Section 13402(a) of the TCJA repealed the 10-percent credit for pre-1936 build-

ings and modified the rules for claiming the 20-percent credit for certified historic structures. Section 13402(b) of the TCJA amended § 47(c), in part, by redesignating former § 47(c)(1)(C) and (D) as § 47(c)(1)(B) and (C). Section 13402(c)(1) of the TCJA provides that the amendments made by section 13402(a) and (b) are generally applicable to QRE amounts paid or incurred after December 31, 2017, subject to a statutory transition rule provided in section 13402(c)(2) of the TCJA (TCJA transition rule).

Section 47(a)(1) provides for the purposes of § 46, for any taxable year during the 5-year period beginning in the taxable year in which a QRB is placed in service, the rehabilitation credit for such year is an amount equal to the ratable share for such year.

Section 47(a)(2) defines the ratable share for any taxable year during the 5-year period described in § 47(a)(1) as an amount equal to 20 percent of the QREs with respect to the QRB, as allocated ratably to each year during the 5-year period.

Section 47(b) provides that QREs with respect to any QRB are taken into account for the taxable year in which the QRB is placed in service.

Under § 47(c)(1)(A)(i), a QRB must be a building that has been substantially rehabilitated. Under § 47(c)(1)(B)(i), a building is treated as substantially rehabilitated only if the QREs during the 24-month period selected by the taxpayer ending with or within the taxable year exceed the greater of the taxpayer’s adjusted basis in the building (and its structural components) or \$5,000. For certain rehabilitations expected to be completed in phases set forth in architectural plans and specifications completed before the rehabilitation begins as described in § 47(c)(1)(B)(ii) (phased rehabilitation), the taxpayer selects a 60-month period rather than a 24-month period.

Section 1.48-12(b)(2)(i) of the Income Tax Regulations defines “substantial rehabilitation test” and provides that a building is treated as having been substantially rehabilitated for a taxable year only if the QREs incurred during any 24-month period selected by the taxpayer ending

with or within the taxable year exceed the greater of (A) the adjusted basis of the building (and its structural components), or (B) \$5,000. Section 1.48-12(b)(2)(v) describes special rules for phased rehabilitation and provides that § 1.48-12(b)(2)(i) is applied by substituting “60-month period” for “24-month period.”

The TCJA transition rule provides that in the case of QREs (for either a certified historic structure eligible for a 20-percent credit or a pre-1936 building eligible for a 10-percent credit prior to December 31, 2017), with respect to any building owned or leased by the taxpayer at all times on and after January 1, 2018, the 24-month period selected by the taxpayer under § 47(c)(1)(B)(i), or the 60-month period selected by the taxpayer under the rule for phased rehabilitation under § 47(c)(1)(B)(ii), is to begin no later than the end of the 180-day period beginning on December 22, 2017, and the amendments made by section 13402 of the TCJA apply to such QREs paid or incurred after the end of the taxable year in which such 24-month or 60-month period ends. For taxpayers selecting a 24-month period, the requirement to begin the period within 180 days from December 22, 2017, means that the latest day that such a 24-month period can end under the TCJA transition rule is June 20, 2020. For taxpayers permitted to select a 60-month period for phased rehabilitation, the requirement to begin the period within 180 days from December 22, 2017, means that the latest day that such a 60-month period can end under the TCJA transition rule is June 20, 2023.

Section 7508A provides the Secretary of the Treasury or his delegate (Secretary) with authority to postpone the time for performing certain acts under the internal revenue laws for a taxpayer determined by the Secretary to be affected by a Federally declared disaster as defined in § 165(i)(5)(A). Pursuant to § 7508A(a), a period of up to one year may be disregarded in determining whether the performance of certain acts is timely under the internal revenue laws.

On April 9, 2020, the Department of the Treasury and the Internal Revenue Service (IRS) issued Notice 2020-23,

2020-18 I.R.B. 742, which pursuant to § 7508A provided certain relief to affected taxpayers and postponed due dates until July 15, 2020, with respect to certain tax filings and payments, certain time-sensitive government actions, and all time-sensitive actions listed in Rev. Proc. 2018-58, 2018-50 I.R.B. 990 (Dec. 10, 2018), that were due to be performed on or after April 1, 2020, and before July 15, 2020. *See* Notice 2020-23 and Rev. Proc. 2018-58. Among the relief granted, Notice 2020-23 (referencing Rev. Proc. 2018-58) postponed until July 15, 2020, the time to perform certain time-sensitive actions for purposes of § 47 that were due to be performed on or after April 1, 2020, and before July 15, 2020, including the time period for satisfying the substantial rehabilitation test described in former § 47(c)(1)(C) (redesignated as § 47(c)(1)(B) by the TCJA) and § 1.48-12(b)(2).

### III. GRANT OF RELIEF UNDER SECTION 47 PURSUANT TO SECTION 7508A

The Secretary has determined that persons with deadlines under § 47 that are described in sections III.A and B of this notice are persons affected by the COVID-19 emergency for the purposes of the relief provided under § 7508A(a) as described in sections III.A and B of this notice.

#### A. MEASURING PERIOD UNDER THE SUBSTANTIAL REHABILITATION TEST

For purposes of §§ 47(c)(1)(B) and 1.48-12(b)(2), if the 24- or 60-month measuring period in which the requisite amount of QREs have to be paid or incurred in order to satisfy the substantial rehabilitation test for a building originally ends on or after April 1, 2020, and before March 31, 2021, the last day of the 24- or 60-month measuring period for a taxpayer to incur the requisite QREs with respect to the building is postponed to March 31, 2021. This means that a taxpayer may have a measuring period that is longer than 24 or 60 months.

#### B. DEADLINE FOR TCJA TRANSITION RULE

For purposes of taxpayers subject to the TCJA transition rule, if the 24- or 60-month measuring period in which the requisite amount of QREs have to be paid or incurred in order to satisfy the substantial rehabilitation test for a building originally ends on or after April 1, 2020, and before March 31, 2021, the last day of the 24- or 60-month measuring period for a taxpayer to pay or incur the requisite QREs with respect to the building is postponed to March 31, 2021. Thus, if the requisite QREs described in the preceding sentence are paid or incurred by

March 31, 2021, the TCJA transition rule allows the rules of former § 47 allowing the 10-percent and 20-percent credits in a single year to apply to QREs paid or incurred with respect to such building in the taxable year in which the 24- or 60-month measuring period (the last day of which is postponed by this notice) ends. In addition, the amendments made by section 13402(a) and (b) of the TCJA, under which only the 20-percent credit is allowed over five years, apply to QREs paid or incurred with respect to such building in succeeding taxable years.

#### C. OTHER REQUIREMENTS

Except as expressly provided in this notice, all other rules and requirements of § 47 continue to apply.

#### IV. EFFECT ON OTHER DOCUMENTS

Notice 2020-23 is amplified.

#### V. DRAFTING INFORMATION

The principal authors of this notice are Barbara J. Campbell and Michael J. Torruella Costa, Office of the Associate Chief Counsel (Passthroughs and Special Industries). For further information regarding this notice, contact Barbara J. Campbell or Michael J. Torruella Costa at (202) 317-4137 (not a toll-free number).



## Part IV

### Notice of Proposed Rulemaking by Cross-reference to Temporary Regulations

### Recapture of Excess Employment Tax Credits under the Families First Act and the CARES Act

#### REG-111879-20

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of Proposed Rulemaking by cross-reference to temporary regulations.

**SUMMARY:** In the Rules and Regulations section of this issue of the **Federal Register**, the IRS is issuing temporary regulations pursuant to the regulatory authority granted under the Families First Coronavirus Response Act and the Coronavirus Aid, Relief, and Economic Security Act to prescribe such regulations as may be necessary for reconciling advance payments of refundable employment tax credits provided under these acts and recapturing the benefit of the credits when necessary. These proposed regulations affect businesses and tax-exempt organizations that claim certain credits under the Families First Coronavirus Response Act for qualifying sick and family leave wages and that claim certain employee retention credits under the Coronavirus Aid, Relief, and Economic Security Act. The text of those temporary regulations serves as the text of these proposed regulations.

**DATES:** Written or electronic comments and requests for a public hearing must be received by September 28, 2020. Requests for a public hearing must be submitted as prescribed in the “**Comments and Requests for a Public Hearing**” section.

**ADDRESSES:** Commenters are strongly encouraged to submit public comments

electronically. Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-111879-20) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through the mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket. Send paper submissions to: CC:PA:LPD:PR (REG-111879-20), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

#### FOR FURTHER INFORMATION

**CONTACT:** Concerning the proposed regulations, NaLee Park at (202) 317-6879; concerning submissions of comments and/or requests for a public hearing, Regina Johnson, (202) 317-5177 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background and Explanation of Provisions

Temporary regulations in the Rules and Regulations section of this issue of the **Federal Register** amend the Employment Taxes and Collection of Income at the Source Regulations (26 CFR part 31) relating to sections 3111 and 3221 of the Internal Revenue Code (Code) pursuant to the regulatory authority granted under the Families First Coronavirus Response Act (Families First Act) and the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) to prescribe such regulations as may be necessary for reconciling advance payments of refundable employment tax credits provided under these acts and recapturing the benefit of the credits when necessary. Consistent with this au-

thority, these proposed regulations authorize the assessment of erroneous refunds of the credits paid under sections 7001 and 7003 of the Families First Act and section 2301 of the CARES Act. The text of those temporary regulations also serves as the text of these proposed regulations. The preamble to the temporary regulations explains the amendments.

#### Special Analyses

The Office of Management and Budget’s Office of Information and Regulatory Analysis has determined that these regulations are not significant and not subject to review under section 6(b) of Executive Order 12866.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), the Secretary certifies that these proposed regulations will not have a significant economic impact on a substantial number of small entities because these proposed regulations impose no compliance burden on any business entities, including small entities. Although these proposed regulations will apply to all employers eligible for the credits under the Families First Act and the CARES Act, including small businesses and tax-exempt organizations with fewer than 500 employees, and will therefore be likely to affect a substantial number of small entities, the economic impact will not be significant. These proposed regulations do not affect the employer’s employment tax reporting or the necessary information to substantiate entitlement to the credits. Rather, these proposed regulations merely implement the statutory authority granted under sections 7001(f) and 7003(f) of the Families First Act and section 2301(l) of the CARES Act that authorize the Service to assess, reconcile, and recapture any portion of the credits erroneously paid or refunded in excess of the actual amount allowed as if such amounts were tax liabilities under sections 3111(a) and 3221(a) subject to assessment and administrative collection procedures. Notwithstanding this certification, the Treasury Department and the IRS invite comments on any impact these regulations would have on small entities.



Pursuant to section 7805(f), this notice of proposed rulemaking has been submitted to the Chief Counsel of the Office of Advocacy of the Small Business Administration for comment on its impact on small business.

### Comments and Requests for Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are timely submitted to the IRS as prescribed in the preamble under the “ADDRESS-ES” section. The Treasury Department and the IRS request comments on all aspects of these proposed regulations. Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at [www.regulations.gov](http://www.regulations.gov) or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a hearing are strongly encouraged to be submitted electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020-4, 2020-17 IRB 1, provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

### Statement of Availability of IRS Documents

IRS notices and other guidance cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

### Drafting Information

The principal author of these regulations is NaLee Park, Office of the Associate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the Treasury Department and the IRS par-

ticipated in the development of these regulations.

### List of Subjects in 26 CFR 31

Employment taxes, Income taxes, Penalties, Pensions, Railroad retirement, Reporting and recordkeeping requirements, Social security, Unemployment compensation.

### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 31 is proposed to be amended as follows:

#### PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT SOURCE

Paragraph 1. The authority citation for part 31 is amended by adding entries for §§ 31.3111-6T and 31.3221-5T in numerical order to read in part as follows:

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

Section 31.3111-6T also issued under sec. 7001 and sec. 7003 of the Families First Coronavirus Response Act of 2020 and sec. 2301 of the Coronavirus Aid, Relief, and Economic Security Act of 2020

\* \* \* \* \*

Section 31.3221-5T also issued under sec. 7001 and sec. 7003 of the Families First Coronavirus Response Act of 2020 and sec. 2301 of the Coronavirus Aid, Relief, and Economic Security Act of 2020

\* \* \* \* \*

Par. 2. Section 31.3111-6 is added to read as follows:

*§31.3111-6 Recapture of credits under the Families First Coronavirus Response Act and the Coronavirus Aid, Relief, and Economic Security Act*

[The text of proposed §31.3111-6 is the same as the text of §31.3111-6T published elsewhere in this issue of the **Federal Register**].

Par. 3. Section 31.3221-5 is added to read as follows:

*§31.3221-5 Recapture of credits under the Families First Coronavirus Response Act and the Coronavirus Aid, Relief, and Economic Security Act*

[The text of proposed §31.3221-5 is the same as the text of §31.3221-5T published

elsewhere in this issue of the **Federal Register**].

Sunita Lough,  
*Deputy Commissioner for Services and Enforcement.*

(Filed by the Office of the Federal Register on July 24, 2020, 4:15 p.m., and published in the issue of the Federal Register for July 29, 2020, 85 F.R. 45551)

## Notice of Proposed Rulemaking and Partial Withdrawal of Notice of Proposed Rulemaking

### Excise Taxes; Transportation of Persons by Air; Transportation of Property by Air; Aircraft Management Services

#### REG-112042-19

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and partial withdrawal of notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations relating to the excise taxes imposed on certain amounts paid for transportation of persons and property by air. Specifically, the proposed regulations relate to the exemption for amounts paid for certain aircraft management services. The proposed regulations also amend, revise, redesignate, and remove provisions of existing regulations that are out-of-date or obsolete and generally update the existing regulations to incorporate statutory changes, case law, and other published guidance. In addition, the proposed regulations withdraw a provision that was included in a prior notice of proposed rulemaking that was never finalized and re-propose it. The proposed regulations affect persons that provide air transportation of persons and property, and persons that pay for those services.

**DATES:** Written or electronic comments and requests for a public hearing must be received by September 29, 2020. Requests for a public hearing must be submitted as prescribed in the “**Comments and Requests for a Public Hearing**” section.

**ADDRESSES:** Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-112042-19) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.

Send paper submissions to: CC:PA:LPD:PR (REG-112042-19), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, Michael H. Beker or Rachel S. Smith at (202) 317-6855; concerning submissions of comments and/or requests for a public hearing, Regina Johnson, (202) 317-5177 (not toll-free numbers).

#### **SUPPLEMENTARY INFORMATION:**

##### **Background**

This document contains proposed amendments to the Facilities and Services Excise Tax Regulations (26 CFR part 49) under sections 4261, 4262, 4263, 4264, 4271, 4281, and 4282 of the Internal Revenue Code (Code). This document also contains proposed amendments to the Excise Tax Procedural Regulations (26 CFR part 40).

Section 4261 imposes an excise tax on certain amounts paid for transportation of persons by air. Section 4271 imposes an excise tax on certain amounts paid for transportation of property by air. The excise taxes imposed by sections 4261 and 4271 (collectively, air transportation excise tax), as well as certain Federal fuel taxes, are deposited into the Airport and Airway Trust Fund, which funds the Federal Aviation Administration’s (FAA) operations, air transportation infrastructure, and other aviation-related programs. *See* section 9502 of the Code.

Section 13822 of Public Law 115-97, 131 Stat. 2054, 2182 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA), amended the Code by adding paragraph (e)(5) to section 4261. The new provision provides that no tax shall be imposed by section 4261 or 4271 on any amount paid by an aircraft owner for aircraft management services related to: (1) maintenance and support of the aircraft owner’s aircraft, or (2) flights on the aircraft owner’s aircraft.

Section 4261(e)(5)(B) defines the term “aircraft management services” to include assisting an aircraft owner with: (1) administrative and support services, such as scheduling, flight planning, and weather forecasting; (2) obtaining insurance; (3) maintenance, storage, and fueling of aircraft; (4) hiring, training, and provision of pilots and crew; (5) establishing and complying with safety standards; and (6) such other services as are necessary to support flights operated by an aircraft owner.

Section 4261(e)(5)(C)(i) provides that the term “aircraft owner” includes a person who leases an aircraft other than under a “disqualified lease.” Section 4261(e)(5)(C)(ii) defines the term “disqualified lease” for purposes of section 4261(e)(5)(C)(i) as a lease from a person providing aircraft management services with respect to the aircraft (or a related person (within the meaning of section 465(b)(3)(C)) to the person providing such services), if the lease is for a term of 31 days or less.

Finally, section 4261(e)(5)(D) provides that in the case of amounts paid to any person which (but for section 4261(e)(5)) are subject to air transportation excise tax, a portion of which consists of amounts described in section 4261(e)(5)(A), section

4261(e)(5) shall apply on a pro rata basis only to the portion which consists of amounts described in section 4261(e)(5)(A).

The Conference Report accompanying the TCJA, H.R. Rep. No. 115-466, at 536 (2017) (Conference Report), explains that section 4261(e)(5) “exempts certain payments related to the management of private aircraft from the excise taxes imposed on taxable transportation of persons by air.” The Conference Report further explains that certain arrangements that do not qualify a person as an “aircraft owner” for purposes of section 4261(e)(5) include ownership of stock in a commercial airline and participation in a fractional ownership aircraft program. *Id.* at 536 n.1190.

With regard to commercial airlines, the Conference Report specifically states that ownership of stock in a commercial airline cannot qualify an individual as an “aircraft owner” of a commercial airline’s aircraft, and amounts paid for transportation on such flights remain subject to air transportation excise tax. *Id.*

The Conference Report further states that participation in a fractional ownership aircraft program does not constitute “aircraft ownership” for purposes of section 4261(e)(5). *Id.* Amounts paid to a fractional ownership aircraft program for transportation under such a program are already exempt from air transportation excise tax pursuant to section 4261(j) if certain requirements provided in section 4043 of the Code are satisfied, including that the aircraft is operated under subpart K of part 91 of Title 14 of the Code of Federal Regulations (subpart K). *Id.* Flights under a fractional ownership aircraft program are subject to both the fuel tax levied on noncommercial aviation and an additional fuel surtax imposed by section 4043 (fuel surtax). *Id.* As a result, the Conference Report explains that “a business arrangement seeking to circumvent the fuel surtax by operating outside of subpart K, allowing an aircraft owner the right to use any of a fleet of aircraft, be it through an aircraft interchange agreement, through holding nominal shares in a fleet of aircraft, or any other arrangement that does not reflect true tax ownership of the aircraft being flown upon, is not considered ownership for purposes of [section 4261(e)(5)].” *Id.*

With regard to the pro rata allocation rule in section 4261(e)(5)(D), the Conference Report states that in the event that a payment made to an aircraft management company is allocated in part to exempt services and flights on the aircraft owner's aircraft, and in part to flights on aircraft other than that of the aircraft owner, air transportation excise tax must be collected on that portion of the payment attributable to flights on aircraft not owned by the aircraft owner. *Id.* at 536.

Section 4007 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), Pub. L. 116-136, 134 Stat. 181 (2020), created an excise tax holiday on certain aviation taxes by suspending air transportation excise tax and certain fuel excise taxes from March 28, 2020, through December 31, 2020. Nothing in these proposed regulations should be construed as affecting the excise tax holiday created by the CARES Act. In addition, except with regard to the provisions in 26 CFR part 40, the Treasury decision adopting these proposed regulations as final regulations will apply no sooner than January 1, 2021.

## Explanation of Provisions

### 1. Aircraft Management Services

The proposed regulations provide rules related to the exemption from air transportation excise tax for amounts paid by an aircraft owner for aircraft management services pursuant to section 4261(e)(5).

During the development of these proposed regulations, the Treasury Department and the IRS received various requests for guidance from stakeholders (referred to herein as "commenters") related to the first five issues discussed in part 1 of this Explanation of Provisions.

#### a. Applicability of Possession, Command, and Control Test

Commenters requested clarification on the applicability of the possession, command, and control test in existing guidance to amounts paid for aircraft management services in light of section 4261(e)(5). The possession, command, and control test is a facts-and-circumstances analytical framework that is used to determine whether a person is providing taxable transportation

to another person in cases where each of the parties contribute some, but not all, of the elements necessary for complete air transportation services. *See e.g.*, Rev. Rul. 60-311 (1960-2 C.B. 341), Rev. Rul. 70-325 (1970-1 C.B. 231), and Rev. Rul. 76-394 (1976-2 C.B. 355). Section 4261(e)(5) directly addresses a situation that, but for section 4261(e)(5), would be analyzed using the possession, command, and control test. As a result, in situations to which the section 4261(e)(5) exemption applies, the possession, command, and control test is not relevant.

#### b. Related-Party Payments

The second issue for which commenters requested guidance relates to the treatment of payments for aircraft management services made by a person who has a close relationship to the aircraft owner, but is not itself the owner of the aircraft. The commenters suggested that payments that are made by certain parties related to the aircraft owner should be considered as though made by the aircraft owner.

First, the commenters suggested that the proposed regulations should treat payments made by one member of an affiliated group (as that term is used in section 4282) on behalf of an aircraft owner that is a member of the same affiliated group as being made by the aircraft owner.

Second, the commenters suggested that payments made by an owner of a special purpose entity should be treated as being made by the aircraft owner if the special purpose entity owns the aircraft. For example, individuals and corporations often create a single member limited liability company (SMLLC) to own an aircraft in order to comply with FAA regulations or limit liability exposure. In such cases, the owner of the SMLLC often makes payments for aircraft management services on behalf of the SMLLC.

Finally, the commenters suggested that payments made by an aircraft owner's family members, as well as other persons and entities (for example, trusts, as well as the trust's fiduciaries and beneficiaries) closely related to an aircraft owner be treated as being made by the aircraft owner. For this purpose, the commenters suggested that the proposed regulations should treat payments for aircraft man-

agement services made on behalf of the aircraft owner by a family member of the aircraft owner and by persons and entities bearing relationships to the aircraft owner described in sections 267(b) and 707(b) of the Code as amounts paid by the aircraft owner.

The Treasury Department and the IRS understand that it is common practice in the private aviation sector for persons that bear certain close relationships to an aircraft owner to make payments for aircraft management services on behalf of the aircraft owner. However, exceptions to tax, like deductions, are matters of legislative grace, and such provisions are construed narrowly. *See Comm'r v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-9 (1974) ("The propriety of a deduction [...] depends upon legislative grace; and only as there is clear provision therefor can any particular deduction be allowed." (citations omitted)); *Shami v. Comm'r*, 741 F.3d 560, 567 (5th Cir. 2014) ("Tax credits are a matter of legislative grace, are only allowed as clearly provided for by statute, and are narrowly construed." (citation omitted)); *Lettie Pate Whitehead Found., Inc. v. U.S.*, 606 F.2d 534, 539 (5th Cir. 1979) ("Deductions are matters of legislative grace and must be narrowly construed." (citation omitted)); *Chrysler Corp. v. Comm'r*, 436 F.3d 644, 654 (6th Cir. 2006) ("While statutes imposing a tax are generally construed liberally in favor of the taxpayer, those granting a deduction are matters of legislative grace and are strictly construed in favor of the government." (citations omitted)). Section 4261(e)(5) specifically states that the exemption applies to "amounts paid by an aircraft owner" and makes no reference to any other entity or arrangement. The Treasury Department and the IRS are concerned that if the regulations were to treat payments for aircraft management services made on behalf of an aircraft owner (other than in a principal-agent scenario in which the aircraft owner is the principal) as being made by the aircraft owner itself, the regulations would effectively expand the exemption in a manner not authorized by Congress.

Additionally, a qualified subchapter S subsidiary (QSub) (as defined in section 1361(b)(3)(B)) that is generally not treated as a separate corporation from its S cor-



poration owner under section 1361(b)(3)(A), and a non-corporate, wholly-owned business entity, such as a SMLLC, that is disregarded as an entity separate from its owner for Federal income tax purposes (under §§301.7701-1 through 301.7701-3 of the Procedure and Administration Regulations), are each treated as an entity separate from its owner for certain Federal excise tax purposes. *See* §1.1361-4(a)(8) of the Income Tax Regulations and §301.7701-2(c)(2)(v). The rules under §§1.1361-4(a)(8) and 301.7701-2(c)(2)(v) were adopted because difficulties arose from the interaction of the rules in section 1361(b)(3)(A) and §§301.7701-1 through 301.7701-3 with the Federal excise tax rules. It would be contrary to the existing rules in §§1.1361-4(a)(8) and 301.7701-2(c)(2)(v) to treat a person or entity that is separate from the aircraft owner as the aircraft owner for purposes of the exemption from air transportation excise tax in section 4261(e)(5). For these reasons, the proposed regulations do not adopt the commenters' suggestion to provide a related-party rule.

#### *c. Choice of Flight Rules*

The third issue for which commenters requested guidance relates to whether an aircraft owner's decision to operate its aircraft under certain parts of the Federal Aviation Regulations (FARs) promulgated by the FAA affects the application of section 4261(e)(5). Part 91 of the FARs governs general aviation. However, some aircraft owners choose to operate their aircraft under Part 135 of the FARs (governing on-demand and commuter flights), which imposes additional FAA regulatory requirements related to operational safety and enhanced liability protection. Commenters suggested that the proposed regulations provide that if an aircraft owner elects to conduct flights on its own aircraft under Part 135 of the FARs (rather than under Part 91 of the FARs), then payments made by the aircraft owner for aircraft management services related to those flights qualify for the exemption provided in section 4261(e)(5) in the same manner as a flight conducted under Part 91 of the FARs.

It has long been the position of the Treasury Department and the IRS that

rules promulgated by the FAA, including the FARs, do not control for Federal excise tax purposes. *See* Rev. Rul. 78-75 (1978-1 C.B. 340). Further, section 4261(e)(5) makes no reference to the FARs; under the plain language of section 4261(e)(5), its application does not depend upon the FAR flight rules under which an aircraft is operated. The Treasury Department and the IRS agree with the commenters' suggestion. Accordingly, the proposed regulations provide that whether an aircraft owner operates its aircraft pursuant to the rules under FARs Part 91 or pursuant to the rules under FARs Part 135 does not affect the application of section 4261(e)(5).

#### *d. Charters*

The fourth issue for which commenters requested guidance relates to situations in which an aircraft owner permits an air charter operator (which may or may not be the same person as the person or persons providing aircraft management services to the aircraft owner) to use the aircraft owner's aircraft to provide charter flights. It is common for an aircraft owner to permit an air charter operator to use the aircraft owner's aircraft for a fee (in cash or in kind) when the aircraft would otherwise sit idle or when the aircraft is being repositioned and would otherwise not carry any passengers. In such instances, amounts paid for charter flights operated on the aircraft owner's aircraft are subject to air transportation excise tax, unless otherwise exempt from the taxes (for example, in the case of an aircraft used as an air ambulance dedicated to acute care emergency medical services under section 4261(g)(2)). *See* §49.4261-7(h) for the rules regarding the taxation of charter flights.

The commenters suggested that the proposed regulations clarify that the application of section 4261(e)(5) is not affected by an aircraft owner permitting a charter operator to use the aircraft owner's aircraft for charter flights. The Treasury Department and the IRS agree with the commenters that, in general, the application of section 4261(e)(5) should not be affected by an aircraft owner permitting an aircraft management services provider or other person to use the aircraft owner's aircraft for for-hire flights (such as charter flights, air taxi flights, and flightseeing

flights). Accordingly, the proposed regulations provide that whether an aircraft owner permits its aircraft to be used for for-hire flights does not affect the application of section 4261(e)(5) to amounts paid by the aircraft owner for aircraft management services.

The proposed regulations also clarify that to the extent such for-hire flights are subject to the tax imposed by section 4261 or 4271, taxable fuel (as defined in section 4083(a) of the Code) or any other liquid taxable under section 4041(c) of the Code that is used as fuel on such flights is used in commercial aviation, as that term is defined in section 4083(b). *See* sections 4081(a)(2) and 4041(c) for the applicable fuel tax rates.

#### *e. Payment Arrangements*

The fifth issue for which commenters requested guidance relates to business decisions made by a person providing aircraft management services regarding how to charge, invoice, or bill (referred to collectively herein as "bill" or "billed") aircraft owners for their services. An aircraft owner may be billed for aircraft management services in a variety of ways. For example, an aircraft owner may be charged a monthly fee for aircraft management services and an hourly fee for each hour of flight time. Alternatively, an aircraft owner may be billed for specific costs related to the operation of the aircraft, plus a mark-up to compensate the aircraft management services provider. In addition to these two examples, there are many other possible arrangements that may be used to bill an aircraft owner based on the particular agreement between an aircraft owner and the aircraft management services provider. The commenters suggested that the proposed regulations should clarify that the manner in which an aircraft owner is billed for aircraft management services should not control whether the exemption from air transportation excise tax provided in section 4261(e)(5) applies to amounts paid for those services.

The Treasury Department and the IRS agree with the commenters that the manner in which an aircraft owner is billed for aircraft management services is a business decision that providers of aircraft management services and aircraft owners should



be free to make with each other in order to satisfy their particular needs. Accordingly, the proposed regulations provide that the method or manner by which an aircraft owner is billed for aircraft management services does not affect whether the exemption from air transportation excise tax provided in section 4261(e)(5) applies to amounts paid for those services.

While the proposed regulations acknowledge that the manner in which an aircraft owner is billed for aircraft management services is a business decision, the proposed regulations require both the aircraft owner and the aircraft management services provider to maintain adequate records to show that amounts paid by the aircraft owner to the aircraft management services provider relate to aircraft management services specifically for the aircraft owner's aircraft or for flights on the aircraft owner's aircraft.

#### *f. Other Proposed Aircraft Management Services Rules*

The proposed regulations clarify that the exemption from air transportation excise tax in section 4261(e)(5) is limited to private aviation. Section 49.4261-10(b)(6) of the proposed regulations defines "private aviation" as the use of an aircraft for civilian flights except scheduled passenger service. This rule is consistent with the Conference Report, which explicitly states that section 4261(e)(5) "exempts certain payments related to the management of private aircraft from the excise taxes imposed on taxable transportation by air." Conference Report at 536.

The proposed regulations also clarify the application of section 4261(e)(5)(D), which requires a pro rata allocation of the amounts paid for aircraft management services between services that relate to flights taken by an aircraft owner on the aircraft owner's aircraft and services that relate to flights taken by an aircraft owner on an aircraft that is not owned by the aircraft owner. An aircraft that is not owned by the aircraft owner is referred to in the proposed regulations as a "substitute aircraft." Section 4261(e)(5)(D) limits the section 4261(e)(5) exemption to amounts paid for aircraft management services related to flights taken by an aircraft owner on the aircraft owner's aircraft. Therefore,

the section 4261(e)(5) exemption does not extend to those amounts paid for aircraft management services that relate to flights taken by an aircraft owner on a substitute aircraft (that is, an aircraft not owned by the aircraft owner). The proposed regulations provide that the pro rata allocation is calculated by applying to the amount paid by the aircraft owner for aircraft management services the ratio of flight hours provided on substitute aircraft during the calendar quarter over the total flight hours flown by the aircraft owner on both the aircraft owner's aircraft and substitute aircraft during the calendar quarter. The Treasury Department and the IRS request comments regarding whether the proposed flight hour ratio allocation method is fair and practicable or whether a different allocation method should be required (and if so, what exactly such required method should be).

In addition, the proposed regulations clarify that taxable fuel (as defined in section 4083(a)) or any other liquid taxable under section 4041(c) that is used as fuel on a flight for which amounts paid are exempt from the taxes imposed by sections 4261 and 4271 by reason of section 4261(e)(5) is not fuel used in commercial aviation, as that term is defined in section 4083(b). *See* sections 4081(a)(2) and 4041(c) for the applicable fuel tax rates.

Finally, the section 4043 fuel surtax applies to fuel used in fractional program aircraft operated under FARs Part 91K (14 CFR part 91K) but not to fuel used on flights for which amounts paid are exempt by reason of section 4261(e)(5). The Treasury Department and the IRS are concerned that this creates an incentive for persons to operate flights that would otherwise be subject to the section 4043 fuel surtax outside of FARs Part 91K in order to avoid the surtax. In these instances, such persons would likely also argue that amounts paid for aircraft management services related to the fractional program aircraft are exempt from air transportation excise tax under section 4261(e)(5).

To address this issue, the proposed regulations include an anti-abuse rule providing that the section 4261(e)(5) exemption does not apply to any amount paid for aircraft management services by a participant in any transaction or arrangement, or

through other means, that seeks to circumvent the surtax imposed by section 4043. In addition, the proposed regulations clarify that the section 4261(e)(5) exemption does not apply to amounts paid for aircraft management services related to flights on fractional program aircraft operated (or required to be operated) under FARs Part 91K. The proposed regulations also provide that if an amount paid qualifies for both the exemption provided in section 4261(e)(5) and the exemption provided in section 4261(j), the section 4261(j) exemption applies to the amount paid and the surtax imposed by section 4043 applies to any liquid used in the fractional program aircraft as fuel. *See* sections 4261(j) and 4043. This provision is consistent with the Conference Report and the definition of "aircraft owner" in §49.4261-10(b)(3)(B) in the proposed regulations.

#### *2. Additional Proposed Changes to the Regulations*

##### *a. Changes to Part 40*

The privilege to file consolidated returns under section 1501 applies only to income tax returns and not to excise tax returns. The proposed regulations add §40.0-1(d) to note this rule and also reflect the rules of §§1.1361-4(a)(8) and 301.7701-2(c)(2)(v) that treat QSubs and certain business entities as entities separate from their owners for Federal excise tax purposes. *See also* Revenue Ruling 2008-18 (2008-1 C.B. 674). Thus, proposed §40.0-1(d) treats each business unit that has, or is required to have, a separate Employer Identification Number as a separate person. In the context of air transportation excise tax, this rule applies with respect to both the person required to pay the tax under proposed §49.4261-1(b) and the person required to collect and pay over the tax under §40.6011(a)-1(a)(3) and section 4291 of the Code.

Proposed §40.0-1(d) was originally proposed on July 29, 2008, in a notice of proposed rulemaking (REG-155087-05) published in the **Federal Register** (73 FR 43890), but the rules in that regulation project have not been finalized. Because of the length of time that has passed since it was originally proposed, this document withdraws proposed §40.0-1(d) and

re-proposes the provision as part of these proposed regulations.

Existing §40.6071(a)-3 provides excise tax return filing rules that apply only to the quarterly return required under §40.6011(a)-1(a) for the third calendar quarter of 2001. The proposed regulations remove §40.6071(a)-3 in its entirety because it is obsolete.

#### b. *Changes to Part 49*

The existing regulations under section 4261 have not been revised since 1962. The proposed regulations remove existing language relating to taxes on transportation by rail, motor vehicle, and water, which have been repealed, and otherwise update the existing regulations to conform to current law. The proposed regulations also remove references to exemptions that were repealed in 1970. More specifically, the proposed regulations update §49.4261-1 to reflect: (i) the enactment of the international travel facilities tax in 1970 (Airport and Airway Development Act of 1970 (AADA), Pub. L. No. 91-258, 84 Stat. 236 (1970)); (ii) the enactment of the domestic segment tax in 1997 (Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788 (1997)), and (iii) the current statutory exemptions from tax under sections 4261(e)(5), 4261(f), 4261(g), 4261(h), 4261(j), 4281, 4282, and 4293 of the Code.

Section 49.4261-1(b)(1) of the proposed regulations incorporates the payment and collection rules in sections 4261(d) and 4291.

Section 49.4261-1(b)(2) of the proposed regulations reflects the statutory change to section 4263(c) under section 1031 of the Taxpayer Relief Act of 1997, and case law interpreting that revision. Under prior law, section 4263(c) provided that where any tax imposed by section 4261 was not paid at the time payment for transportation was made, the tax was paid by the person paying for the transportation or by the person using the transportation. In other words, the prior law placed no payment obligation on the air carrier. The current version of section 4263(c) provides that where any tax imposed by section 4261 is not paid at the time the payment for transportation is made, the air carrier providing the initial segment of transpor-

tation that begins and ends in the United States is liable for the tax. Several courts have rejected arguments that current section 4263(c) imposes only secondary liability for the applicable section 4261 tax on the air carrier if the tax is not otherwise collected. *See Sundance Helicopters, Inc. v. U.S.*, 104 Fed. Cl. 1, 11 (2012) (“The plain language of IRC [section] 4263(c) provides that the air carrier is to pay the tax if it is not otherwise collected. There is no mention of primary versus secondary liability in the text of the statute [...] The language of IRC [section] 4263(c) clearly imposes a payment obligation on the air carrier.”); *Temco Helicopters, Inc. v. U.S.*, 409 F.App’x 64, 67 (9<sup>th</sup> Cir. 2010) (“nothing in [section] 4263(c) requires that the government first attempt to collect the [air transportation excise tax] from the purchasers...”); *Papillon Airways, Inc. v. U.S.*, 105 Fed. Cl. 154, 163 (2012) (IRC 4263(c) makes “the carrier’s liability conditional on *whether the tax was collected* at the time payment for transportation was made, *not whether the government is unsuccessful at collecting the tax.*” (emphasis in original)).

Section 49.4261-1(d) of the proposed regulations generally incorporates the holdings of Revenue Ruling 71-126 (1971-1 C.B. 363) regarding the general applicability of the section 4261 taxes to the transportation of persons on all types of aircraft, and Revenue Ruling 67-414 (1967-2 C.B. 382) regarding the inapplicability of the section 4261 taxes to the transportation of persons on hovercraft.

Section 49.4261-2 of the proposed regulations generally updates the existing regulations to reflect the statutory additions of the domestic segment tax and the international travel facilities tax to section 4261. This section also incorporates the holdings in Revenue Ruling 72-309 (1972-1 C.B. 348) and Revenue Ruling 2002-34 (2002-1 C.B. 1150) regarding the computation of the domestic segment tax and the international travel facilities tax.

Section 49.4261-9(a) of the proposed regulations reflects the rule in section 4261(e)(3)(A) regarding the tax treatment of mileage awards. The Treasury Department and the IRS are currently considering whether to exercise their authority under section 4261(e)(3)(C) to prescribe rules for excluding from the tax base

amounts attributable to mileage awards that are used other than for transportation of persons by air. *See* Notice 2015-76 (2015-46 I.R.B. 669). Nothing in these proposed regulations can be construed as an exercise of that authority. The proposed regulations reserve §49.4261-9(b) for the possible future exercise of the authority granted to the Secretary of the Treasury or his delegate under section 4261(e)(3)(C).

The regulations under sections 4262 and 4263 also have generally not been revised since the 1960s. Amendments to the Code since then, including the repeal of the seats and berths tax, a change to the definition of “uninterrupted international air transportation” under section 4262(c) (3), and a change to the rules in section 4263(c), have rendered certain provisions in the existing regulations obsolete. The proposed regulations remove obsolete provisions and generally update the existing regulations to conform to current law.

Section 4264 of the Code was redesignated as section 4263 in 1970 by Title II, section 205(c)(2), of the AADA. However, the regulations under section 4264 were not similarly redesignated. The proposed regulations redesignate the current section 4264 regulations as section 4263 regulations, remove obsolete provisions, and generally update the existing regulations to conform to current law.

The proposed regulations update the rule in §49.4263-5 (which the proposed regulations redesignate as §49.4281-1) relating to small aircraft on nonestablished lines to reflect statutory changes to the exemption. Specifically, the current regulation provides, in relevant part, that amounts paid to transport a person on a small aircraft are “exempt from the tax imposed under section 4261 provided the aircraft: (1) has a gross take-off weight of less than 12,500 pounds [...] and (2) has a passenger seating capacity of less than 10 adult passengers, including the pilot.” In 1970, the permissible aircraft weight to qualify for the exemption for small aircraft on nonestablished lines was reduced to a maximum certificated take-off weight of 6,000 pounds or less and the maximum passenger seating capacity rule was eliminated. AADA, Title II, section 205(a)(1). In 2005, Congress amended section 4281 to clarify that flights for which the sole purpose is sightseeing are not considered

to be operated on an established line. Safe, Accountable, Flexible, Efficient Transportation Equity Act: A Legacy for Users, Pub. L. No. 109-59, section 11124(a), 119 Stat 1144 (2005). In 2012, Congress amended section 4281 to exclude jet aircraft from the exemption. FAA Modernization and Reform Act of 2012, Pub. L. No. 112-95, section 1107(a), 126 Stat 11 (2012). The proposed regulations incorporate the changes to the exemption for small aircraft on nonestablished lines as described above.

Section 4282 provides an exemption from the taxes imposed by section 4261 and 4271 for certain transportation by air for members of an affiliated group. The Treasury Department and the IRS have not issued regulations regarding this provision. The proposed regulations reserve §49.4282-1 for future rules regarding the affiliated group exemption under section 4282.

The updates to part 49 in these proposed regulations are not comprehensive and do not fully update every provision and example that require modernization. The updates are intended to address only the most straightforward and well-settled issues; they are not intended to introduce new rules or address issues that may require a more nuanced approach. The Treasury Department and the IRS believe that these updates will help reduce the burden on taxpayers, collectors, and revenue agents by providing much needed basic updates to the part 49 regulations.

#### Effect on Other Documents

Revenue Ruling 67-414 (1967-2 C.B. 382), Revenue Ruling 72-309 (1972-1 C.B. 348), and Revenue Ruling 2002-34 (2002-1 C.B. 1150) will be obsoleted on the date these regulations are published as final regulations in the **Federal Register**.

#### Partial Withdrawal of Proposed Regulations

Under the authority of 26 U.S.C. 7805, §40.0-1(d) of the notice of proposed rulemaking (REG-155087-05) published in the **Federal Register** on July 29, 2008 (73 FR 43890) is withdrawn.

#### Proposed Applicability Date

The regulations, other than §40.0-1(d), generally are proposed to apply on and after the later of the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register** or January 1, 2021. Section 40.0-1(d) of the regulations is proposed to apply on and after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

#### Special Analyses

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Department of the Treasury and the Office of Management and Budget regarding review of tax regulations.

Because the regulation does not impose a collection of information on small entities a Regulatory Flexibility Act (5 U.S.C. chapter 6) analysis is not required.

Pursuant to section 7805(f) of the Code these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

#### Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, Notices and other guidance cited in this document are published in the Internal Revenue Bulletin and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

#### Comments and Requests for a Public Hearing

Before these proposed amendments to the regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the “ADDRESSES” section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. Any electronic comments submitted, and to the extent practicable

any paper comments submitted, will be made available at [www.regulations.gov](http://www.regulations.gov) or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020-4 (2020-17 I.R.B. 1) provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

#### Drafting Information

The principal authors of these regulations are Michael H. Beker and Rachel S. Smith, Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

#### List of Subjects

##### 26 CFR Part 40

Excise taxes, Reporting and record-keeping requirements.

##### 26 CFR Part 49

Excise taxes, Reporting and record-keeping requirements, Telephone, Transportation.

#### Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 40 and 49 are proposed to be amended as follows:

#### PART 40—EXCISE TAX PROCEDURAL REGULATIONS

Paragraph 1. The authority citation for part 40 is amended by removing the entry for §40.6071(a)-3 to read in part as follows:

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

Par. 2. Section 40.0-1 is amended by redesignating paragraph (d) as paragraph



(e), adding a new paragraph (d), and revising newly redesignated paragraph (e) to read as follows:

*§40.0-1 Introduction.*

\* \* \* \* \*

(d) *Person.* For purposes of this part, each business unit that has, or is required to have, a separate employer identification number is treated as a separate person. Thus, business units (for example, a parent corporation and a subsidiary corporation, a partner and the partner's partnership, or the various members of a consolidated group), each of which has, or is required to have, a different employer identification number, are separate persons.

(e) *Applicability date*—(1) *Paragraphs (a), (b), and (c).* Paragraphs (a), (b), and (c) of this section apply to returns that relate to periods beginning after March 31, 2013. For rules that apply before that date, see 26 CFR part 40, revised as of April 1, 2013.

(2) *Paragraph (d).* Paragraph (d) of this section applies to returns that relate to periods beginning on or after [date these regulations are published as final regulations in the **Federal Register**]. For rules that apply before that date, see 26 CFR part 40, revised as of April 1, 2020.

**§40.6071(a)-3 [Removed]**

Par. 3. Section 40.6071(a)-3 is removed.

**PART 49—FACILITIES AND SERVICES EXCISE TAX REGULATIONS**

Par. 4. The authority citation for part 49 continues to read in part as follows:

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

Par. 5. Section 49.4261-1 is revised to read as follows:

*§49.4261-1 Imposition of tax; in general.*

(a) *In general.* Section 4261 of the Internal Revenue Code (Code) imposes three separate taxes on amounts paid for certain transportation of persons by air. Tax attaches at the time of payment for any transportation taxable under section 4261. The applicability of each section

4261 tax is generally determined on a flight-by-flight basis.

(1) *Percentage tax.* Section 4261(a) imposes a 7.5 percent tax on the amount paid for the taxable transportation of any person. See section 4262(a) of the Code and §49.4262-1(a) for the definition of the term *taxable transportation*.

(2) *Domestic segment tax.* Section 4261(b)(1) imposes a \$3 tax (indexed annually for inflation pursuant to section 4261(e)(4)) on the amount paid for each domestic segment of taxable transportation. See section 4261(b)(2) for the definition of the term *domestic segment*. The domestic segment tax does not apply to a domestic segment beginning or ending at an airport that is a rural airport for the calendar year in which the segment begins or ends (as the case may be). See section 4261(e)(1)(B) for the definition of the term *rural airport*.

(3) *International travel facilities tax.* Section 4261(c) imposes a \$12 tax (indexed annually for inflation pursuant to section 4261(e)(4)) on any amount paid (whether within or without the United States) for any transportation by air that begins or ends in the United States. The international travel facilities tax does not apply to any transportation that is entirely taxable under section 4261(a) (determined without regard to sections 4281 and 4282). See section 4261(c)(2). A special rule applies to Alaska and Hawaii flights. See section 4261(c)(3).

(b) *Payment and collection obligations*—(1) *In general.* The taxes imposed by section 4261 are collected taxes. In general, the person making the payment subject to tax is the *taxpayer*. See section 4261(d). The person receiving the payment is the *collector* (also commonly referred to as the collecting agent). See section 4291 of the Code. The collector must collect the applicable tax from the taxpayer, report the tax on Form 720, *Quarterly Federal Excise Tax Return*, and remit the tax to the Internal Revenue Service. See sections 4291, 6011, and 7501 of the Code. See §40.6011(a)-1 of this chapter and §49.4291-1. The collector must also make semimonthly deposits of the taxes imposed by section 4261. See section 6302(e) of the Code. See §§40.0-1(c), 40.6302(c)-1, and 40.6302(c)-3 of this chapter. See section 4263(a) and (c) of

the Code for special rules relating to the payment and collection of tax.

(2) *Failure to collect tax.* Where any tax imposed by section 4261 is not paid at the time payment for transportation is made, then, to the extent the tax is not collected under any other provision of subchapter C of chapter 33 of the Code, the tax must be paid by the carrier providing the initial segment of transportation that begins or ends in the United States. See section 4263(c). In other words, if an amount paid for transportation is subject to tax under section 4261 and the applicable tax is not collected at the time the payment is made, the carrier providing the initial segment of transportation that begins or ends in the United States is liable for the tax. See section 6672 of the Code for rules relating to the application of the trust fund recovery penalty.

(c) *Type of aircraft.* The taxes imposed by section 4261 generally apply regardless of the type of aircraft on which the transportation is provided, provided all of the other conditions for liability are present and no specific statutory exemption applies. See paragraph (f) of this section for a list of statutory exemptions from tax. Amounts paid for the transportation of persons by air cushion vehicles, also known as hovercraft, are not subject to the taxes imposed by section 4261.

(d) *Purpose of transportation.* The purpose of the transportation (for example, business or pleasure) is not a factor in determining taxability under section 4261.

(e) *Routes.* Amounts paid for transportation may be taxable even if the transportation is not between two definite points. Unless otherwise exempt, a payment for continuous transportation that begins and ends at the same point is subject to tax. See section 4281 of the Code and §49.4282-1 for the exemption for small aircraft on nonestablished lines.

(f) *Exemptions from tax; cross-references*—(1) *Aircraft management services.* For the exemption for certain aircraft management services, see section 4261(e) (5) of the Code and §49.4261-10.

(2) *Hard minerals, oil, and gas.* For the exemption for certain uses related to the exploration, development, or removal of hard minerals, oil, or gas, see section 4261(f)(1).



(3) *Trees and logging operations.* For the exemption for certain uses related to trees and logging operations, see section 4261(f)(2).

(4) *Air ambulances.* For the exemption for air ambulances providing certain emergency medical transportation, see section 4261(g).

(5) *Skydiving.* For the exemption for certain skydiving uses, see section 4261(h).

(6) *Seaplanes.* For the exemption for certain seaplane segments, see section 4261(i).

(7) *Fractionally-owned aircraft.* For the exemption for certain aircraft in fractional ownership aircraft programs, see section 4261(j).

(8) *Small aircraft on nonestablished lines.* For the exemption for certain small aircraft on nonestablished lines, see section 4281 of the Code and §49.4281-1.

(9) *Affiliated groups.* For the exemption for certain transportation of members of an affiliated group, see section 4282.

(10) *United States and territories.* For exemptions authorized by the Secretary of the Treasury or his delegate for the exclusive use of the United States, see section 4293.

(g) *Applicability date.* This section applies on and after the later of [date these regulations are published as final regulations in the **Federal Register**] or January 1, 2021. For rules that apply before that date, see 26 CFR part 49, revised as of April 1, 2020.

Par. 6. Section 49.4261-2 is amended by:

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

The revisions and addition read as follows:

*§49.4261-2 Application of tax.*

(a) *Tax on total amount paid.* The tax imposed by section 4261(a) of the Internal Revenue Code (Code) is measured by the total amount paid for taxable transportation, whether paid in cash or in kind.

(b) *Tax on transportation of each person.* The taxes imposed by section 4261(b) and (c) of the Code are head taxes and, therefore, apply on a per-passenger basis. The taxes apply to each passenger for whom an amount is paid, regardless of

whether the payment is made as a single lump sum or is made individually for each passenger. In the case of charter flights for which a fixed amount is paid, the section 4261(b) and (c) taxes are computed by multiplying the applicable rate of tax by the number of passengers transported on the aircraft.

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(d) *Applicability date.* Paragraphs (a) and (b) of this section apply on and after the later of [date these regulations are published as final regulations in the **Federal Register**] or January 1, 2021. For rules that apply before that date, see 26 CFR part 49, revised as of April 1, 2020.

Par. 7. Section 49.4261-3 is amended by:

1. Removing “§49.4262(c)-1” wherever it appears and adding “§49.4262-3” in its place.

2. In the first sentence of paragraph (a), removing “The tax imposed by section 4261(a)” and adding “The taxes imposed by section 4261(a) and (b) of the Internal Revenue Code (Code)” in its place.

3. In the second sentence of paragraph (a), adding “under section 4261(a) and (b)” at the end of the sentence.

4. Removing (b) introductory text and (b)(1) and redesignating paragraph (b)(2) as paragraph (b).

5. Revising newly redesignated paragraph (b).

6. Revising paragraph (c).

7. In paragraph (d), removing “section 4262(b) and §49.4262(b)-1” and adding “section 4262(b) of the Code and §49.4262-2” in its place.

8. Adding paragraph (e).

The revisions and additions read as follows:

*§49.4261-3 Payments made within the United States.*

\*\*\*\*\*

(b) *Other transportation.* In the case of transportation, other than that described in paragraph (a) of this section, for which payment is made in the United States, the taxes imposed by section 4261(a) and (b) apply with respect to the amount paid for that portion of such transportation by air which is directly or indirectly from one port or station in the United States to another port or station in the United States,

but only if such portion is not a part of uninterrupted international air transportation within the meaning of section 4262(c)(3) of the Code and §49.4262-3(c). Transportation that:

(1) Begins in the United States or the 225-mile zone and ends outside such area,

(2) Begins outside the United States or the 225-mile zone and ends inside such area, or

(3) Begins outside the United States and ends outside such area, is taxable only with respect to such portion of the transportation by air which is directly or indirectly from one port or station in the United States to another port or station in the United States, but only if such portion is not a part of “uninterrupted international air transportation” within the meaning of section 4262(c)(3) and §49.4262-3(c). Thus, on a trip by air from Chicago to London, England, with a stopover at New York, for which payment is made in the United States, if the portion from Chicago to New York is not a part of “uninterrupted international air transportation” within the meaning of section 4262(c)(3) and §49.4262-3(c), the taxes would apply to the part of the payment which is applicable to the transportation from Chicago to New York. However, if the portion from Chicago to New York is a part of “uninterrupted international air transportation” within the meaning of section 4262(c)(3) and §49.4262-3(c), the taxes would not apply.

(c) *Method of computing tax on taxable portion.* Where a payment is made for transportation which is partially taxable under paragraph (b) of this section, the tax imposed by section 4261(a) may be computed on that proportion of the total amount paid which the mileage of the taxable portion of the transportation bears to the mileage of the entire trip.

\*\*\*\*\*

(e) *Applicability date.* This section applies on and after the later of [the date these regulations are published as final regulations in the **Federal Register**] or January 1, 2021. For rules that apply before that date, see 26 CFR part 49, revised as of April 1, 2020.

*§49.4261-4 [Amended]*

Par. 8. Section 49.4261-4 is amended by:

1. In paragraph (a), removing the first “4261(a)” and add “4261 of the Internal Revenue Code (Code)” in its place.

2. In paragraph (a), removing “section 4261(a) (see section 4264(d))” and adding “section 4261 (see section 4263(d) of the Code)” in its place.

3. In paragraph (b), removing “§49.4262(c)-1” and adding “§49.4262-3” in its place.

4. In the first sentence of paragraph (d), removing “§49.4262(c)-1” and adding “§49.4262-3” in its place.

5. In the first sentence of paragraph (d), removing “six-hour” and adding “12-hour” in its place.

#### ***§49.4261-5 [Amended]***

Par. 9. Section 49.4261-5 is amended as follows:

1. In paragraph (a), remove “4261(b)” wherever it appears and add “4261(a) and (b)” in its place.

2. In paragraph (c), remove “§49.4262(b)-1” and add “§49.4262-2” in its place.

Par. 10. Section 49.4261-7 is amended by:

1. In the introductory paragraph, removing “4263, 4292, 4293, or 4294” and adding “4261, 4281, 4282 or 4293 of the Internal Revenue Code” in its place.

2. Removing and reserving paragraphs (b), (d), (e), and (g).

3. Revising paragraph (h).

4. In paragraph (i), remove “paragraph (c) of §49.4261-2 and paragraph (f)(4) of §49.4261-8” and add “§§49.4261-2(c) and 49.4261-8(f)(4)” in its place.

5. Adding paragraph (k).

The revision and addition read as follows:

#### ***§49.4261-7 Examples of payments subject to tax.***

\*\*\*\*\*

(h) *Aircraft charters*—(1) When no charge is made by the charterer of an aircraft to the persons transported, the amount paid by the charterer for the charter of the aircraft is subject to tax.

(2) The charterer of an aircraft who sells transportation to other persons must collect and account for the tax with respect to all amounts paid to the charterer

by such other persons. In such case, no tax will be due on the amount paid by the charterer for the charter of the aircraft but it shall be the duty of the owner of the aircraft to advise the charterer of the charterer’s obligation for collecting, accounting for, and paying over the tax to the Internal Revenue Service.

\*\*\*\*\*

(k) *Applicability date.* Paragraph (h) of this section applies on and after the later of [the date these regulations are published as final regulations in the **Federal Register**] or January 1, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

#### ***§49.4261-8 [Amended]***

Par. 11. Section 49.4261-8 is amended as follows:

1. In the introductory paragraph, remove “4263, 4292, 4293, or 4294” and add “4261, 4281, 4282 or 4293 of the Internal Revenue Code” in its place.

2. Paragraphs (f)(2), (3), and (5) are removed and reserved.

Par. 12. Section 49.4261-9 is revised to read as follows:

#### ***§49.4261-9 Mileage awards.***

(a) *Tax imposed.* Any amount paid (and the value of any other benefit provided) to an air carrier (or any related person) for the right to provide mileage awards for or other reductions in the cost of any transportation of persons by air is an amount paid for taxable transportation and is therefore subject to the tax imposed by section 4261(a) of the Internal Revenue Code. *See* section 4261(e)(3)(A).

(b) *[Reserved]*

(c) *Applicability date.* This section applies on and after the later of [date these regulations are published as final regulations in the **Federal Register**] or January 1, 2021.

Par. 13. Section 49.4261-10 is revised to read as follows:

#### ***§49.4261-10 Aircraft management services.***

(a) *In general*—(1) *Overview.* This section prescribes rules relating to the exemption from tax for amounts paid (in

cash or in kind) by an aircraft owner to an aircraft management services provider for certain aircraft management services. Pursuant to section 4261(e)(5) of the Internal Revenue Code (Code), the taxes imposed by sections 4261 and 4271 of the Code do not apply to amounts paid by an aircraft owner to an aircraft management services provider for aircraft management services related to maintenance and support of the aircraft owner’s aircraft; or related to flights (flight services) on the aircraft owner’s aircraft. The exemption in section 4261(e)(5) applies to amounts paid by an aircraft owner to an aircraft management services provider for flight services on the aircraft owner’s aircraft, even if the aircraft owner is not on the flight. The exemption in section 4261(e)(5) does not apply to amounts paid to an aircraft management services provider on behalf of an aircraft owner (other than in a principal-agent scenario in which the aircraft owner is the principal). For example, amounts paid for aircraft management services by one member of an affiliated group (as that term is defined in section 4282 of the Code) for flights on an aircraft owned by another member of the affiliated group are not treated as amounts paid by the aircraft owner. *See* paragraph (b) of this section for definitions of terms used in this section.

(2) *Private aviation.* The exemption in section 4261(e)(5) is limited to aircraft management services related to aircraft used in private aviation.

(3) *Adequate records required.* In order to qualify for the exemption in section 4261(e)(5), an aircraft owner and aircraft management services provider must maintain adequate records to show that the amounts paid by the aircraft owner to the aircraft management services provider relate to aircraft management services specifically for the aircraft owner’s aircraft or for flights on the aircraft owner’s aircraft.

(b) *Definitions.* This paragraph provides definitions applicable to this section.

(1) *Aircraft management services.* The term *aircraft management services* means—

(i) *Statutory services.* The services listed in section 4261(e)(5)(B); and

(ii) *Other services.* Any service (including, but not limited to, purchasing fuel, purchasing aircraft parts, and arrange-

ing for the fueling of an aircraft owner's aircraft) provided directly or indirectly by an aircraft management services provider to an aircraft owner, that is necessary to keep the aircraft owner's aircraft in an airworthy state or to provide air transportation to the aircraft owner on the aircraft owner's aircraft at a level and quality of service required under the agreement between the aircraft owner and the aircraft management services provider.

(2) *Aircraft management services provider.* The term *aircraft management services provider* means a person that provides aircraft management services, as defined in paragraph (b)(1) of this section, to an aircraft owner, as defined in paragraph (b)(3) of this section.

(3) *Aircraft owner*—(i) *In general.* The term *aircraft owner* means an individual or entity that leases or owns (that is, holds title to or substantial incidents of ownership in) an aircraft managed by an aircraft management services provider (commonly referred to as a managed aircraft). The term *aircraft owner* does not include a lessee of an aircraft under a disqualified lease, as defined in paragraph (b)(4) of this section. A person that owns stock in a commercial airline does not qualify as an aircraft owner of that commercial airline's aircraft.

(ii) *Fractional aircraft ownership and similar arrangements.* A participant in a fractional aircraft ownership program, as defined in section 4043(c)(2) of the Code, does not qualify as an aircraft owner of the program's managed aircraft if the amount paid for such person's participation is exempt from the taxes imposed by sections 4261 and 4271 by reason of section 4261(j). Similarly, a participant in a business arrangement seeking to circumvent the surtax imposed by section 4043 by operating outside of subpart K of 14 CFR part 91, that allows an aircraft owner the right to use any of a fleet of aircraft (through an aircraft interchange agreement, through holding nominal shares in a fleet of aircraft, or any other similar arrangement), is not an aircraft owner with respect to any of the aircraft owned or leased as part of that business arrangement.

(4) *Disqualified lease.* The term *disqualified lease* has the meaning given to it by section 4261(e)(5)(C)(ii). A disqualified lease also includes any arrange-

ment that seeks to circumvent the rule in section 4261(e)(5)(C)(ii) by providing a lease term that is greater than 31 days but does not provide the lessee with exclusive and uninterrupted access and use of the leased aircraft, as identified by the aircraft's airframe serial number and tail number. For purposes of the preceding sentence, the fact that a lease permits the lessee to use the aircraft for for-hire flights, as defined in paragraph (b)(5) of this section, when the lessee is otherwise not using the aircraft does not, because of this fact alone, cause a lease with a term that is greater than 31 days to be a disqualified lease.

(5) *For-hire flight.* The term *for-hire flight* means the use of an aircraft to transport passengers for compensation that is paid in cash or in kind. The term includes, but is not limited to, charter flights, air taxi flights, and sightseeing flights (commonly referred to as flightseeing flights).

(6) *Private aviation.* The term *private aviation* means the use of an aircraft for civilian flights except scheduled passenger service.

(7) *Substitute aircraft.* The term *substitute aircraft* means an aircraft, other than the aircraft owner's aircraft, that is provided by an aircraft management services provider to the aircraft owner when the aircraft owner's aircraft is not available, regardless of the reason for the unavailability.

(c) *Substitute Aircraft*—(1) *Allocation required.* If an aircraft management services provider provides flight services to an aircraft owner on a substitute aircraft during a calendar quarter, the taxes imposed by section 4261 (including the taxes imposed by section 4261(b) or (c), as appropriate, on each passenger transported) or 4271, as the case may be, apply to that portion of the amounts paid by the aircraft owner to the aircraft management services provider, determined on a pro rata basis, as described in paragraph (c) (2) of this section, that are related to the flight services provided on the substitute aircraft.

(2) *How calculated.* The allocation described in paragraph (c)(1) of this section is calculated by applying to the total amount paid by an aircraft owner to an aircraft management services provider during the calendar quarter the ratio of—

(i) *Substitute aircraft hours.* The total flight hours provided on substitute aircraft during the calendar quarter; over

(ii) *Total hours.* The sum of—

(A) The total flight hours made on the aircraft owner's aircraft during the calendar quarter; and

(B) The total flight hours provided to the aircraft owner on substitute aircraft during the calendar quarter.

(d) *Choice of flight rules.* Whether a flight on an aircraft owner's aircraft operates pursuant to the rules under Federal Aviation Regulations prescribed by the Federal Aviation Administration (FARs) Part 91 (14 CFR part 91) or pursuant to the rules under FARs Part 135 (14 CFR part 135) does not affect the application of section 4261(e)(5).

(e) *Aircraft available for hire*—(1) *In general.* Whether an aircraft owner permits an aircraft management services provider or other person to use its aircraft to provide for-hire flights (for example, when the aircraft is not being used by the aircraft owner or when the aircraft is being moved in deadhead service) does not affect the application of section 4261(e)(5). However, an amount paid for for-hire flights on the aircraft owner's aircraft does not qualify for the section 4261(e)(5) exemption. Therefore, an amount paid for a for-hire flight on an aircraft owner's aircraft is subject to the tax imposed by section 4261 or 4271, as the case may be, unless the amount paid is otherwise exempt from the tax imposed by section 4261 or 4271 other than by reason of section 4261(e)(5). See §49.4261-7(h) for rules relating to the application of the tax imposed by section 4261 on amounts paid for charter flights.

(2) *Fuel used on for-hire flights.* To the extent amounts paid for for-hire flights are subject to the tax imposed by section 4261 or 4271, taxable fuel (as defined in section 4083(a) of the Code) or any liquid taxable under section 4041(c) of the Code that is used as fuel on such flights is used in commercial aviation, as that term is defined in section 4083(b). See sections 4081(a)(2) and 4041(c) for the applicable fuel tax rates.

(f) *Billing methods.* Except as provided in paragraph (a)(3) of this section (relating to adequate records), the method an aircraft management services provider bills, invoices, or otherwise charges an aircraft



owner for aircraft management services, whether by specific itemization of costs, flat monthly or hourly fee, or otherwise, does not affect the application section 4261(e)(5).

(g) *Coordination with fuel tax provisions.* Taxable fuel (as defined in section 4083(a)) or any liquid taxable under section 4041(c) that is used as fuel on a flight for which amounts paid are exempt from the taxes imposed by sections 4261 and 4271 by reason of section 4261(e)(5) is not fuel used in commercial aviation, as that term is defined in section 4083(b). See sections 4081(a)(2) and 4041(c) for the applicable fuel tax rates.

(h) *Multiple aircraft management services providers not disqualifying.* Whether an aircraft owner pays amounts to more than one aircraft management services provider for aircraft management services does not affect the application of section 4261(e)(5).

(i) *Coordination with exemption for aircraft in fractional ownership aircraft programs and fuel surtax; no choice of exemption; anti-abuse rule.* The exemption in section 4261(e)(5) does not apply to any amount paid for aircraft management services by a participant in any transaction or arrangement, or through other means, that seeks to circumvent the surtax imposed by section 4043. Further, the exemption in section 4261(e)(5) does not apply to any amounts paid for aircraft management services related to flights that are (or are required to be) operated under FARs Part 91K (14 CFR part 91K). As a result, if an amount paid qualifies for both the exemption provided in section 4261(e)(5) and the exemption provided in section 4261(j), the exemption provided in section 4261(j) applies to the amount paid and the surtax imposed by section 4043 applies to any liquid used in the managed aircraft as fuel. See sections 4261(j) and 4043.

(j) *Examples.* The following examples illustrate the provisions of this section.

(1) *Example 1—(i) Facts.* An aircraft owner, which is organized as corporation under state law, pays a monthly fee of \$1,000 to an aircraft management services provider for the provision of a pilot for flights on the aircraft owner's aircraft to transport employees of the aircraft owner's business to business meetings. The flights constitute taxable transportation, as that term is defined in section 4262(a), and no exemptions (other than section 4261(e)(5)) apply. During the first calendar quarter of 2020, the pilot provides 200 flight hours of service on the air-

craft owner's aircraft and 50 hours of service on a substitute aircraft.

(ii) *Analysis.* The tax imposed by section 4261(a) applies on a pro rata basis to the pilot's flight hours on a substitute aircraft. The allocation is calculated by applying to the \$3,000 total amount paid (3 months x \$1,000 monthly fee) by the aircraft owner to the aircraft management services provider during the calendar quarter the ratio of: 50 (the total pilot flight hours provided on substitute aircraft during the calendar quarter) over 250 (the sum of the total pilot flight hours on the aircraft owner's aircraft during the calendar quarter and the total pilot flight hours provided on substitute aircraft during the calendar quarter). The computation is as follows:  $\$3,000 \times (50/250) = \$600$  (amount subject to tax). The portion of the amount paid that is exempt from the section 4261 taxes by application of section 4261(e)(5) is \$2,400. The portion of the amount paid that is subject to the tax imposed by section 4261(a) is \$600. The tax imposed by section 4261(b) also applies to amounts paid for flights on substitute aircraft on a per-passenger basis. See §49.4261-2(b) for rules regarding the application of the tax imposed by section 4261(b).

(2) *Example 2—(i) Facts.* An aircraft owner pays a monthly fee to an aircraft management services provider for aircraft management services related to the aircraft owner's aircraft. When the aircraft is not being used by the owner, the owner sometimes permits a charter company to use the aircraft for charter flights. At other times when the aircraft is not being used by the owner, the owner permits a tour operator to use the aircraft for flightseeing tours. All charter and flightseeing flights on the aircraft constitute taxable transportation, as that term is defined in section 4262(a), and no exemptions (other than section 4261(e)(5)) apply. The aircraft's maximum certificated takeoff weight is 7,000 pounds and the aircraft uses kerosene as fuel.

(ii) *Analysis.* Amounts paid by the aircraft owner to the aircraft management services provider for aircraft management services related to the aircraft owner's own aircraft are exempt under section 4261(e)(5). Amounts paid by the charterer or passengers for the charter flights are subject to tax under section 4261(a) and (b). See §49.4261-7(h) for rules relating to the application of the tax imposed by section 4261 on amounts paid for charter flights. See §49.4261-2(b) for rules regarding the application of the tax imposed by section 4261(b). Amounts paid by flightseeing customers for flightseeing tours are also subject to tax under section 4261(a) and (b). If a payment for a flightseeing tour includes charges for nontransportation services, the charges for the nontransportation services may be excluded in computing the tax payable provided the payments are separable and provided in exact amounts. See §49.4261-2(c). The kerosene used as fuel on the charter flights and the flightseeing flights is subject to the tax imposed by section 4081(a) at the commercial rate.

(k) *Applicability date.* This section applies on and after the later of [date these regulations are published as final regulations in the **Federal Register**] or January 1, 2021.

## **§49.4262(a)-1 [Redesignated]**

Par. 14. Section 49.4262(a)-1 is redesignated as §49.4262-1.

Par. 15. Newly redesignated §49.4262-1 is amended by:

1. In paragraph (a) introductory text, removing “section 4262(b) (see §49.4262(b)-1)” and adding “section 4262(b) of the Internal Revenue Code (Code) (see §49.4262-2)” in its place.

2. In the first sentence of paragraph (a) (1), removing “Transportation” and adding “Transportation by air” in its place.

3. In the first sentence of paragraph (a) (1), removing “(the “225-mile zone”)” and adding “(225-mile zone)” in its place.

4. Revising paragraphs (a)(2) and (b) (2).

5. In paragraph (b), removing “subparagraphs (1) and (5) of this paragraph” and adding “paragraph (b)(1) and (5) of this section” in its place.

6. In paragraph (b), removing “subject to the tax” and adding “subject to the taxes imposed by section 4261(a) and (b)” in its place.

7. Removing and reserving paragraph (c).

8. Revising introductory paragraph (d); designating *Example (1)* as paragraph (d) (1) and revising new paragraph (d)(1) *Example 1*.

9. In paragraph (d), designating *Example (2)* as (d)(2) and removing and reserving newly designated paragraph (d)(2) *Example 2*.

10. In paragraph (d), designating *Example (3)* as paragraph (d)(3) and removing “6 hours” wherever it appears and adding “12 hours” in its place and also removing “subject to tax” wherever it appears and adding “subject to the taxes imposed by section 4261(a) and (b)” in its place.

11. In paragraph (d), designating *Example (4)* as paragraph (d)(4), and removing “six hours” wherever it appears and adding “12 hours” in its place and also removing “subject to tax” wherever it appears and adding “subject to the taxes imposed by section 4261(a) and (b)” in its place.

12. Revising paragraph (e).

13. Adding paragraph (f).

The revisions and addition read as follows:



§49.4262-1 Taxable transportation.

(a) \* \* \*

(2) In the case of any other transportation by air, that portion of such transportation that is directly or indirectly from one port or station in the United States to another port or station in the United States, but only if such transportation is not part of *uninterrupted international air transportation* within the meaning of section 4262(c) (3) of the Code and §49.4262-3(c). Transportation from one port or station in the United States occurs whenever a carrier, after leaving any port or station in the United States, makes a regularly scheduled stop at another port or station in the United States irrespective of whether stopovers are permitted or whether passengers disembark.

\* \* \* \* \*

(b) \* \* \*

(2) New York to Vancouver, Canada, with a stop at Toronto, Canada;

\* \* \* \* \*

(d) *Examples.* The following examples illustrate the application of section 4262(a)(2) and the taxes imposed by section 4261(a) and (b) of the Code:

(1) *Example (i).* A purchases in New York a ticket for air transportation from New York to Nassau, Bahamas, with a scheduled stopover of 14 hours in Miami. The part of the transportation from New York to Miami is taxable transportation as defined in section 4262(a) because such transportation is from one station in the United States to another station in the United States and the trip is not uninterrupted international air transportation (because the scheduled stopover interval in Miami is greater than 12 hours). Therefore, the amount paid for the transportation from New York to Miami is subject to the taxes imposed by section 4261(a) and (b).

\* \* \* \* \*

(e) *Examples of transportation that is not taxable transportation.* The following examples illustrate transportation that is not taxable transportation:

(1) New York to Trinidad with no intervening stops;

(2) Minneapolis to Edmonton, Canada, with a stop at Winnipeg, Canada;

(3) Los Angeles to Mexico City, Mexico, with stops at Tijuana and Guadalajara, Mexico;

(4) New York to Whitehorse, Yukon Territory, Canada, by air with a scheduled stopover in Chicago of five hours. Amounts paid for the transportation referred to in examples set forth in paragraphs (e)(1), (2), and (3) of this section are not subject to the tax regardless of where payment is made, since none of the trips:

(i) Begin in the United States or in the 225-mile zone and end in the United States or in the 225-mile zone, nor

(ii) Contain a portion of transportation which is directly or indirectly from one port or station in the United States to another port or station in the United States. The amount paid within the United States for the transportation referred to in the example set forth in paragraph (4) of this section is not subject to tax since the entire trip (including the domestic portion thereof) is “uninterrupted international air transportation” within the meaning of section 4262(c)(3) and paragraph (c) of §49.4262-3. In the event the transportation is paid for outside the United States, no tax is due since the transportation does not begin and end in the United States.

\* \* \* \* \*

(f) *Applicability date.* This section applies on and after the later of [date these regulations are published as final regulations in the **Federal Register**] or January 1, 2021. For rules that apply before that date, *see* 26 CFR part 49, revised as of April 1, 2020.

§49.4262(b)-1 [Redesignated]

Par. 16. Section 49.4262(b)-1 is redesignated as §49.4262-2.

§49.4262-2 [Amended]

Par. 17. Newly redesignated §49.4262-2 is amended as follows:

1. In paragraph (a), “section 4262(b)” is removed and “section 4262(b) of the Internal Revenue Code” is added in its place.

2. In paragraph (b)(2), *Example (2)* is removed and reserved.

3. Revise paragraph (d). “Illustration” and add “Example” in its place.

The revisions and additions reads as follows:

§49.4262-2 Exclusion of certain travel.

\* \* \* \* \*

(d) *Example.* The application of paragraph (c) of this section may be illustrated by the following example: A purchases in San Francisco a ticket for transportation by air to Honolulu, Hawaii. The portion of the transportation which is outside the continental United States and is outside Hawaii is excluded from taxable transportation. The tax applies to that part of the payment made by A which is applicable to the portion of the transportation between the airport in San Francisco and the three-mile limit off the coast of California (a distance of 15 miles) and between the three-mile limit off the coast of Hawaii and the airport in Honolulu (a distance of 5 miles). The part of the payment made by A which is applicable to the taxable portion of his transportation and the tax due thereon are computed in accordance with paragraph (c)(1) as follows:

Mileage of entire trip (San Francisco airport to Honolulu airport) (miles).....	2,400
Mileage in continental United States (miles).....	15
Mileage in Hawaii (miles).....	5
	<hr/>
	20
Fare from San Francisco to Honolulu.....	\$168.00
Payment for taxable portion (20/2400 x \$168).....	\$1.40
Tax due (7.5% (rate in effect on date of payment) x \$1.40)...	\$0.11

(All distances and fares assumed for purposes of this example. This example only addresses the computation of the tax imposed by section 4261(a). It does not address the computation of any other tax imposed by section 4261 that may apply to these facts.)

#### **§49.4262(c)-1 [Redesignated]**

Par. 18. Section 49.4262(c)-1 is redesignated as §49.4262-3.

Par. 19. Newly redesignated §49.4262-3 is amended as follows:

1. In the first sentence of paragraph (a), remove “includes only the 48 States existing on July 25, 1956 (the date of the enactment of the Act of July 25, 1956 (Pub. L. 796, 84th Cong., 70 Stat. 644) and the District of Columbia” and add “means the District of Columbia and the States other than Alaska and Hawaii” in its place.

2. In paragraph (a), the last sentence is removed.

3. In paragraph (c), remove “six hours” wherever it appears and add “12 hours” in its place.

4. In paragraph (c), remove “6 hours” wherever it appears and add “12 hours” in its place.

5. In paragraph (c), remove “six-hour” wherever it appears and add “12-hour” in its place.

6. In paragraph (c)(2), remove “paragraph (a)(2) of §49.4264(c)-1” and add “§49.4263-3(a)(2)” in its place.

7. Adding paragraphs (d) and (e).

The additions read as follows:

#### **§49.4262-3 Definitions.**

\* \* \* \* \*

(d) *Transportation*. For purposes of the regulations in this subpart, the term *transportation* includes layover or waiting time and movement of the aircraft in deadhead service.

(e) *Applicability date*. This section applies on and after the later of [date these regulations are published as final regulations in the **Federal Register**] or January 1, 2021. For rules that apply before that date, see 26 CFR part 49, revised as of April 1, 2020.

#### **§49.4263-5 [Redesignated]**

Par. 20. Section 49.4263-5 is redesignated as §49.4281-1.

Par. 21. Newly redesignated §49.4281-1 is amended by:

1. Revising paragraphs (a) and (b).

2. In paragraph (c), adding a sentence at the end of the paragraph.

3. Adding paragraphs (d) and (e).

The revisions and additions read as follows:

#### **§49.4281-1 Small aircraft on nonestablished lines.**

(a) *In general*. Amounts paid for the transportation of persons on a small aircraft of the type sometimes referred to as air taxis shall be exempt from the tax imposed under section 4261 of the Internal Revenue Code provided the aircraft has a maximum certificated takeoff weight of 6,000 pounds or less determined as provided in paragraph (b) of this section. The exemption does not apply, however, when the aircraft is operated on an established line or when the aircraft is a jet aircraft.

(b) *Maximum certificated takeoff weight*. The term *maximum certificated takeoff weight* means the maximum certificated takeoff weight shown in the type certificate or airworthiness certificate issued by the Federal Aviation Administration.

(c) \* \* \* An aircraft is not considered as operated on an established line at any time during which the aircraft is being operated on a flight the sole purpose of which is sightseeing.

(d) *Jet aircraft*. For purposes of this section, the term *jet aircraft* does not include any aircraft which is a rotorcraft (such as a helicopter) or propeller aircraft.

(e) *Applicability date*. This section applies on and after the later of [date these regulations are published as final regulations in the **Federal Register**] or January 1, 2021. For rules that apply before that date, see 26 CFR part 49, revised as of April 1, 2020.

#### **§49.4264(a)-1 [Redesignated]**

Par. 22. Section 49.4264(a)-1 is redesignated as §49.4263-1.

Par. 23. Newly redesignated §49.4263-1 is revised to read as follows:

#### **§49.4263-1 Duty to collect the tax; payments made outside the United States.**

Where payment upon which tax is imposed by section 4261 of the Internal Revenue Code is made outside the United States for a prepaid order, exchange order, or similar order, the person furnishing the initial transportation pursuant to such order shall collect the applicable tax. See section 4291 and the regulations thereunder for cases where persons receiving payment must collect the tax.

#### **§49.4264(b)-1 [Redesignated]**

Par. 24. Section 49.4264(b)-1 is redesignated as §49.4263-2.

#### **§49.4263-2 [Amended]**

Par. 25. Newly redesignated §49.4263-2 is amended as follows:

1. In the first sentence of paragraph (a), remove “4264(b)” and add “4263(b) of the Internal Revenue Code (Code)” in its place.

2. In the last sentence of paragraph (a), remove “office of the district director for the district in which the person making the report is located,” and add “Commissioner” in its place.

3. In paragraph (b), add “of the Code” at the end of the paragraph.

4. In paragraph (c), remove “*Illustration*.” and add “*Example*.” in its place.

5. In the last sentence of paragraph (c), remove “office of the district director of internal revenue for the district in which the carrier is located,” and add in its place “Commissioner”.

#### **§49.4264(c)-1 [Redesignated]**

Par. 26. Section 49.4264(c)-1 is redesignated as §49.4263-3.

Par. 27. Newly redesignated §49.4263-3 is amended by:

1. Removing “a district director” wherever it appears and adding “Commissioner” in its place.

2. Revising paragraph (a).

3. In paragraph (b), removing the second sentence.

4. In paragraph (b), removing “4264” wherever it appears and adding “4263” in its place.

5. In paragraph (b), add “of the Code” after “4291”.

6. Removing and reserving paragraph (c).

The revisions read as follows:

*§49.4263-3 Special rule for the payment of tax.*

(a) *In general*—(1) For the rules applicable under section 4263(c) of the Internal Revenue Code, see §49.4261-1(b).

\* \* \* \* \*

***§49.4264(d)-1 [Redesignated]***

Par. 28. Section 49.4264(d)-1 is redesignated as §49.4263-4.

***§49.4263-4 [Amended]***

Par. 29. Newly redesignated §49.4263-4 is amended by removing “4264(d)” and adding “4263(d)” in its place.

***§49.4264(e)-1 [Redesignated]***

Par. 30. Section 49.4264(e)-1 is redesignated as §49.4263-5.

***§49.4264(f)-1 [Redesignated]***

Par. 31. Section 49.4264(f)-1 is redesignated as §49.4263-6.

***§49.4263-6 [Amended]***

Par. 32. Newly redesignated §49.4263-6 is amended by removing and reserving paragraph (b).

Par. 33. In § 49.4271-1, revise paragraphs (a) and (b) to read as follows:

*§49.4271-1 Tax on transportation of property by air.*

(a) *Purpose of this section.* Section 4271 of the Internal Revenue Code (Code) imposes a 6.25% tax on amounts paid within or without the United States for the taxable transportation of property (as defined in section 4272). This section sets forth rules as to the general applicability of the tax. This section also sets forth rules authorized by sec-

tion 4272(b)(2) of the Code which exempt from tax payments for the transportation of property by air in the course of exportation (including shipment to a possession of the United States) by continuous movement, and in due course so exported.

(b) *Imposition of tax.* (1) The tax imposed by section 4271 applies only to amounts paid to persons engaged in the business of transporting property by air for hire.

(2) The tax imposed by section 4271 does not apply to amounts paid for the transportation of property by air if such transportation is furnished on an aircraft having a maximum certificated takeoff weight (as defined in section 4281(b) of the Code) of 6,000 pounds or less, unless such aircraft is operated on an established line or when such aircraft is a jet aircraft. The tax imposed by section 4271 also does not apply to any payment made by one member of an affiliated group (as defined in section 4282(b) of the Code) to another member of such group for services furnished in connection with the use of an aircraft if such aircraft is owned or leased by a member of the affiliated group and is not available for hire by persons who are not members of such group.

\* \* \* \* \*

Par. 34. Section 49.4271-2 is added to read as follows:

*§49.4271-2 Aircraft management services.*

For rules regarding the exemption for certain amounts paid by aircraft owners for aircraft management services, see §49.4261-10.

***§49.4282-1 [Reserved]***

Par. 35. Add and reserve §49.4282-1.

Sunita Lough,  
Deputy Commissioner for Services  
and Enforcement.

(Filed by the Office of the Federal Register on July 29, 2005, 11:15 a.m., and published in the issue of the Federal Register for July 31, 2020, 85 F.R. 46032)

## Notice of Proposed Rulemaking

### Small Business Taxpayer Exceptions Under Sections 263A, 448, 460 and 471

#### REG-132766-18

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations to implement legislative changes to sections 263A, 448, 460, and 471 of the Internal Revenue Code (Code) that simplify the application of those tax accounting provisions for certain businesses having average annual gross receipts that do not exceed \$25,000,000, adjusted for inflation. This document also contains proposed regulations regarding certain special accounting rules for long-term contracts under section 460 to implement legislative changes applicable to corporate taxpayers. The proposed regulations generally affect taxpayers with average annual gross receipts of not more than \$25 million (adjusted for inflation). Additionally, this document contains a request for comments regarding the application of section 460 (or other special methods of accounting) to a contract with income that is accounted for in part under section 460 (or other special method) and in part under section 451.

**DATES:** Written or electronic comments or a request for a public hearing must be received by September 14, 2020.

**ADDRESSES:** Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-132766-18) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited



or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.

Send paper submissions to: CC:PA:LP-D:PR (REG-132766-18), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

#### FOR FURTHER INFORMATION

**CONTACT:** Concerning proposed §§1.460-1 through 1.460-6, Innessa Glazman, (202) 317-7006; concerning all other proposed regulations in this document, Anna Gleysteen, (202) 317-7007; concerning submission of comments and/or requests for a public hearing, Regina Johnson, (202) 317-5177 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background

This document contains proposed amendments to the Income Tax Regulations (26 CFR part 1) to implement statutory amendments to sections 263A, 448, 460, and 471 of the Code made by section 13102 of Public Law No. 115-97 (131 Stat. 2054), commonly referred to as the Tax Cuts and Jobs Act (TCJA). These statutory amendments generally simplify the application of the method of accounting rules under those provisions to certain businesses (other than tax shelters) with average annual gross receipts that do not exceed \$25,000,000, adjusted for inflation.

This document also contains proposed amendments to the existing regulations under section 460 regarding the special accounting rules for long-term contracts to implement amendments to the Code applicable to corporate taxpayers made by TCJA sections 12001 (repealing the corporate alternative minimum tax imposed by section 55) and 14401 (adding the base

erosion anti-abuse tax imposed by new section 59A).

On August 20, 2018, the Treasury Department and the IRS issued Revenue Procedure 2018-40 (2018-34 I.R.B. 320), which provided administrative procedures for a taxpayer (other than a tax shelter under section 448(d)(3)) meeting the requirements of section 448(c) to obtain consent to change the taxpayer's method of accounting to a method of accounting permitted by section 263A, 448, 460, or 471, as amended by the TCJA under the automatic change procedures of Revenue Procedure 2015-13 (2015-5 I.R.B. 419), as clarified and modified by Revenue Procedure 2015-33 (2015-24 I.R.B. 1067), as modified by Revenue Procedure 2016-1 (2016-1 I.R.B. 1), and Revenue Procedure 2017-59 (2017-48 I.R.B. 543). The revenue procedure also invited comments for future guidance regarding the implementation of the TCJA modifications to sections 263A, 448, 460, and 471. Two comments were received in response to Revenue Procedure 2018-40 and are discussed in the Explanation of Provisions.

Finally, part 5 of the Explanation of Provisions requests comments regarding the effects of section 451(b) on the application of section 460, 467, or another special method of accounting, within the meaning of section 451(b)(2). On September 9, 2019, the Treasury Department and the IRS published proposed regulations under section 451(b) (REG-104870-18) in the **Federal Register** (84 FR 47191) in which comments were requested on the allocation of the transaction price for contracts that include items of income subject to section 451 and items of income that are attributable to long-term contract activities subject to section 460. One comment was received in response to this request, but was outside the scope of the rulemaking as it was received after the expiration of the comment period for REG-104870-18. As discussed in part 5 of the Explanation of Provisions, the Treasury Department and the IRS have considered that comment in requesting additional comments regarding the application of sections 451(b)(2) and 451(b)(4) to a contract with income that is accounted for in part under section 451 and in part under section 460, 467, or another special method of accounting.

#### Explanation of Provisions

These proposed regulations provide guidance under sections 263A, 448, 460, and 471 to implement the TCJA's amendments to those provisions. These proposed regulations also modify §§1.381(c)(5)-1 and 1.446-1 to reflect these statutory amendments.

##### 1. Section 263A Small Business Taxpayer Exemption

The uniform capitalization (UNICAP) rules of section 263A provide that, in general, the direct costs and the properly allocable share of the indirect costs of real or tangible personal property produced, or real or personal property described in section 1221(a)(1) acquired for resale, cannot be deducted but must either be capitalized into the basis of the property or included in inventory costs, as applicable. Certain property is exempted from the capitalization requirements of section 263A. For example, section 263A(c)(4) provides an exemption to the capitalization requirements of section 263A for any property produced by a taxpayer pursuant to a long-term contract.

In addition, certain taxpayers are exempt from the capitalization requirements. Prior to the enactment of the TCJA, section 263A(b)(2)(B) and §1.263A-3(b)(1) provided that resellers with average annual gross receipts of \$10,000,000 or less were not subject to the capitalization requirements (Section 263A small business reseller exemption). Section 13102(b) of the TCJA replaced the Section 263A small reseller exemption with a new general exemption from section 263A under new section 263A(i) for small business taxpayers (Section 263A small business taxpayer exemption). The Section 263A small business taxpayer exemption applies to any taxpayer (other than a tax shelter under section 448(a)(3)), meeting the gross receipts test of section 448(c), as amended by section 13102(a) of the TCJA and explained in greater detail in part 2 of this Explanation of Provisions (Section 448(c) gross receipts test).

The proposed regulations remove the now obsolete Section 263A small reseller exemption provided in exist-



ing §1.263A-3(a)(2)(ii) and (b). These proposed regulations also modify existing §§1.263A-1, 1.263A-2, 1.263A-3, 1.263A-4, 1.263A-7, and 1.263A-8 to incorporate the Section 263A small business taxpayer exemption.

#### A. Application of Section 448(c) Gross Receipts Test to Taxpayers That Are Not Corporations or Partnerships

For purposes of the Section 263A small business taxpayer exemption, section 263A(i)(2) provides that the Section 448(c) gross receipts test is applied in the same manner as if each trade or business of the taxpayer were a corporation or partnership. Proposed §1.263A-1(j)(2)(ii) provides that in the case of a taxpayer other than a corporation or partnership, the Section 448(c) gross receipts test is applied by taking into account the amount of gross receipts derived from all trades or businesses of that taxpayer. Under the proposed regulations, amounts not related to a trade or business of that taxpayer, such as inherently personal amounts of an individual taxpayer, are generally excluded from gross receipts. Such excluded amounts include, in the case of an individual, items such as Social Security benefits, personal injury awards and settlements, disability benefits, and wages received as an employee that are reported on Form W-2. The exclusion for wages does not extend to guaranteed payments, which are not generally equivalent to salaries and wages. See Revenue Ruling 69-184 (1969-1 CB 45). These proposed regulations implementing the Section 263A small business taxpayer exemption are consistent with the proposed regulations implementing the Section 460 small business taxpayer exemption and Section 471 small business taxpayer exemption discussed later in this Explanation of Provisions, which incorporate statutory language similar to that in section 263A(i).

A commenter responding to Revenue Procedure 2018-40 requested clarification on the application of the Section 448(c) gross receipts test to individuals, noting that it was unclear whether the individual owner is required to include the owner's share of gross receipts from pass-through entities in the individual's

gross receipts. The commenter noted that including such amounts in the individual's gross receipts would be distortive to the individual's other trades or business reported on Schedules C, *Profit or Loss From Business*, Schedule E, *Supplemental Income and Loss*, and Schedule F, *Profit or Loss From Farming*, of the Form 1040, *U.S. Individual Income Tax Return*.

The Treasury Department and the IRS note that section 263A(i) refers to section 448(c), and section 448(c)(2) expressly requires the aggregation rules of sections 52(a) or (b) and 414(m) or (o) to apply. Thus, the aggregation rules under section 52(a) or (b) or section 414(m) or (o) will always apply in connection with applying section 263A(i)(2). Under section 52, an individual taxpayer with two or more trades or businesses reported on the individual's Schedule C or Schedule E of the individual's Form 1040 is required to aggregate the gross receipts of those trades or businesses. Proposed §1.263A-1(j)(2)(ii) is consistent with these rules. Additionally, under section 263A(i)(2), each trade or business of the taxpayer is treated as if it were a corporation or partnership, and it is well-established under §1.448-1T(f) that a corporation or partnership includes in its gross receipts all receipts that are properly recognized under that corporation's or partnership's accounting method in that taxable year, regardless of the source of the receipts. Since corporations and partnerships do not have inherently personal items, the exclusion of such items from the individual's trade or business gross receipts is not inconsistent with §1.448-1T(f)(2)(iv).

Consistent with section 263A(i), proposed §1.263A-1(j)(2)(iii) provides that when determining whether a taxpayer qualifies for the Section 263A small business taxpayer exemption, each partner in a partnership includes a share of partnership gross receipts in proportion to such partner's distributive share of items of gross income that were taken into account by the partnership under section 703; similarly, each shareholder in an S corporation includes a *pro rata* share of the S corporation's gross receipts taken into account by the S corporation under section 1363(b).

#### B. Removal of Small Reseller Exception

Prior to the TCJA, the Section 263A small reseller exception in section 263A(b)(2)(B) exempted from section 263A resellers with gross receipts of \$10 million or less (small reseller gross receipts test). The TCJA removed the Section 263A small reseller exception provided in section 263A(b)(2)(B).

Consistent with the TCJA, these proposed regulations remove existing §1.263A-3(a)(2)(ii) and modify existing §1.263A-3(b) by removing the small reseller gross receipts test. The Treasury Department and the IRS expect that most taxpayers who previously satisfied the small reseller gross receipts test will meet the Section 448(c) gross receipts test due to the increased dollar threshold in section 448(c), and therefore would be eligible to apply the small business taxpayer exemption under section 263A(i).

The definition of gross receipts used for the small reseller gross receipts test under existing §1.263A-3(b) is applied for purposes of other simplifying conventions under the existing section 263A regulations. Since the TCJA removed the small reseller gross receipts test and added the Section 263A small business taxpayer exemption that refers to section 448(c), these proposed regulations update those simplifying conventions by cross referencing to the definition of gross receipts set forth in the proposed regulations under section 448 where applicable.

Specifically, proposed §1.263A-3(a)(5) modifies the definition of gross receipts that is used to determine whether a reseller has *de minimis* production activities and proposed §1.263A-1(d)(3)(ii)(B)(I) modifies the definition of gross receipts used to permit certain taxpayers to use the simplified production method under §1.263A-2(b) by cross referencing to the definition of "gross receipts" for purposes of the Section 448(c) gross receipts test.

#### C. Changes to the Uniform Interest Capitalization Rules

Prior to the TCJA, section 263A(f)(1) required the capitalization of interest if the taxpayer produced certain types of property (designated property). The Section 263A small business taxpayer

exception applies for all purposes of section 263A, including the requirement to capitalize interest under section 263A(f). Accordingly, these proposed regulations modify §1.263A-7 and §1.263A-8 to add new paragraphs to implement the Section 263A(i) small business taxpayer exemption for purposes of the requirement to capitalize interest.

Additionally, existing §1.263A-9 contains an election that permits taxpayers whose average annual gross receipts do not exceed \$10 million to use the highest applicable Federal rate as a substitute for the weighted average interest rate when tracing debt. Again, the Section 263A small business taxpayer exception applies for all purposes of section 263A, including the election for small business taxpayers who choose to capitalize interest under section 263A(f). Therefore, these proposed regulations modify §1.263A-9 to remove the \$10 million gross receipts test in the definition of eligible taxpayer and replace it with the Section 448(c) gross receipts test. The Treasury Department and the IRS have determined that the use of a single gross receipts test under the section 263A (other than the pre-existing higher \$50 million threshold for testing eligibility to apply the simplified production method) simplifies application of the UNICAP rules for taxpayers.

#### D. Changes to §1.263A-4 for Farming Trades or Businesses

Prior to the TCJA, section 263A(d)(3) permitted certain taxpayers to elect not to have the rules of section 263A apply to certain plants produced in a farming business conducted by the taxpayer. An electing taxpayer and any related person, as defined in §1.263A-4(d)(4)(iii), are required to apply the alternative depreciation system, as defined in section 168(g)(2), to property used in the taxpayer's and any related persons' farming business and placed in service in the taxable years in which the election was in effect.

The Treasury Department and the IRS are aware that taxpayers that made an election under section 263A(d)(3) may also qualify for the Section 263A small business taxpayer exemption, and may

prefer to apply that exemption rather than the election under section 263A(d)(3). Proposed §1.263A-4(d)(5) permits a taxpayer to revoke its section 263A(d)(3) election for any taxable year in which the taxpayer is eligible for and wants to apply the Section 263A small business taxpayer exemption by following applicable administrative guidance, such as Revenue Procedure 2020-13 (2020-11 IRB 515). In addition, some taxpayers may be eligible to apply the election under section 263A(d)(3) in a taxable year in which they cease to qualify for the Section 263A small business taxpayer exemption. Therefore, proposed §1.263A-4(d)(6) permits such a taxpayer to change its method of accounting from the exemption under section 263A(i) by making a section 263A(d)(3) election in the same taxable year by following applicable administrative guidance, such as Revenue Procedure 2020-13.

Proposed §1.263A-4(d)(3)(i) is modified to remove the requirement that the election under section 263A(d)(3) by a partnership or S corporation be made by the partner, shareholder or member. The Treasury Department and the IRS believe that the inclusion of this requirement was a drafting error, as sections 703(b) and 1363(c) require the election to be made at the entity level.

The TCJA added new section 263A(d)(2)(C), which provides a special temporary rule for citrus plants lost by reason of casualty. The provision, which expires in 2027, provides that section 263A does not apply to replanting costs paid or incurred by a taxpayer other than the owner if certain conditions are met. Proposed §1.263A-4(e)(5) is added to incorporate this special temporary rule.

#### E. Costing Rules for Self-Constructed Assets

One commenter stated that the costing rules for self-constructed property used in a taxpayer's trade or business prior to the enactment of section 263A, which would apply to small business taxpayers choosing to apply the Section 263A small business taxpayer exemption, are not clear. The commenter asked for clarification of what costs a small business taxpayer is required to

capitalize to its depreciable property if the taxpayer has chosen to apply the Section 263A small business taxpayer exemption. The Treasury Department and the IRS request further comments on specific clarifications needed regarding the costing rules that existed prior to the enactment of the UNICAP rules under section 263A.

#### 2. Changes to the Regulations under Section 448

Section 448(a) generally prohibits C corporations, partnerships with a C corporation as a partner, and tax shelters from using the cash receipts and disbursements method of accounting (cash method). However, section 448(b)(3) provides that section 448(a) does not apply to C corporations and partnerships with a C corporation as a partner that meet the Section 448(c) gross receipts test. Prior to the TCJA's enactment, a taxpayer met the gross receipts test of section 448(c) if, for all taxable years preceding the current taxable year, the average annual gross receipts of the taxpayer (or any predecessor) for any 3-taxable-year period did not exceed \$5 million. If a taxpayer had not been in existence for the entire 3-taxable-year period, then the gross receipt test was applied on the basis of the period during which the taxpayer or trade or business was in existence. For a taxable year less than 12 months, the gross receipts of that short taxable year were annualized (short taxable year rule). Additionally, this gross receipts test also required the aggregation of gross receipts for all persons treated as a single employer under section 52(a) or (b) or section 414(m) or (o) (aggregation rule).

Section 13102(a) of the TCJA amended the Section 448(c) gross receipts test to permit a taxpayer (other than a tax shelter) to meet the test if the taxpayer's average annual gross receipts for the 3-taxable-year period ending with the year preceding the current taxable year does not exceed \$25 million and indexed the \$25 million threshold for inflation (Section 448 small business taxpayer exemption). Other rules in section 448(c), such as the short taxable year rule and the aggregation rule, were not altered by section 13102(a) of the TCJA.

#### A. General rules of section 448(c) and Section 448(c) gross receipts test

These proposed regulations modify existing §1.448-1 to clarify that it applies to taxable years beginning before January 1, 2018 for purposes of applying the restrictions on the use of the cash method by C corporations and partnerships with C corporation partners. Proposed §1.448-2 provides rules applicable for taxable years beginning after December 31, 2017. These rules are generally similar to the existing regulations under §1.448-1 and §1.448-1T of the Temporary Income Tax Regulations, including the short taxable year rule and the aggregation rule. However, for taxable years beginning after December 31, 2017, the proposed regulations update the rules to reflect the post-TCJA Section 448(c) gross receipts test. These proposed regulations also clarify that the gross receipts of a C corporation partner are included in the gross receipts of a partnership if the aggregation rules apply to the C corporation partner and the partnership.

The Treasury Department and the IRS publish an annual revenue procedure for inflation-adjusted amounts and intend to include the inflation-adjusted section 448(c) dollar threshold in that revenue procedure. See, for example, Revenue Procedure 2019-44 (2019-47 IRB 1093).

#### B. Tax Shelters Defined in Section 448(d)(3)

Under section 448(a)(3), a tax shelter is prohibited from using the cash method. Section 448(d)(3) cross references section 461(i)(3) to define the term “tax shelter.” Section 461(i)(3)(B), in turn, includes a cross reference to the definition of “syndicate” in section 1256(e)(3)(B), which defines a syndicate as a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of that entity during the taxable year are *allocable* to limited partners or limited entrepreneurs. Section 1.448-1T(b)(3) narrowed this definition by providing that a taxpayer is a syndicate only if more than 35 percent of its losses are *allocated* to limited partners or limited entrepreneurs. Consequently, a partnership or other entity (other than a C corporation) may be considered a syndicate only for a taxable year in which it has losses. These

proposed regulations adopt the same definition of syndicate provided in §1.448-1T.

One commenter expressed concern that the definition of syndicate is difficult to administer because many small business taxpayers may fluctuate between taxable income and loss between taxable years, thus their status as tax shelters may change each tax year. The commenter suggested that the Treasury Department and the IRS exercise regulatory authority under section 1256(e)(3)(C)(v) to provide that all the interests held in entities that meet the definition of a syndicate but otherwise meet the Section 448(c) gross receipts test be deemed as held by individuals who actively participate in the management of the entity, so long as the entities do not qualify to make an election as an electing real property business or electing farm business under section 163(j)(7)(B) or (C), respectively. The Treasury Department and the IRS decline to adopt this recommendation. The recommendation would allow a taxpayer that meets the Section 448(c) gross receipts test to completely bypass the “syndicate” portion of the tax shelter definition under section 448(d)(3). Neither the statutory language of section 448 nor the legislative history of the TCJA support limiting the application of the existing definition of tax shelter in section 448(d)(3) in this manner.

The Treasury Department and the IRS are aware of practical concerns regarding the determination of tax shelter status for the taxable year. For example, a taxpayer may determine computationally that it is a syndicate under section 1256 after the close of the taxable year while preparing its Federal income tax return for the taxable year. However, a taxpayer that is a tax shelter is not permitted to use the cash method for that taxable year, but may no longer be able to timely file a Form 3115, *Application for Change in Accounting Method*, to change from the cash method to an appropriate method, such as an accrual method of accounting (accrual method) for that taxable year, or it may otherwise have time constraints in filing its Federal income tax return by the due date of the return (without extensions) for such taxable year. While these procedural constraints also existed prior to the TCJA, the TCJA’s modifications to several other sections of the Code to reference the section 448(d)(3) definition

of tax shelter made the tax shelter status determination under section 448(c)(3) applicable to more taxpayers than prior to the TCJA, increasing the number of taxpayers affected by these procedural constraints.

In light of the increased relevance of the definition of tax shelter under section 448(d)(3) after enactment of the TCJA, proposed §1.448-2(b)(2)(iii)(B) permits a taxpayer to elect to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a syndicate for purposes of section 448(d)(3) for the current taxable year. A taxpayer that makes this election will know at the beginning of the taxable year whether it is a tax shelter for the current taxable year, alleviating concerns about the difficulties in timely determining whether it is a tax shelter under section 448(d)(3) and filing changes in method of accounting, if necessary. A taxpayer that makes this election must apply the rule to all subsequent taxable years, and for all purposes for which status as a tax shelter under section 448(d)(3) is relevant, unless the Commissioner permits a revocation of the election.

Another commenter suggested a rule to provide relief to taxpayers that report negative taxable income in a taxable year solely because of a negative section 481(a) adjustment arising from an accounting method change and are consequently within the definition of tax shelter under section 448(d)(3), but that would otherwise meet the Section 448(c) gross receipts test. The suggested rule would deem such taxpayers to not be tax shelters for purposes of section 448(d)(3). The Treasury Department and the IRS decline to adopt this suggestion. No exception was provided in the TCJA to limit the application of the definition of tax shelter in section 448(d)(3) for taxpayers making an overall method change.

The Treasury Department and the IRS continue to study the definition of tax shelter under section 448(d)(3) and request comments on whether additional relief is necessary.

#### C. Procedures for Taxpayers Required to Change from the Cash Method

Prior to its amendment by the TCJA, a taxpayer met the gross receipts test of



section 448(c) if its average annual gross receipts did not exceed \$5 million for all prior 3-taxable-year periods. Once a taxpayer's average annual gross receipts had exceeded \$5 million (first section 448 year), a taxpayer was prohibited under section 448 from using the cash method for all subsequent taxable years.

The TCJA removed the requirement under section 448(c) that all prior taxable years of a taxpayer must satisfy the Section 448(c) gross receipts test for the taxpayer to qualify for the cash method for taxable years beginning after December 31, 2017. Thus, section 448 no longer permanently prevents a C corporation or a partnership with a C corporation partner from using the cash method for a year subsequent to a taxable year in which its gross receipts first exceed the dollar threshold for the Section 448(c) gross receipts test. Accordingly, the proposed regulations do not require taxpayers to meet the gross receipts test for all prior taxable years in order to satisfy the Section 448(c) gross receipts test.

The term "first section 448 year" used in existing §1.448-1 no longer reflects the statutory language of section 448 and these proposed regulations remove this term for taxable years beginning after December 31, 2017. Proposed §1.448-2(g)(1) uses the term "mandatory section 448 year" to describe the first taxable year that a taxpayer is prevented by section 448 from using the cash method, or a subsequent taxable year in which the taxpayer is again prevented by section 448 from using the cash method after previously making a change in method of accounting that complied with section 448.

Proposed §1.448-2(g)(3) requires a taxpayer that meets the Section 448(c) gross receipts test in the current taxable year to obtain the written consent of the Commissioner before changing to the cash method if the taxpayer had previously changed its overall method from the cash method during any of the five taxable years ending with the current taxable year. A taxpayer that makes multiple changes in its overall method of accounting within a short period of time may not be treating items of income and expense consistently from year to year, and a change back to the cash method within the five year period may not clearly reflect income, as

required by §1.446-1(a)(2), even if section 448 otherwise does not prohibit the use of the cash method.

The proposed regulations also do not contain specific procedures to make a method change from the cash method to a permissible method. The Treasury Department and the IRS have determined that providing a single procedure in administrative guidance, such as Revenue Procedure 2015-13 (or successor) and Revenue Procedure 2019-43 (2019-48 IRB 1107) (or successor) will reduce confusion for taxpayers to make voluntary changes in method of accounting to comply with section 448. Consequently, the proposed regulations provide that a taxpayer in a mandatory section 448 year must follow the applicable administrative procedures to change from the cash method to a permissible method.

### *3. Changes to the Regulations under Section 460*

Section 460(a) provides that income from a long-term contract must be determined using the percentage-of-completion method (PCM). A long-term contract is defined in section 460(f) as generally any contract for the manufacture, building, installation, or construction of property if such contract is not completed within the taxable year in which such contract is entered into. Subject to special rules in section 460(b)(3), section 460(b)(1)(A) generally provides that the percentage of completion of a long-term contract is determined by comparing costs allocated to the contract under section 460(c) and incurred before the close of the taxable year with the estimated total contract costs. Section 460(b)(1)(B) generally provides that a taxpayer is required to pay or is entitled to receive interest determined under the look-back rules of section 460(b)(2) on the amount of any tax liability under chapter 1 of the Code that was deferred or accelerated as a result of overestimating or underestimating total allocable contract costs or contract price with respect to income from long-term contracts reported under the PCM. Section 56(a)(3) generally provides that for alternative minimum tax (AMT) purposes, the taxable income from a long-term contract (other than a

home construction contract defined in section 460(e)(5)(A)) is determined under the PCM (as modified by section 460(b)).

Section 460(e)(1)(A) provides an exemption from the requirement to use the PCM for home construction contracts. Prior to the TCJA, section 460(e)(1)(B) provided a separate exemption from the PCM for a long-term construction contract of a taxpayer who estimated that the contract would be completed within the 2-year period from the commencement of the contract (two-year rule), and whose average annual gross receipts for the 3-taxable-year period ending with the year preceding the year the contract was entered into did not exceed \$10 million (Section 460(e) gross receipts test). The flush language of section 460(e)(1) provides that a home construction contract with respect to which the two-year rule and Section 460(e) gross receipts test are not met will be subject to section 263A, notwithstanding the general exemption under section 263A(c)(4) for property produced pursuant to a long-term contract (large homebuilder rule). Additionally, for AMT purposes, section 56(a)(3) provides in the case of contract described in section 460(e)(1), other than a home construction contract, the percentage of the contract completed is determined under section 460(b)(1) by using the simplified procedures for allocation of costs prescribed under section 460(b)(3).

Section 13102(d) of the TCJA amended section 460(e)(1)(B) by removing the Section 460(e) gross receipts test and replacing it with the Section 448(c) gross receipts test, as amended by section 13102(a) of the TCJA, for the taxable year in which the contract is entered into. Thus, section 460(e)(1)(B), as modified by TCJA, provides a small contractor exemption for long-term construction contracts of a taxpayer other than a tax shelter that estimates that the contract will be completed within two years of the commencement of the contract and meets the Section 448(c) gross receipts test (Section 460 small contractor exemption). The Section 460 small contractor exemption does not apply to home construction contracts, which remain exempt from required use of PCM under section 460(e)(1)(A).



#### A. Application of the Section 448(c) Gross Receipts Test and Rules Applicable to Taxpayers Other Than a Corporation or Partnership

Proposed §1.460-3(b) modifies the rules relating to the small contractor exemption by incorporating the requirement in section 460(e)(1)(B)(ii) that an eligible taxpayer must meet the Section 448(c) gross receipts test for the taxable year in which the contract is entered into.

Section 460(e)(2), which has statutory language identical to that in section 263A(i)(2), provides that for a taxpayer that is not a corporation or partnership, the Section 448(c) gross receipts test is applied in the same manner as if each trade or business of the taxpayer were a corporation or a partnership. Proposed §1.460-3(b)(3)(ii)(A) through (D) provide guidance under section 460(e)(2) consistent with the rules in proposed §1.263A-1(j) (2).

#### B. Home Construction Contract Rules

The large homebuilder rule under section 460(e)(1) exempts home construction contracts from PCM but requires capitalization of costs under the UNICAP rules under section 263A. Consistent with section 460(e)(1), proposed §1.460-5(d)(3) provides that a taxpayer must capitalize the costs of home construction contracts under section 263A and the regulations under section 263A, unless the taxpayer estimates, when entering into the contract, that it will be completed within two years of the contract commencement date and the taxpayer satisfies the Section 448(c) gross receipts test for the taxable year in which the contract is entered into.

#### C. Clarification of Method of Accounting Rules

Section 460(e)(2)(B) provides that any change in method of accounting made pursuant to section 460(e)(1)(B)(ii) is treated as initiated by the taxpayer and made with the consent of the Secretary of the Treasury or his delegate (Secretary). The change is made on a cut-off basis for all similarly classified contracts entered into on or after the year of change.

Revenue Ruling 92-28 (92-1 CB 153) held that within the same trade or business, a taxpayer may use different methods of accounting for contracts exempt under section 460(e)(1) and contracts subject to mandatory use of PCM under section 460(a). Accordingly, a taxpayer with both exempt contracts and nonexempt contracts within the same trade or business may use a method of accounting other than PCM for all exempt contracts, even though the taxpayer would be required to use PCM for the nonexempt contracts.

A commenter requested clarification on the interaction of Revenue Ruling 92-28 with section 460(e)(2)(B). The commenter asked for clarification because Revenue Ruling 92-28 describes situations in which a taxpayer is not required to obtain consent to a change in method of accounting because it is either adopting a method of accounting for a new item (Situation 1: PCM for nonexempt long-term contracts) or returning to the use of a previously adopted method (Situation 2: completed contract method for contracts exempt because taxpayer's average annual gross receipts have fallen below the threshold for the small contractor exemption).

The Treasury Department and the IRS have determined that the holding in Revenue Ruling 92-28 remains correct, and that section 460(e)(2)(B) does not apply to Situations 1 and 2 in Revenue Ruling 92-28. In reconciling the statutory language of section 460(e)(2)(B) with section 446, the Treasury Department and the IRS interpret section 460(e)(2)(B) as applying to situations in which a taxpayer has been using PCM for exempt contracts and would like to change to a different exempt contract method. Accordingly, proposed §1.460-1(f)(3) incorporates the holding of Revenue Ruling 92-28 and provides that a taxpayer may adopt any permissible method of accounting for each classification of contract (that is, exempt and nonexempt).

#### D. Look-Back Rules

Section 460(b) provides that, upon the completion of any long-term contract, the look-back method is applied to amounts reported under the contract using PCM, whether for regular income tax purposes or for AMT purposes. Under the look-back method, taxpayers are required to pay in-

terest if the taxpayer's Federal income tax liability is deferred as a result of underestimating the total contract price or overestimating total contract costs. Alternatively, a taxpayer is entitled to receive interest if the taxpayer's Federal income tax liability has been accelerated as a result of overestimating the total contract price or underestimating total contract costs. Any interest to be paid is based on a comparison of the difference between the Federal income tax liability actually reported by the taxpayer compared to the Federal income tax liability that would have been reported if the taxpayer had used actual contract prices and costs instead of estimated contract prices and costs in computing income under PCM.

#### i. Look-Back Rules and AMT

Section 12001 of the TCJA amended section 55(a) so that the AMT is no longer imposed on corporations for taxable years beginning after December 31, 2017. Consistent with section 12001 of the TCJA, proposed §1.460-6(c) reflects the changes to section 55(a) by providing that in applying the look-back method, alternative minimum taxable income is redetermined only for taxable years in which the AMT is applicable. Similarly, the recomputed tax liability for prior contract years includes the AMT only for the taxable years in which the AMT is applicable. Consequently, for taxable years beginning after December 31, 2017, for purposes of the look-back method, a corporation will not redetermine alternative minimum taxable income or recompute AMT liability. However, a corporation that has a contract that spans a period beginning before the TCJA (taxable years beginning before January 1, 2018) and ending after the TCJA (taxable years beginning after December 31, 2017), would be required to redetermine alternative minimum taxable income and recompute AMT for those taxable years beginning before January 1, 2018.

#### ii. *De Minimis* Exception to Look-Back Rules

Section 460(b)(3) provides an exception to the requirement to apply the look-back method. Under the exception, the look-back method need not be applied

if the contract price does not exceed the lesser of \$1,000,000 or one percent of the taxpayer's average annual gross receipts for the prior 3-taxable-year period ending with the year preceding the taxable year in which the contract is completed, and the contract is completed within two years of the commencement of the contract. Proposed §1.460-3(b)(3) provides that, for purposes of this *de minimis* exception, gross receipts are determined in accordance with the regulations under section 448(c).

### iii. Look-Back Rules and the BEAT

Proposed §1.460-6 is also updated to reflect the enactment of the base erosion anti-abuse tax (BEAT) imposed by section 59A. For any taxable year, the BEAT is a tax on each applicable taxpayer (see §1.59A-2) equal to the base erosion minimum tax amount (BEMTA) for that year. Generally, the taxpayer's BEMTA equals the excess of (1) the applicable tax rate for the taxable year (BEAT rate) multiplied by the taxpayer's modified taxable income under §1.59A-3(b) for the taxable year over (2) the taxpayer's adjusted regular Federal income tax liability for that year.

Proposed §1.460-6 applies the look-back method to re-determine the taxpayer's modified taxable income under §1.59-3(b) and the taxpayer's BEMTA for the taxable year. Specifically, the taxpayer must determine its modified taxable income and BEMTA for each year prior to the filing year that is affected by contracts completed or adjusted in the filing year as if the actual total contract price and costs had been used in applying the percentage of completion method.

The Treasury Department and the IRS have proposed this rule because the income from long-term contracts determined using the PCM may be overestimated or underestimated, which may change the taxpayer's modified taxable income or BEMTA, or whether or not a taxpayer is an applicable taxpayer in a particular taxable year. Clarifying in the regulations under section 460 that the look-back method must take into account any application of the BEAT makes clear that section 460 provides taxpayers will pay or receive interest (whichever is the case) if their Federal income tax liability,

including any BEAT liability, is deferred, eliminated, understated, or overstated as a result of the taxpayer's estimation of the total contract price or total contract costs.

### 4. Section 471 Small Business Taxpayer Exemption

Section 471(a) requires inventories to be taken by a taxpayer when, in the opinion of the Secretary, taking an inventory is necessary to determine the income of the taxpayer. Section 1.471-1 requires the taking of an inventory at the beginning and end of each taxable year in which the production, purchase, or sale of merchandise is an income-producing factor. Additionally, when an inventory is required to be taken, §1.446-1(c)(1)(iv) and (c)(2) require that an accrual method be used for purchases and sales.

Section 13102(c) of the TCJA added new section 471(c) to remove the statutory requirement to take an inventory when the production, purchase, or sale of merchandise is an income-producing factor for a taxpayer (other than a tax shelter) meeting the Section 448(c) gross receipts test (Section 471 small business taxpayer exemption). The Section 471 small business taxpayer exemption provides that the requirements of section 471(a) do not apply to a taxpayer for that taxable year, and the taxpayer's method of accounting for inventory for such taxable year shall not be treated as failing to clearly reflect income if the taxpayer either: (1) treats the taxpayer's inventory as non-incidental materials and supplies, or (2) conforms the taxpayer's inventory method to the taxpayer's method of accounting for inventory reflected in an applicable financial statement as defined in section 451(b)(3) (AFS), or if the taxpayer does not have an AFS, in the taxpayer's books and records prepared in accordance with the taxpayer's accounting procedures.

Section 471(c)(3) provides that in the case of a taxpayer that is not a corporation or partnership, the Section 448(c) gross receipts test is determined in the same manner as if each trade or business of such taxpayer were a corporation or partnership.

A taxpayer's method of accounting for inventory may not clearly reflect income if a taxpayer meets the Section 448(c)

gross receipts test but does not take an inventory, and also does not either treat its inventory as non-incidental materials and supplies or in conformity with its AFS, or its books and records if it does not have an AFS. In such instances, the general rules under section 446 for analyzing whether a method of accounting clearly reflects income are applicable.

These proposed regulations modify existing §1.471-1 by adding proposed §1.471-1(b) to implement the Section 471 small business taxpayer exemption under section 471(c). Proposed §1.471-1(b) provides guidance on the application of the Section 448(c) gross receipts test to taxpayers other than a corporation or partnership, the treatment of inventory as non-incidental materials and supplies, and the conforming of inventory to an AFS or the taxpayer's books and records.

#### A. Application of the Section 448(c) Gross Receipts Test to Taxpayers Other Than a Corporation or Partnership

These proposed regulations provide guidance under section 471(c)(3), which has statutory language identical to section 263A(i)(2), consistent with the rules in proposed §1.263A-1(j)(2). See part I.A of this Explanation of Provisions for discussion of the application of the Section 448(c) gross receipts test to individuals and other taxpayers that are not a corporation or partnership.

#### B. Treatment of Inventory as Non-Incidental Materials and Supplies

Section 471(c)(1)(B)(i) provides that a taxpayer, other than a tax shelter, that meets the Section 448(c) gross receipts test can treat its inventory as non-incidental materials and supplies.

Prior to the TCJA, the Treasury Department and the IRS provided administrative relief for certain taxpayers from the requirements of section 471(a) with regard to purchases and sales of inventory. Under Revenue Procedure 2001-10 (2001-2 IRB 272), a taxpayer with average annual gross receipts that did not exceed \$1 million was exempted from the requirements to use an accrual method under section 446 and to account for inventories under section 471. Similarly, under Revenue

Procedure 2002-28 (2002-28 IRB 815), a “qualifying small business taxpayer,” as defined in section 4.01 of Revenue Procedure 2002-28, was also exempted from the requirements to use an accrual method under section 446 and to account for inventories under section 471. To qualify, a taxpayer must have had average annual gross receipts that did not exceed \$10 million in certain industries, or reasonably determined that its principal business activity was the provision of services, or reasonably determined its principal business activity was the fabrication or modification of customized tangible personal property.

Under both revenue procedures, a taxpayer was permitted to account for its inventory in the same manner as non-incidental materials and supplies under §1.162-3. Under § 1.162-3, materials and supplies that are not incidental are deductible only in the year in which they are actually consumed and used in the taxpayer’s business. For purposes of these revenue procedures, inventoriable items treated as non-incidental materials and supplies were treated as consumed and used in the taxable year the taxpayer provided the items to a customer. Thus, the costs of such inventoriable items were recovered by a cash basis taxpayer only in that year, or in the year in which the taxpayer actually paid for the goods, whichever was later. See section 4.02 of Revenue Procedure 2001-10 and section 4.05 of Revenue Procedure 2002-28.

Section 471(c)(1)(B)(i) generally codified the treatment of inventory using the non-incidental materials and supplies method of accounting described in Revenue Procedure 2001-10 and Revenue Procedure 2002-28, with certain exceptions. Accordingly, proposed §1.471-1(b)(4) provides rules similar to the provisions of these revenue procedures, including that the items continue to be inventory property. The proposed regulations refer to inventory treated as non-incidental materials and supplies as “section 471(c) materials and supplies.”

#### i. Definition of the Term “Used and Consumed”

As explained previously and as noted in the Conference Report to the TCJA, an exception to the requirement to take

an inventory was provided under Revenue Procedure 2001-10 and Revenue Procedure 2002-28. H.R. Rep. No. 115-466, at 378 fn. 638 and 639 (2017). Under that exception, a taxpayer was able to account for inventory as materials and supplies that are not incidental. The cost of non-incidental materials and supplies is deductible in the taxable year in which the materials and supplies are first used or consumed in the taxpayer’s operations. *Id.* at 378 fn. 640. As discussed in part 4.B of this Explanation of Provisions, the administrative guidance as in existence prior to the TCJA provided that inventory treated as non-incidental materials and supplies under §1.162-3 remained inventory property, the cost of which was recovered by a cash basis taxpayer when the items were provided to a customer, or when the taxpayer paid for the items, whichever was later. The Conference Report describes the TCJA as generally permitting the costs of non-incidental materials and supplies to be recovered in the taxable year that is “consistent with present law.” *Id.* at 380 fn. 657. The Treasury Department and IRS interpret section 471(c)(1)(B)(i) as generally codifying the administrative guidance existing at the time of enactment (that is, Revenue Procedure 2001-10 and Revenue Procedure 2002-28). Accordingly, proposed §1.471-1(b)(4)(i) provides that section 471(c) materials and supplies are used or consumed in the taxable year in which the taxpayer provides the item to a customer and the cost of such item is recovered in that year or the taxable year in which the taxpayer pays for or incurs (in the case of an accrual method taxpayer) such cost, whichever is later.

One commenter requested that raw materials used in the production of finished goods be deemed “used or consumed” when the raw material is used during production instead of when the finished product is provided to a customer. Under this approach, a producer would be able to recover production costs earlier than allowed under the administrative guidance of Revenue Procedure 2001-10 and Revenue Procedure 2002-28. Further, under this approach, a producer would be permitted to recover costs earlier than a reseller. The Treasury Department and the IRS decline to adopt this suggestion.

As discussed previously, the Treasury Department and the IRS interpret section 471(c)(1)(B)(i) and its legislative history generally as codifying the rules provided in the administrative guidance existing at the time the Act was enacted. Accordingly, proposed §1.471-1(b)(4) provides that section 471(c) materials and supplies are “used and consumed” in the taxable year the taxpayer provides the goods to a customer, and that the cost of goods is recovered in that year or the taxable year in which such cost is paid or incurred (in accordance with the taxpayer’s method of accounting), whichever is later.

#### ii. De Minimis Safe Harbor under §1.263(a)-1(f)

Section 1.263(a)-1(f) provides a regulatory *de minimis* safe harbor election through which an electing taxpayer may choose not to treat as a material or supply under §1.162-3(a) any amount paid in the taxable year for tangible property if the amount paid meets certain requirements, and instead to deduct the *de minimis* amount in accordance with its AFS, or books and records, if the taxpayer has no AFS. Section 1.263(a)-1(f)(2)(i) provides that the *de minimis* safe harbor election does not apply to amounts paid for property that is or is intended to be included in inventory property.

Two commenters asked for clarification on whether a taxpayer using the non-incidental materials and supplies method under section 471(c)(1)(B)(i) may use the *de minimis* safe harbor election of §1.263(a)-1(f). As discussed in part 4.B of this Explanation of Provisions, the Treasury Department and the IRS continue to interpret inventory treated as non-incidental materials and supplies as remaining characterized as inventory property. Consequently, proposed §1.471-1(b)(4)(i) provides that inventory treated as section 471(c) non-incidental materials and supplies is not eligible for the *de minimis* safe harbor election under §1.263(a)-1(f). Extending the regulatory election under §1.263(a)-1(f) to encompass section 471(c) materials and supplies is outside the intended scope of the election and runs counter to section 471(c), which indicates section 471(c) materials and supplies are inventory property.



### iii. Identification and Valuation of Section 471(c) Materials and Supplies

One commenter asked for guidance on how a taxpayer determines the cost basis of inventory items that are treated as non-incidental materials and supplies. Proposed §1.471-1(b)(4)(ii) provides guidance on how a taxpayer may identify and value section 471(c) materials and supplies. These identification and valuation methods would apply whether the taxpayer used the cash method or an accrual method.

Consistent with Revenue Procedure 2002-28, and the legislative history to section 471(c), proposed §1.471-1(b)(4)(ii) permits taxpayers to determine the amount of their section 471(c) materials and supplies by using either a specific identification method, a first-in, first-out (FIFO) method, or an average cost method, provided that the method is used consistently. Taxpayers may not identify their inventory using a last-in, first-out (LIFO) method or value section 471(c) materials and supplies using a lower-of-cost-or-market (LCM) method. The Treasury Department and the IRS are aware that the purpose of the section 471(c) materials and supplies method is to provide simplification. Accounting methods using LIFO and LCM require sophisticated computations and are allowed under the more complex inventory rules of sections 471(a) and 472. Accordingly, these proposed regulations do not permit a taxpayer using the section 471(c) materials and supplies method to use either a LIFO method or the LCM method.

### iv. Direct Labor and Overhead Costs for Section 471(c) Materials and Supplies

Commenters asked for clarification as to the treatment of direct labor and overhead costs for section 471(c) materials and supplies. Revenue Procedure 2001-10 and Revenue Procedure 2002-28 did not directly address whether direct labor and overhead costs for inventory treated as non-incidental materials and supplies were immediately deductible. The commenters argue that if inventories are treated as non-incidental materials and supplies, then all of the direct labor and overhead costs incurred in producing the

goods are deductible when incurred. One commenter noted that prior to the enactment of section 263A, the costing rules for inventoriable goods produced by a taxpayer were governed by the full absorption method under §1.471-11, and §1.471-3, in the case of a reseller of inventory.

The Treasury Department and the IRS have determined that under the section 471(c) materials and supplies method, the items retain their character as inventory property. Because the property remains characterized as inventory property, the costing rules in §1.471-11 and §1.471-3 are the applicable rules to determine which costs are to be included under the section 471(c) materials and supplies method. However, the Treasury Department and the IRS are aware that the purpose of section 471(c)(1)(A)(i) is to provide simplification for taxpayers. Accordingly, these proposed regulations provide that a taxpayer using the section 471(c) materials and supplies method is required to include only direct costs paid to produce or acquire the inventory treated as section 471(c) materials and supplies. These direct costs are not immediately deductible but are recovered in accordance with proposed §1.471-1(b)(4). Consistent with existing law, these proposed regulations provide that a taxpayer is not permitted to recover a cost that it otherwise would be neither permitted to recover nor deduct for Federal income tax purposes solely by reason of it being included in the costs of section 471(c) materials and supplies.

### C. Treatment of Inventory for an AFS Taxpayer

A taxpayer, other than a tax shelter, that meets the Section 448(c) gross receipts test need not take an inventory under section 471(a) and may choose to treat its inventory as the inventory is reflected in the taxpayer's AFS, or if the taxpayer does not have an AFS, as the inventory is treated in the taxpayer's books and records prepared in accordance with the taxpayer's accounting procedures. These proposed regulations provide guidance on the definition of AFS, the types and amounts of costs reflected in an AFS that can be recovered under section 471(c), and when such costs may be taken into account. The proposed regulations use

the term "AFS section 471(c) method" to describe the permissible section 471(c)(1)(B)(ii) method for a taxpayer with an AFS (AFS taxpayer).

### i. Definition of AFS

Section 471(c)(2) defines an AFS by cross-reference to section 451(b)(3). Consistent with the statute, proposed §1.471-1(b)(5)(ii) defines the term AFS in accordance with section 451(b)(3), and incorporates the definition provided in proposed §1.451-3(c)(1). The rules relating to additional AFS issues provided in §1.451-3(h) also apply to the AFS section 471(c) method. The proposed regulations also provide that a taxpayer has an AFS for the taxable year if all of the taxpayer's taxable year is covered by an AFS.

If a taxpayer's AFS is prepared on the basis of a financial accounting year that differs from the taxpayer's taxable year, proposed §1.471-1(b)(5)(ii) provides that a taxpayer determines its inventory for the mismatched reportable period by using a method of accounting described in proposed §1.451-3(h)(4). The Treasury Department and the IRS propose to require a taxpayer with an AFS that uses the AFS section 471(c) method to consistently apply the same mismatched reportable period method provided in proposed §1.451-3(h)(4) for purposes of its AFS section 471(c) method of accounting that is used for section 451. The Treasury Department and the IRS request comments on the consistency requirement and other issues related to the application of proposed §1.451-3(h) to the AFS section 471(c) method.

### ii. Types and Amounts of Costs Reflected in an AFS

Proposed §1.471-1(b)(5) provides rules relating to the AFS section 471(c) method, including a description of the costs included in this method. The proposed regulations provide that an AFS taxpayer, other than a tax shelter, that meets the Section 448(c) gross receipts test may use the AFS section 471(c) method to account for its inventory costs for that taxable year. The proposed regulations also clarify that a taxpayer using the AFS section 471(c) method is maintaining inventory, but generally recovers the costs of inventory in



accordance with its AFS inventory method and not by using an inventory method specified under section 471(a) and the regulations under section 471.

Under the AFS section 471(c) method, the term “inventory costs” means the costs that a taxpayer capitalizes to property produced or property acquired for resale in its AFS. However, these proposed regulations clarify that the amount of an inventory cost in a taxpayer’s AFS may not properly reflect the amount recoverable under the taxpayer’s AFS section 471(c) method. These proposed regulations provide that a taxpayer is not permitted to recover a cost that it otherwise would be neither permitted to recover nor deduct for Federal income tax purposes solely by reason of it being an inventory cost in the taxpayer’s AFS inventory method. In addition, these proposed regulations provide that a taxpayer may not capitalize a cost to inventory any earlier than the taxable year in which the amount is paid or incurred under the taxpayer’s overall method of accounting for Federal income tax purposes (for example, if applicable, section 461(h) is met) or not permitted to be capitalized by another Code provision (for example, section 263(a)). As a result, a taxpayer may be required to reconcile any differences between its AFS and Federal income tax return treatment (book-tax adjustments) for all or a portion of a cost that was included in the taxpayer’s AFS inventory method under the AFS section 471(c) method.

The Treasury Department and the IRS are aware that some taxpayers may interpret section 471(c)(1)(B)(ii) as permitting a taxpayer to capitalize a cost to inventory for Federal income tax purposes when that cost is included in the taxpayer’s AFS inventory method irrespective of: (1) whether the amount is deductible or otherwise recoverable for Federal income tax purposes; or (2) when the amount is capitalizable under the taxpayer’s overall method of accounting used for Federal income tax purposes. The Treasury Department and the IRS do not agree with this interpretation because section 471 is a timing provision. Section 471 is in subchapter E of chapter 1, Accounting Periods and Methods of Accounting. It is not in subchapter B of chapter 1, Computation of Taxable Income. A method of accounting deter-

mines when an item of income or expense is recognized, not whether it is deductible or recoverable through cost of goods sold or basis.

Accordingly, the Treasury Department and the IRS view section 471(c)(1)(B)(ii) as an exemption from taking an inventory under section 471(a) for certain taxpayers that meet the Section 448(c) gross receipts test and not as an exemption from the application of Code provisions other than section 471(a). While Congress provided an exemption from the general inventory timing rules of section 471(a), Congress did not exempt these taxpayers from applying other Code provisions that determine the deductibility or recoverability of costs, or the timing of when costs are considered paid or incurred. For example, Congress did not modify or alter section 461 regarding when a liability is taken into account, or any of the provisions that disallow a deduction, in whole or in part, such as any disallowance under section 274, to exempt these taxpayers. Accordingly, these proposed regulations require an AFS taxpayer that uses the AFS section 471(c) method to make book-tax adjustments for costs capitalized in its AFS that are not deductible or otherwise recoverable, in whole or in part, for Federal income tax purposes or that are taken into account in a taxable year different than the year capitalized under the AFS as a result of another Code provision.

#### D. Treatment of Inventory by Taxpayers Without an AFS

Under section 471(c)(1)(B)(ii), a taxpayer, other than a tax shelter, that does not have an AFS and that meets the Section 448(c) gross receipts test is not required to take an inventory under section 471(a), and may choose to treat its inventory as reflected in the taxpayer’s books and records prepared in accordance with the taxpayer’s accounting procedures (non-AFS section 471(c) method). These proposed regulations permit a taxpayer without an AFS (non-AFS taxpayer) to follow its method of accounting for inventory used in its books and records that properly reflect its business activities for non-Federal income tax purposes. The proposed regulations clarify that a non-AFS taxpayer using the non-AFS section 471(c) method

has inventory, but recovers the costs of inventory through its book method, rather than through an inventory method under section 471(a) and the regulations under section 471.

Two comments received requested a definition of “books and records of the taxpayer prepared in accordance with the taxpayer’s accounting procedures.” The Treasury Department and the IRS decline to define books and records in these proposed regulations. It is well-established under existing law that the books and records of a taxpayer comprise the totality of the taxpayer’s documents and electronically-stored data. *See, for example, United States v. Eugene*, 444 U.S. 707 (1980). *See also Digby v. Comm’r*, 103 T.C. 441 (1994), and §1.6001-1(a). A commenter specifically asked for clarification on whether books and records of the taxpayer include the accountant’s workpapers (whether recorded on paper, electronically or on other media). The Treasury Department and the IRS note that under existing law, these workpapers are generally considered part of the books and records of the taxpayer. *United States v. Arthur Young & Co.*, 465 U.S. 805 (1984).

The Treasury and the IRS interpret section 471(c)(1)(B)(ii) as a simplification of the inventory accounting rules in section 471(a) for certain small business taxpayers. Proposed §1.471-1(b)(6)(i) provides that under the non-AFS section 471(c) method, a taxpayer recovers the costs of inventory in accordance with the method used in its books and records and not by using an inventory method specified under section 471(a) and regulations under 471. A books and records method that determines ending inventory and cost of goods sold that properly reflects the taxpayer’s business activities for non-Federal income tax purposes is to be used under the taxpayer’s non-AFS section 471(a) method. For example, a taxpayer that performs a physical count that is used in determining inventory in the taxpayer’s books and records must use that count for purposes of the non-AFS section 471 method.

Consistent with the rules applicable to AFS taxpayers, proposed §1.471-1(b)(6)(ii) clarifies that a non-AFS taxpayer is not permitted to recover a cost that it otherwise would not be permitted to recover or deduct for Federal income tax purposes

solely by reason of it being an inventory cost in the taxpayer's non-AFS inventory method. These proposed regulations provide that a taxpayer may not capitalize a cost to inventory any earlier than the taxable year in which the amount is paid or incurred under the taxpayer's overall method of accounting for Federal income tax purposes (for example, if applicable, section 461(h) is met) or not permitted to be capitalized by another Code provision (for example, section 263(a)). See section 4.C.ii of this Explanation of Provisions.

#### *5. Section 451 Allocation of Transaction Price*

As noted in the Background section of this preamble, section 13221(a) of the TCJA added a new section 451(b) to the Code effective for taxable years beginning after December 31, 2017. This provision provides that, for an accrual method taxpayer with an AFS, the all events test with respect to any item of gross income (or portion thereof) is not treated as met any later than when the item (or portion thereof) is included in revenue for financial accounting purposes on an AFS. Section 451(b)(1)(A) sets forth the general AFS Income Inclusion Rule, providing that, for an accrual method taxpayer with an AFS, the all events test with respect to an item of gross income, or portion thereof, is met no later than when the item, or portion thereof, is included as revenue in an AFS (AFS Income Inclusion Rule). However, section 451(b)(2) provides that the AFS Income Inclusion Rule does not apply with respect to any item of gross income the recognition of which is determined using a special method of accounting, "other than any provision of part V of subchapter P (except as provided in clause (ii) of paragraph (1)(B))." In addition, section 451(b)(4) provides that for purposes of section 451(b), in the case of a contract which contains multiple performance obligations, the allocation of the transaction price to each performance obligation is equal to the amount allocated to each performance obligation for purposes of including such item in revenue in the taxpayer's AFS. Additionally, section 451(c)(4)(D), which provides rules for allocating payments to each performance obligation for purposes of applying the advance pay-

ment rules under section 451(c), provides that for purposes of section 451(c), "rules similar to section 451(b)(4) shall apply."

The preamble to the proposed regulations under section 451(b) contained in REG-104870-18 (84 FR 47191) requested comments on the allocation of transaction price for contracts that include both income subject to section 451 and income subject to a special method of accounting provision (specifically section 460). One commenter suggested that the allocation provisions under section 460 and the regulations thereunder, and not section 451(b)(4), should control the amount of gross income from a long-term contract that is accounted for under section 460. The commenter notes that using this approach is appropriate in light of section 451(b)(2), which reflects Congress's intent to not disturb the treatment of amounts for which a taxpayer uses a special method of accounting. The preamble to the proposed regulations under section 451(c) contained in REG-104554-18 (84 FR 47175) also included a similar request for comments for advance payment purposes; however, no comments were received in response to this request.

In light of the comment in the preceding paragraph and the questions received from taxpayers and practitioners regarding this issue in the context of other special methods of accounting (for example, section 467), the Treasury Department and the IRS are considering a rule that addresses the application of sections 451(b)(2) and (4) to contracts with income that is accounted for in part under section 451 and in part under a special method of accounting provision. The Treasury Department and the IRS are also considering a similar rule that addresses the application of section 451(c)(4)(D) to certain payments received under such contracts. The Treasury Department and the IRS have determined that these rules would benefit from further notice and public comment.

The Treasury Department and the IRS are considering a rule providing that if an accrual method taxpayer with an AFS has a contract with a customer that includes one or more items of gross income subject to a special method of accounting (as defined in proposed §1.451-3(c)(5)) and one or more items of gross income subject to section 451, the allocation rules

under section 451(b)(4) do not apply to determine the amount of each item of gross income that is accounted for under the special method of accounting provision. Accordingly, the transaction price allocation rules in section 451(b)(4) and proposed §1.451-3(g)(1) (as contained in REG-104870-18) would apply to only the portion of the gross transaction price that is not accounted for under the special method of accounting provision (that is, the residual amount) and only to the extent the contract contains more than one performance obligation that is subject to section 451. To the extent such a contract contains more than one performance obligation that is subject to section 451, the residual amount would be allocated to each section 451 performance obligation in proportion to the amount allocated to each such performance obligation for purposes of including such item in revenue in the taxpayer's AFS. The Treasury Department and the IRS request comments on this rule (section 451(b) special method allocation rule), including (i) whether taxpayers should be permitted to use the allocation rules under section 451(b)(4) to determine the amount of an item of gross income that is accounted for under a special method of accounting, (ii) whether a specific allocation standard should be provided for determining the amount of an item of gross income that is accounted for under a special method of accounting in situations where an allocation standard is not provided under the applicable special method of accounting rules, and (iii) whether alternative allocation options may be appropriate for allocating the residual amount to multiple performance obligations that are within the scope of section 451.

The Treasury Department and the IRS are also considering a similar allocation rule for purposes of applying the advance payment rules under section 451(c). Specifically, the Treasury Department and the IRS are considering a rule providing that if an accrual method taxpayer with an AFS receives a payment that is attributable to one or more items of gross income that are described in proposed §1.451-8(b)(1)(i)(C) and one or more items of gross income that are subject to a special method of accounting (as defined in proposed §1.451-3(c)(5)), then the taxpayer must determine the portion of the payment al-

locable to the item(s) of gross income that are described in proposed §1.451-8(b)(1)(i)(C) by using an objective criteria standard (consistent with objective criteria standard under section 5.02(4) of Revenue Procedure 2004-34 (2004-22 IRB 991)). Under this rule a taxpayer that allocates the payment to each item of gross income in proportion to the total amount of each such item of gross income (as determined under the section 451(b) special method allocation rule that is described in the preceding paragraph), will be deemed to have met the objective criteria standard. The Treasury Department and the IRS request comments on this rule, including whether alternative payment allocation approaches may be more appropriate (for example, an approach that permits the taxpayer to follow its AFS allocation).

### Proposed Applicability Date

These regulations are proposed to be applicable for taxable years beginning on or after the date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**. For taxable years beginning before the date the Treasury Decision adopting these regulations as final is published in the **Federal Register**, see §§ 1.448-1, 1.448-2, 1.263A-0, 1.263A-1, 1.263A-2, 1.263A-3, 1.263A-4, 1.263A-7, 1.263A-8, 1.263A-9, 1.263A-15, 1.381-1, 1.446-1, 1.460-0, 1.460-1, 1.460-3, 1.460-4, 1.460-5, 1.460-6, and 1.471-1 as contained in 26 CFR part 1, April 1, 2019.

However, for taxable years beginning after December 31, 2017, and before the date the Treasury Decision adopting these regulations as final regulations is published in the **Federal Register**, a taxpayer may rely on these proposed regulations, provided that the taxpayer follows all the applicable rules contained in the proposed regulations for each Code provision that the taxpayer chooses to apply. For example, a taxpayer using an accrual method with inventory subject to the capitalization rules of section 263A, may rely on proposed §1.448-2 to determine whether it must continue its use of its accrual method and proposed §1.263A-1 to determine its cost capitalizing rules, but may maintain its current inventory method rather than follow the proposed regulations under section 471.

### Statement of Availability of IRS Documents

The IRS notices, revenue rulings, and revenue procedures cited in this preamble are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

### Special Analysis

This regulation is not subject to review under section 6(b) of Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

#### I. Paperwork Reduction Act

Proposed §1.448-2(b)(2)(iii)(B) imposes a collection of information for an election to use prior year's allocated taxable income or loss to determine whether a partnership or other entity (other than a C corporation) is a "syndicate" for purposes of section 448(d)(3) for the current tax year. The election is made by attaching a statement to the taxpayer's original Federal income tax return for the current tax year. The election is binding for all subsequent taxable years, and can only be revoked with the consent of the Commissioner. The collection of information is voluntary for purposes of obtaining a benefit under the proposed regulations. The likely respondents are businesses or other for-profit institutions, and small businesses or organizations.

*Estimated total annual reporting burden:* 199,289 hours

*Estimated average annual burden hours per respondent:* 1 hour

*Estimated number of respondents:* 199,289

*Estimated annual frequency of responses:* once.

Other than the election statement, these proposed regulations do not impose any additional information collection requirements in the form of reporting, recordkeeping requirements or third-party disclosure statements. However, because

the exemptions in sections 263A, 448, 460 and 471 are methods of accounting under the statute, taxpayers are required to request the consent of the Commissioner for a change in method of accounting under section 446(e) to implement the statutory exemptions. The IRS expects that these taxpayers will request this consent by filing Form 3115, *Application for Change in Accounting Method*. Taxpayers may request these changes using reduced filing requirements by completing only certain parts of Form 3115. See Revenue Procedure 2018-40 (2018-34 I.R.B. 320). Revenue Procedure 2018-40 provides procedures for a taxpayer to make a change in method of accounting using the automatic change procedures of Revenue Procedure 2015-13 (2015-5 IRB 419) in order to use the exemptions provided in sections 263A, 460 and/or 471.

For purposes of the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(c)) (PRA), the reporting burden associated with the collection of information for the election statement and Form 3115 will be reflected in the PRA submission associated with the income tax returns under the OMB control number 1545-0074 (in the case of individual filers of Form 3115) and 1545-0123 (in the case of business filers of Form 3115).

In 2018, the IRS released and invited comment on a draft of Form 3115 in order to give members of the public the opportunity to benefit from certain specific provisions made to the Code. The IRS received no comments on the forms during the comment period. Consequently the IRS made the forms available in January 2019 for use by the public. The IRS notes that Form 3115 applies to changes of accounting methods generally and is therefore broader than sections 263A, 448, 460 and 471.

As discussed above, the reporting burdens associated with the proposed regulations are included in the aggregated burden estimates for OMB control numbers 1545-0074 (in the case of individual filers of Form 3115), 1545-0123 (in the case of business filers of Form 3115 subject to Revenue Procedure 2019-43 and business filers that make the election under proposed §1.448-2(b)(2)(iii)(B)). The overall burden estimates associated with the OMB control numbers below



are aggregate amounts related to the entire package of forms associated with the applicable OMB control number and will include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of the information collections in these proposed regulations. These numbers are therefore not specific to the burden imposed by these proposed regulations. The burdens have been reported for other income tax regulations that rely on the same information collections and the Treasury Department and the IRS urge readers to recognize that these numbers are duplicates and to guard against overcounting the burdens imposed by tax provisions prior to the Act. No burden estimates specific to the forms affected by the proposed regulations are currently available. For the OMB control numbers discussed in the preceding paragraphs, the Treasury Department and the IRS estimate PRA burdens on a taxpayer-type basis rather than a provision-specific basis. Those estimates capture both changes made by the Act and those that arise out of discretionary authority exercised in the proposed regulations (when final) and other regulations that affect the compliance burden for that form.

The Treasury Department and IRS request comment on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize paperwork burden. In addition, when available, drafts of IRS forms are posted for comment at <https://appsirs.gov/app/picklist/lit/draftTaxForms.htm>. IRS forms are available at <https://www.irs.gov/forms-instructions>. Forms will not be finalized until after they have been approved by OMB under the PRA.

## II. Regulatory Flexibility Act

The Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*) (RFA) imposes certain requirements with respect to federal rules that are subject to the notice and comment requirements of section 553(b) of the Administrative Procedure Act (5 U.S.C. 551 *et seq.*) and that are likely to have a sig-

nificant economic impact on a substantial number of small entities. Unless an agency determines that a proposal is not likely to have a significant economic impact on a substantial number of small entities, section 603 of the RFA requires the agency to present an initial regulatory flexibility analysis (IRFA) of the proposed rules. The Treasury Department and the IRS have not determined whether the proposed rules, when finalized, will likely have a significant economic impact on a substantial number of small entities. The determination of whether the voluntary exemptions under sections 263A, 448, 460, and 471 will have a significant economic impact requires further study. However, because there is a possibility of significant economic impact on a substantial number of small entities, an IRFA is provided in these proposed regulations. The Treasury Department and the IRS invite comments on both the number of entities affected and the economic impact on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on its impact on small business.

## 1. Need for and Objectives of the Rule

As discussed earlier in the preamble, these proposed regulations largely implement voluntary exemptions that relieve small business taxpayers from otherwise applicable restrictions and requirements under sections 263A, 448, 460, and 471.

Section 448 provides a general restriction for C corporations and partnerships with C corporation partners from using the cash method of accounting, and sections 263A, 460 and 471 impose specific rules on uniform capitalization of direct and indirect production costs, the percentage of completion method for long-term contracts, and accounting for inventory costs, respectively. Section 13102 of TCJA provided new statutory exemptions from certain of these rules and expanded the scope of existing statutory exemptions from certain of these rules to reduce compliance burdens for small taxpayers. The proposed regulations clarify the exemption qualification requirements and provide guidance with respect to the applicable methods of

accounting should a taxpayer choose to apply one or more exemptions.

The objective of the proposed regulations is to provide clarity and certainty for small business taxpayers implementing the exemptions. Under the Code, small business taxpayers were able to implement these provisions for taxable years beginning after December 31, 2017 (or, in the case of section 460, for contracts entered into after December 31, 2017) even in the absence of these proposed regulations. Thus, the Treasury Department and the IRS expect that, at the time these proposed regulations are published, many small business taxpayers may have already implemented some aspects of the proposed regulations.

## 2. Affected Small Entities

The voluntary exemptions under sections 263A, 448, 460 and 471 generally apply to taxpayers that meet the \$25 million (adjusted for inflation) gross receipts test in section 448(c) and are otherwise subject to general rules under sections 263A, 448, 460, or 471.

### A. Section 263A

The Treasury Department and the IRS expect that the addition of section 263A(i) will expand the number of small business taxpayers exempted from the requirement to capitalize costs, including interest, under section 263A. Under section 263A(i), taxpayers (other than tax shelters) that meet the \$25 million (adjusted for inflation) gross receipts test in section 448(c) can choose to deduct certain costs that are otherwise required to be capitalized to the basis of property. Section 263A applies to taxpayers that are producers, resellers, and taxpayers with self-constructed assets. The Treasury Department and the IRS estimate that there are between 38,100 and 38,900 respondents with gross receipts of not more than \$25 million (adjusted for inflation) that are eligible to change their method of accounting to no longer capitalize costs under section 263A. These estimates come from information collected on: Form 1125-A, *Cost of Goods Sold*, and attached to Form 1120, *U.S. Corporation Income Tax Return*, Form 1065,

*U.S. Return of Partnership Income* or Form 1120-S, *U.S. Income Tax Return for an S Corporation*, on which the taxpayer also indicated it had additional section 263A costs. The Treasury Department and the IRS do not have readily available data to measure the prevalence of entities with self-constructed assets. In addition, these data also do not include other business entities, such as a business reported on Schedule C, *Profit or Loss Form Business*, of an individual's Form 1040, *U.S. Individual Income Tax Return*.

Under section 263A, as modified by the TCJA, small business entities that qualified for Section 263A small reseller exception will no longer be able to use this exception. The Treasury Department and the IRS estimate that nearly all taxpayers that qualified for the small reseller exception will qualify for the small business taxpayer exemption under section 263A(i) since the small reseller exception utilized a \$10 million gross receipts test. The Treasury Department and the IRS estimate that there are between 38,100 and 38,900 respondents with gross receipts of not more than \$25 million that are eligible for the exemption under section 263A(i). These estimates come from information collected on: Form 1125-A, *Cost of Goods Sold*, and attached to Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income* or Form 1120-S, *U.S. Income Tax Return for an S Corporation* on which the taxpayer also indicated it had additional section 263A costs. These data provide an upper bound for the number of taxpayers affected by the repeal of the small reseller exception and enactment of section 263A(i) because the data includes taxpayers that were not previously eligible for the small reseller exception, such as producers and taxpayers with gross receipts of more than \$10 million.

The proposed regulations modify the \$50 million gross receipts test in §1.263A-1(d)(3)(ii)(B)(1) by using the section 448 gross receipts test. The \$50 million gross receipts amount is used by taxpayers to determine whether they are eligible to treat negative adjustments as additional section 263A costs for purposes of the simplified production method (SPM) under section 263A. The Treasury Department and the IRS do not have read-

ily available data to measure the prevalence of entities using the SPM.

Proposed §1.263A-9 modifies the current regulation to increase the eligibility threshold to \$25 million for the election permitting taxpayers to use the highest applicable Federal rate as a substitute for the weighted average interest rate when tracing debt for purposes of capitalizing interest under section 263A(f). The Treasury Department and the IRS estimate that there are between 38,100 and 38,900 respondents with gross receipts of not more than \$25 million that are eligible to make this election. These estimates come from information collected on: Form 1125-A, *Cost of Goods Sold*, attached to Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income* or Form 1120-S, *U.S. Income Tax Return for an S Corporation*, on which the taxpayer also indicated it had additional section 263A costs. The Treasury Department and the IRS expect that many taxpayers eligible to make the election for purposes of section 263A(f) will instead elect the small business exemption under section 263A(i). Additionally, taxpayers who chose to apply section 263A even though they qualify for the small business exemption under 263A(i) may not have interest expense required to be capitalized under section 263A(f). As a result, although these data do not include taxpayers with self-constructed assets that are eligible for the election, the Treasury Department and the IRS estimate that this data provides an upper bound for the number of eligible taxpayers.

#### B. Section 448

The Treasury Department and the IRS expect that the changes to section 448(c) by the TCJA will expand the number of taxpayers permitted to use the cash method. Section 448(a) provides that C corporations, partnerships with C corporations as partners, and tax shelters are not permitted to use the cash method of accounting; however section 448(c), as amended by the TCJA, provides that C corporations or partnerships with C corporations as partners, other than tax shelters, are not restricted from using the cash method if their average annual gross receipts are \$25 million (adjusted for inflation) or less. Pri-

or to the amendments made by the TCJA, the applicable gross receipts threshold was \$5 million. Section 448 does not apply to S corporations, partnerships without a C corporation partner, or any other business entities (including sole proprietorships reported on an individual's Form 1040). The Treasury Department and the IRS estimate that there are between 587,000 and 595,000 respondents with gross receipts of not more than \$5 million presently using an accrual method, and between 70,000 and 73,000 respondents with gross receipts of more than \$5 million but not more than \$25 million that are permitted to use to the cash method. These estimates come from information collected on Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income* and Form 1120-S, *U.S. Income Tax Return for an S Corporation*.

Under the proposed regulations, taxpayers that would meet the gross receipts test of section 448(c) and seem to be eligible to use the cash method but for the definition of "syndicate" under section 448(d)(3), may elect to use the allocated taxable income or loss of the immediately preceding taxable year to determine whether the taxpayer is a "syndicate" for purposes of section 448(d)(3) for the current taxable year. The Treasury Department and IRS estimate that 199,289 respondents may potentially make this election. This estimate comes from information collected on the Form 1065, *U.S. Return of Partnership Income* and Form 1120-S, *U.S. Income Tax Return for an S Corporation*, and the Form 1125-A, *Cost of Goods Sold*, attached to the Forms 1065 and 1120-S. The Treasury Department and the IRS estimate that these data provide an upper bound for the number of eligible taxpayers because not all taxpayers eligible to make the election will choose to do so.

#### C. Section 460

The Treasury Department and the IRS expect that the modification of section 460(e)(1)(B) by the TCJA will expand the number of taxpayers exempted from the requirement to apply the percentage-of-completion method to long-term construction contracts. Under section 460(e)(1)(B), as modified by the TCJA, taxpayers (other than a tax shelters) that

meet the \$25 million (adjusted for inflation) gross receipts test in section 448(c) are not required to use PCM to account for income from a long-term construction contract expected to be completed in two years. Prior to the modification of section 460(e)(1)(B) by the TCJA, a separate \$10 million dollar gross receipts test applied. The Treasury Department and the IRS estimate that there are between 15,400 and 18,000 respondents with gross receipts of between \$10 million and \$25 million who are eligible to change their method of accounting to apply the modified exemption. This estimate comes from information collected on the Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income*, and Form 1120-S, *U.S. Income Tax Return for an S Corporation* in which the taxpayer indicated its principal business activity was construction (NAICS codes beginning with 23). These data available do not distinguish between long-term contracts and other contracts, and also do not include other business entities that do not file Form 1120, *U.S. Corporation Income Tax Return*, Form 1065, *U.S. Return of Partnership Income*, and Form 1120-S, *U.S. Income Tax Return for an S Corporation*, such as a business reported on Schedule C, *Profit or Loss from Business*, of an individual's Form 1040, *U.S. Individual Income Tax Return*.

#### D. Section 471

The Treasury Department and the IRS expect that the addition of section 471(c) will expand the number of taxpayers exempted from the requirement to take inventories under section 471(a). Under section 471(c), taxpayers (other than tax shelters) that meet the \$25 million (adjusted for inflation) gross receipts test in section 448(c) can choose to apply certain simplified inventory methods rather than those otherwise required by section 471(a). The Treasury Department and the IRS estimate that there are between 3,200,000 and 3,400,000 respondents with gross receipts of not more than \$25 million that are exempted from the requirement to take inventories, and will treat their inventory either as non-incidental materials and supplies, or conform their inventory method to the method reflected in their AFS, or

if they do not have an AFS, in their books and records. This estimate comes from data collected on the Form 1125-A, *Cost of Goods Sold*. Within that set of taxpayers, the Treasury Department and the IRS estimate that there are between 10,500 and 11,300 respondents that may choose to conform their method of accounting for inventories to their method for inventory reflected in their AFS. This estimate comes from IRS-collected data on taxpayers that filed the Form 1125-A, *Cost of Goods Sold*, in addition to a Schedule M3, *Net Income (Loss) Reconciliation for Corporations With Total Assets of \$10 Million or More*, that indicated they had an AFS. These data provide a lower bound because they do not include other business entities, such as a business reported on Schedule C, *Profit or Loss from Business*, of an individual's Form 1040, *U.S. Individual Income Tax Return*, that are not required to file the Form 1125-A, *Cost of Goods Sold*.

#### 3. Impact of the Rule

As discussed earlier in the preamble, section 448 provides a general restriction for C corporations, partnerships with C corporation partners, and tax shelters from using the cash method of accounting, and sections 263A, 460 and 471 impose specific rules on uniform capitalization of direct and indirect production costs, the percentage of completion method for long-term contracts, and accounting for inventory costs, respectively. Section 13102 of TCJA provided new statutory exemptions and expanded the scope of existing statutory exemptions from these rules to reduce compliance burdens for small taxpayers (e.g., reducing the burdens associated with applying complex accrual rules under section 451 and 461, maintaining inventories, identifying and tracking costs that are allocable to property produced or acquired for resale, identifying and tracking costs that are allocable to long-term contracts, applying the look-back method under section 460, etc.). For example, a small business taxpayer with average gross receipts of \$20 million may pay an accountant an annual fee to perform a 25 hour analysis to determine the section 263A costs that are capitalized to inventory produced during the year. If this taxpayer chooses to apply the exemption

under section 263A and these proposed regulations, it will no longer need to pay an accountant for the annual section 263A analysis.

The proposed regulations implementing these exemptions are completely voluntary because small business taxpayers may continue using an accrual method of accounting, and applying sections 263A, 460 and 471 if they so choose. Thus, the exemptions increase the flexibility small business taxpayers have regarding their accounting methods relative to other businesses. The proposed regulations provide clarity and certainty for small business taxpayers implementing the exemptions.

#### 4. Projected Reporting, Recordkeeping, and Other Compliance Requirements

The Treasury Department and the IRS have not performed an analysis with respect to the projected reporting, recordkeeping, and other compliance requirements associated with the statutory exemptions under sections 263A, 448, 460, and 471 and the proposed regulations implementing these exemptions. However, the Treasury Department and the IRS anticipate that the statutory exemptions and the proposed regulations implementing these exemptions will reduce the reporting, recordkeeping, and other compliance requirements of affected taxpayers relative to the requirements that exist under the general rules in sections 263A, 448, 460, and 471.

#### 5. Alternatives Considered

As described in more detail earlier in the preamble, the Treasury Department and the IRS considered a number of alternatives under the proposed regulations. For example, in providing rules related to inventory exemption in Section 471(c)(1)(B)(i), which permits the taxpayer to treat its inventory as non-incidental materials and supplies, the Treasury Department and the IRS considered whether inventoriable costs should be recovered by (i) using an approach similar to the approach set forth under Revenue Procedure 2001-10 (2001-2 IRB 272) and Revenue Procedure 2002-28 (2002-28 IRB 815), which provided that inventory treated as non-incidental materials and



supplies was “used and consumed,” and thus recovered through costs of goods sold by a cash basis taxpayer, when the inventory items were provided to a customer, or when the taxpayer paid for the items, whichever was later, or (ii) using an alternative approach that treated inventory as “used and consumed” and thus recovered through costs of goods sold by the taxpayer, in a taxable year prior to the year in which the inventory item is provided to the customer (e.g., in the taxable year in which an inventory item is acquired or produced). The alternative approach described in (ii) would produce a savings equal the amount of the cost recovery multiplied by an applicable discount rate (determined based on the number of years the cost of goods sold recovery would be accelerated under this alternative). The Treasury Department and the IRS interpret section 471(c)(1)(B)(i) and its legislative history generally as codifying the rules provided in the administrative guidance existing at the time TCJA was enacted. Based on this interpretation, the Treasury Department and the IRS have determined that section 471(c) materials and supplies are “used and consumed” in the taxable year the taxpayer provides the goods to a customer, and are recovered through costs of goods sold in that year or the taxable year in which the cost of the goods is paid or incurred (in accordance with the taxpayer’s method of accounting), whichever is later. The Treasury Department and the IRS do not believe this approach creates or imposes undue burdens on taxpayers.

## 6. Duplicate, Overlapping, or Relevant Federal Rules

The proposed rules would not conflict with any relevant federal rules. As discussed above, the proposed regulations merely implement voluntary exemptions that relieve small business taxpayers from otherwise applicable restrictions and requirements under sections 263A, 448, 460, and 471.

### III. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from

publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial, direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

## Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the “ADDRESS-ES” heading. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at [www.regulations.gov](http://www.regulations.gov) or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the Federal Register. Announcement 2020-4, 2020-17 I.R.B. 667 (April 20, 2020), provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

## Drafting Information

The principal author of these proposed regulations is Anna Gleysteen, IRS Office of the Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the Treasury Department and the IRS participated in their development.

### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

## Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

### PART 1—INCOME TAXES

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

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

Par. 2. Section 1.263A-0 is amended by:

1. Revising the entry in the table of contents for §1.263A-1(b)(1).
2. Redesignating the entries in the table of contents for §1.263A-1(j), (k), and (l) as the entries for §1.263A-1(k), (l), and (m).
3. Adding a new entry in the table of contents for §1.263A-1(j).
4. Revising the newly designated entries for §1.263A-1(k), (l), and (m).
5. Revising the entries in the table of contents for §1.263A-3(a)(2)(ii).
6. Adding entries for §1.263A-3(a)(5) and revising the entry for §1.263A-3(b).
7. Redesignating the entries in the table of contents for §1.263A-4(a)(3) and (4) as the entries for §1.263A-4(a)(4) and (5).
8. Adding in the table of contents a new entry for §1.263A-4(a)(3).
9. Revising the entry in the table of contents for §1.263A-4(d) introductory text.
10. Redesignating the entry in the table of contents for §1.263A-4(d)(5) as the entry for §1.263A-4(d)(7).
11. Adding in the table of contents a new entry for §1.263A-4(d)(5).
12. Adding an entry in the table of contents for §1.263A-4(d)(6).
13. Adding an entry in the table of contents for §1.263A-4(e)(5).
14. Revising the entry in the table of contents for §1.263A-4(f) introductory text.
15. Adding an entry in the table of contents for §1.263A-4(g).
16. Revising the entry in the table of contents for §1.263A-7(a)(4).

The revisions and additions read as follows:

*§1.263A-0 Outline of regulations under section 263A.*

\* \* \* \* \*

*§1.263A-1 Uniform Capitalization of Costs.*

\*\*\*\*\*

(b) \*\*\*

(1) Small business taxpayers.

\*\*\*\*\*

(j) Exemption for certain small business taxpayers.

(1) In general.

(2) Application of the section 448(c) gross receipts test.

(i) In general.

(ii) Gross receipts of individuals, etc.

(iii) Partners and S corporation shareholders.

(iv) Examples.

(A) Example 1

(B) Example 2

(3) Change in method of accounting.

(i) In general.

(ii) Prior section 263A method change.

(k) Special rules

(1) Costs provided by a related person.

(i) In general

(ii) Exceptions

(2) Optional capitalization of period costs.

(i) In general.

(ii) Period costs eligible for capitalization.

(3) Trade or business application

(4) Transfers with a principal purpose of tax avoidance. [Reserved]

(1) Change in method of accounting.

(1) In general.

(2) Scope limitations.

(3) Audit protection.

(4) Section 481(a) adjustment.

(5) Time for requesting change.

(m) Effective/applicability date.

*§1.263A-3 Rules Relating to Property Acquired for Resale.*

(a) \*\*\*

(2) \*\*\*

(ii) Exemption for small business taxpayers.

\*\*\*\*\*

(5) De minimis production activities.

(i) In general.

(ii) Definition of gross receipts to determine de minimis production activities.

(iii) Example.

(b) [Reserved].

\*\*\*\*\*

*§1.263A-4 Rules for Property Produced in a Farming Business.*

(a) \*\*\*

(3) Exemption for certain small business taxpayers.

\*\*\*\*\*

(d) Election not to have section 263A apply under section 263A(d)(3).

\*\*\*\*\*

(5) Revocation of section 263A(d)(3) election in order to apply exemption under section 263A(i).

(6) Change from applying exemption under section 263A(i) to making a section 263A(d)(3) election.

\*\*\*\*\*

(e) \*\*\*

(5) Special temporary rule for citrus plants lost by reason of casualty.

(f) Change in method of accounting.

\*\*\*\*\*

(g) Effective date.

(1) In general.

(2) Changes made by Tax Cuts and Jobs Act (Pub. L. No. 115-97).

*§1.263A-7 Changing a method of accounting under section 263A.*

(a) \*\*\*

(4) Applicability dates.

(i) In general.

(ii) Changes made by Tax Cuts and Jobs Act (Pub. L. No. 115-97).

\*\*\*\*\*

Par. 3. Section 1.263A-1 is amended by:

1. Revising the paragraph (a)(2) subject heading.

2. In paragraph (a)(2)(i), revising the second sentence and adding a new third sentence.

3. Revising paragraph (b)(1).

4. In the second sentence of paragraph (d)(3)(ii)(B)(I), the language “§1.263A-3(b)” is removed and the language “§1.263A-1(j)” is added in its place.

5. Redesignating paragraphs (j) through (l) as paragraphs (k) through (m).

6. Adding a new paragraph (j).

The revisions and addition read as follows:

*§1.263A-1 Uniform capitalization of costs.*

(a) \*\*\*

(2) *Applicability dates.* (i) \*\*\* In the case of property that is inventory in the hands of the taxpayer, however, these sections are applicable for taxable years beginning after December 31, 1993. The small business taxpayer exception described in paragraph (b)(1) of this section and set forth in paragraph (j) of this section is applicable for taxable years beginning after December 31, 2017. \*\*\*

\*\*\*\*\*

(b) \*\*\*

(1) *Small business taxpayers.* For taxable years beginning after December 31, 2017, see section 263A(i) and paragraph (j) of this section for an exemption for certain small business taxpayers from the requirements of section 263A.

\*\*\*\*\*

(j) *Exemption for certain small business taxpayers—*(1) *In general.* A taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), that meets the gross receipts test under section 448(c) and §1.448-2(c) (section 448(c) gross receipts test) for any taxable year (small business taxpayer) is not required to capitalize costs under section 263A to any real or tangible personal property produced, and any real or personal property described in section 1221(a) (1) acquired for resale, during that taxable year.

(2) *Application of the section 448(c) gross receipts test—*(i) *In general.* In the case of any taxpayer that is not a corporation or a partnership, and except as provided in paragraphs (j)(2)(ii) and (iii) of this section, the section 448(c) gross receipts test is applied in the same manner as if each trade or business of the taxpayer were a corporation or partnership.

(ii) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security

benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W-2.

(iii) *Partners and S corporation shareholders.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership's gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder of an S corporation includes such shareholder's *pro rata* share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

(iv) *Examples.* The operation of this paragraph (j) is illustrated by the following examples:

(A) *Example 1.* Taxpayer A is an individual who operates two separate and distinct trades or business that are reported on Schedule C, *Profit or Loss from Business*, of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of \$5 million, and the other trade or business has average annual gross receipts of \$35 million. Under paragraph (j)(2)(ii) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (j)(2) of this section (\$5 million + \$35 million = \$40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(B) *Example 2.* Taxpayer B is an individual who operates three separate and distinct trades or business that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of \$15 million, Business Y is a dance studio with average annual gross receipts of \$6 million, and Business Z is a car repair shop with average annual gross receipts of \$12 million. Under paragraph (j)(2)(ii) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (j)(2)(i) of this section (\$15 million + \$6 million + \$12 million = \$33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(3) *Change in method of accounting—*  
(i) *In general.* A change from applying the small business taxpayer exemption under paragraph (j) of this section to not applying the exemption under this paragraph (j), or *vice versa*, is a change in method of accounting under section 446(e) and §1.446-1(e). A taxpayer obtains the consent of the Commissioner to change its method of accounting to comply with paragraph (j) of this section by following the applicable administrative procedures to obtain the consent of the Commis-

sioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (See Revenue Procedure 2015-13, 2015-5 IRB 419 (or successor) (see also §601.601(d)(2) of this chapter)). If an item of income or expense is not treated consistently from year to year, that treatment may not clearly reflect income, notwithstanding the application of this section. For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1.

(ii) *Prior section 263A method change.* A taxpayer that otherwise meets the requirements of paragraph (j) of this section, and that had previously changed its method of accounting to capitalize costs under section 263A because it no longer met the section 448(c) gross receipts test, may not change its method of accounting under section 263A to apply the exemption under paragraph (j) of this section without the consent of the Commissioner. Taxpayers must follow the administrative procedures to obtain the consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (See Revenue Procedure 2015-13, 2015-5 IRB 419 (or successor) (see also §601.601(d)(2) of this chapter)). For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1.

\* \* \* \* \*

Par. 4. Section 1.263A-2 is amended by:

1. Adding a sentence at the end of paragraph (a) introductory text.
2. Revising paragraph (a)(1)(ii)(C).
3. Revising the paragraph (g) subject heading.
4. Adding paragraph (g)(4).

The additions and revisions read as follows:

*§1.263A-2 Rules relating to property produced by the taxpayer.*

(a) \* \* \* For taxable years beginning after December 31, 2017, see §1.263A-1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and §1.448-2(c).

(1) \* \* \*

(ii) \* \* \*

(C) Home construction contracts. Section 460(e)(1) provides that section 263A applies to a home construction contract unless that contract will be completed within two years of the contract commencement date and, for contracts entered into after December 31, 2017, in taxable years ending after December 31, 2017, the taxpayer meets the gross receipts test of section 448(c) and §1.448-2(c) for the taxable year in which such contract is entered into.

\* \* \* \* \*

(g) *Applicability dates.* \* \* \*

(4) The rules set forth in the last sentence of the introductory text of paragraph (a) of this section and in paragraph (a)(1)(ii)(C) of this section apply for taxable years beginning on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**].

Par. 5. Section 1.263A-3 is amended:

1. In paragraph (a)(1), by revising the second sentence.
2. By revising paragraphs (a)(2)(ii) and (iii).
4. In paragraph (a)(3), by removing the language "small reseller" and adding in its place the language "small business taxpayer".
5. In paragraph (a)(4)(ii), by removing the language "(within the meaning of paragraph (a)(2)(iii) of this section)" and adding in its place the language "(within the meaning of paragraph (a)(5) of this section)".
6. By adding paragraph (a)(5).
7. By removing and reserving paragraph (b).
8. By revising paragraph (f).

The revisions and additions read as follows:

*§1.263A-3 Rules relating to property acquired for resale.*

(a) \* \* \*

(1) \* \* \* However, for taxable years beginning after December 31, 2017, a small business taxpayer, as defined in §1.263A-1(j), is not required to apply section 263A in that taxable year. \* \* \*

(2) \* \* \*

(ii) *Exemption for certain small business taxpayers.* For taxable years be-



ginning after December 31, 2017, see §1.263A-1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and §1.448-2(c).

(iii) *De minimis production activities.* See paragraph (a)(5) of this section for rules relating to an exception for resellers with *de minimis* production activities.

\*\*\*\*\*

(5) *De minimis production activities—*  
(i) *In general.* In determining whether a taxpayer's production activities are *de minimis*, all facts and circumstances must be considered. For example, the taxpayer must consider the volume of the production activities in its trade or business. Production activities are presumed *de minimis* if—

(A) The gross receipts from the sale of the property produced by the reseller are less than 10 percent of the total gross receipts of the trade or business; and

(B) The labor costs allocable to the trade or business's production activities are less than 10 percent of the reseller's total labor costs allocable to its trade or business.

(ii) *Definition of gross receipts to determine de minimis production activities.* Gross receipts has the same definition as for purposes of the gross receipts test under §1.448-2(c), except that gross receipts are measured at the trade-or-business level rather than at the single-employer level.

(iii) *Example: Reseller with de minimis production activities.* Taxpayer N is in the retail grocery business. In 2019, N's average annual gross receipts for the three previous taxable years are greater than the gross receipts test of section 448(c). Thus, N is not exempt from the requirement to capitalize costs under section 263A. N's grocery stores typically contain bakeries where customers may purchase baked goods produced by N. N produces no other goods in its retail grocery business. N's gross receipts from its bakeries are 5 percent of the entire grocery business. N's labor costs from its bakeries are 3 percent of its total labor costs allocable to the entire grocery business. Because both ratios are less than 10 percent, N's production activities are *de minimis*. Further, because N's production activities are incident to its resale activities, N may use the simplified resale method, as provided in paragraph (a)(4) (ii) of this section.

\*\*\*\*\*

(f) *Applicability dates.* (1) Paragraphs (d)(3)(i)(C)(3), (d)(3)(i)(D)(3), and (d)(3)(i)(E)(3) of this section apply for taxable years ending on or after January 13, 2014.

(2) The rules set forth in the second sentence of paragraph (a)(1) of this section, paragraphs (a)(2)(ii) and (iii) of this section, the third sentence of paragraph (a)(3) of this section, and paragraphs (a)(4)(ii) and (a)(5) of this section apply for taxable years beginning on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**].

Par. 6. Section 1.263A-4 is amended:

1. In paragraph (a)(1), by revising the last sentence.

2. In paragraph (a)(2)(ii)(A)(I), by removing the language "section 464(c)" and adding in its place the language with "section 461(k)".

3. By redesignating paragraphs (a)(3) and (4) as paragraphs (a)(4) and (5) respectively.

4. By adding new paragraph (a)(3).

5. By revising the paragraph (d) subject heading.

6. In paragraph (d)(1), by revising the last sentence and adding a new last sentence.

7. In paragraph (d)(3)(i), by removing the last sentence.

8. By revising paragraph (d)(3)(ii).

9. By redesignating paragraph (d)(5) as paragraph (d)(7).

10. By adding new paragraph (d)(5)

11. By adding paragraphs (d)(6) and (e) (5).

12. By redesignating paragraph (f) as paragraph (g).

13. By adding new paragraph (f).

15. By revising the subject headings for newly redesignated paragraphs (g) and (g)(1), and revising newly designated paragraph (g)(2).

The revisions and additions read as follows:

*§1.263A-4 Rules for property produced in a farming business.*

(a) \* \* \*

(1) \* \* \* Except as provided in paragraphs (a)(2), (a)(3), and (e) of this section, taxpayers must capitalize the costs of producing all plants and animals unless the election described in paragraph (d) of this section is made.

\*\*\*\*\*

(3) *Exemption for certain small business taxpayers.* For taxable years be-

ginning after December 31, 2017, see §1.263A-1(j) for an exception in the case of a small business taxpayer that meets the gross receipts test of section 448(c) and §1.448-2(c).

\*\*\*\*\*

(d) *Election not to have section 263A apply under section 263A(d)(3)—*(1) \* \* \* Except as provided in paragraph (d)(5) and (6) of this section, the election is a method of accounting under section 446. An election made under section 263A(d)(3) and this paragraph (d) is revocable only with the consent of the Commissioner.

\*\*\*\*\*

(3) \* \* \*

(ii) *Nonautomatic election.* Except as provided in paragraphs (d)(5) and (6) of this section, a taxpayer that does not make the election under this paragraph (d) as provided in paragraph (d)(3)(i) of this section must obtain the consent of the Commissioner to make the election by filing a Form 3115, *Application for Change in Method of Accounting*, in accordance with §1.446-1(e)(3).

\*\*\*\*\*

(5) *Revocation of section 263A(d)(3) election in order to apply exemption under section 263A(i).* A taxpayer that elected under section 263A(d)(3) and paragraph (d)(3) of this section not to have section 263A apply to any plant produced in a farming business that wants to revoke its section 263A(d)(3) election, and in the same taxable year, apply the small business taxpayer exemption under section 263A(i) and §1.263A-1(j) may revoke the election in accordance with the applicable administrative guidance as published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(b) of this chapter). A revocation of the taxpayer's section 263A(d)(3) election under this paragraph (d)(5) is not a change in method of accounting under sections 446 and 481 and §§1.446-1 and 1.481-1 through 1.481-5.

(6) *Change from applying exemption under section 263A(i) to making a section 263A(d)(3) election.* A taxpayer whose method of accounting is to not capitalize costs under section 263A based on the exemption under section 263A(i), that becomes ineligible to use the exemption under section 263A(i), and is eligible and wants to elect under section 263A(d)(3) for this same taxable year to not cap-

italize costs under section 263A for any plant produced in the taxpayer's farming business, must make the election in accordance with the applicable administrative guidance as published in the Internal Revenue Bulletin (*see* §601.601(d)(2)(ii)(b) of this chapter). An election under section 263A(d)(3) made in accordance with this paragraph (d)(6) is not a change in method of accounting under sections 446 and 481 and §§1.446-1 and 1.481-1 through 1.481-5.

\*\*\*\*\*

(e) \*\*\*

(5) *Special temporary rule for citrus plants lost by reason of casualty.* Section 263A(d)(2)(A) provides that if plants bearing an edible crop for human consumption were lost or damaged while in the hands of the taxpayer by reason of freezing temperatures, disease, drought, pests, or casualty, section 263A does not apply to any costs of the taxpayer of replanting plants bearing the same type of crop (whether on the same parcel of land on which such lost or damaged plants were located or any other parcel of land of the same acreage in the United States). The rules of this paragraph (e)(5) apply to certain costs that are paid or incurred after December 22, 2017, and on or before December 22, 2027, to replant citrus plants after the loss or damage of citrus plants. Notwithstanding paragraph (e)(2) of this section, in the case of replanting citrus plants after the loss or damage of citrus plants by reason of freezing temperatures, disease, drought, pests, or casualty, section 263A does not apply to replanting costs paid or incurred by a taxpayer other than the owner described in section 263A(d)(2)(A) if—

(i) The owner described in section 263A(d)(2)(A) has an equity interest of not less than 50 percent in the replanted citrus plants at all times during the taxable year in which such amounts were paid or incurred and the taxpayer holds any part of the remaining equity interest; or

(ii) The taxpayer acquired the entirety of the equity interest in the land of that owner described in section 263A(d)(2)(A) and on which land the lost or damaged citrus plants were located at the time of such loss or damage, and the replanting is on such land.

(f) *Change in method of accounting.* Except as provided in paragraphs (d)(5)

and (6) of this section, any change in a taxpayer's method of accounting necessary to comply with this section is a change in method of accounting to which the provisions of sections 446 and 481 and §1.446-1 through 1.446-7 and §1.481-1 through §1.481-3 apply.

(g) *Applicability dates—(1) In general.*\*\*\*

(2) *Changes made by Tax Cuts and Jobs Act (Pub. L. No. 115-97).* Paragraphs (a)(3), (d)(5), (d)(6), and (e)(5) of this section apply for taxable years ending on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**]. Except as otherwise provided in this paragraph (g), for taxable years beginning before [date the Treasury Decision adopting these regulations as final is published in the **Federal Register**], see §1.263A-4 as contained in 26 CFR part 1, revised April 1, 2019.

Par. 7. §1.263A-7 is amended:

1. By revising paragraph (a)(3)(i).  
2. By redesignating paragraph (a)(4) as paragraph (a)(4)(i).

3. By adding a paragraph (a)(4) subject heading.

4. By revising the newly designated paragraph (a)(4)(i) subject heading.

5. By adding paragraph (a)(4)(ii).

6. In paragraph (b)(1), by removing the language “Rev. Proc. 97-27 (1997-21 I.R.B.10)” and adding in its place the language “Revenue Procedure 2015-13 (2015-5 IRB 419)”.

7. In paragraph (b)(2)(ii), by removing the language “Rev. Proc. 2002-9 (2002-1 C.B. 327) and Rev. Proc. 97-27 (1991-1 C.B. 680)” and adding the language “applicable administrative procedures” in its place.

The revisions and additions read as follows:

§1.263A-7 *Changing a method of accounting under section 263A.*

(a) \*\*\*

(3) \*\*\*

(i) For taxable years beginning after December 31, 2017, resellers of real or personal property or producers of real or tangible personal property whose average annual gross receipts for the immediately preceding 3-taxable-year period (or lesser period if the taxpayer was not in

existence for the three preceding taxable years, annualized as required) exceed the gross receipts test of section 448(c) and the accompanying regulations where the taxpayer was not subject to section 263A in the prior taxable year;

\*\*\*\*\*

(4) *Applicability dates—(i) In general.*\*\*\*

(ii) *Changes made by Tax Cuts and Jobs Act (Pub. L. No. 115-97).* Paragraph (a)(3)(i) of this section applies to taxable years ending on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**]. Except as otherwise provided in this paragraph (a)(4), for taxable years beginning before [date the Treasury Decision adopting these regulations as final is published in the **Federal Register**], see §1.263A-7(a)(3)(i) as contained in 26 CFR part 1, revised April 1, 2019.

\*\*\*\*\*

Par. 8. Section 1.263A-8 is amended by adding a sentence to the end of paragraph (a)(1) to read as follows:

§1.263A-8 *Requirement to capitalize interest.*

(a)\*\*\*

(1)\*\*\*However, a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), that meets the gross receipts test of section 448(c) for the taxable year is not required to capitalize costs, including interest, under section 263A. See §1.263A-1(j).

\*\*\*\*\*

Par. 9. Section 1.263A-9 is amended by adding a sentence at the end of paragraph (e)(2) to read as follows:

§1.263A-9 *The avoided cost method.*

\*\*\*\*\*

(e)\*\*\*

(2)\*\*\*A taxpayer is an eligible taxpayer for a taxable year for purposes of this paragraph (e) if the taxpayer is a small business taxpayer, as defined in §1.263A-1(j).

\*\*\*\*\*

Par. 10. Section 1.263A-15 is amended by adding paragraph (a)(4) to read as follows:

*§1.263A-15 Effective dates, transitional rules, and anti-abuse rule.*

(a) \* \* \*

(4) The last sentence of each of §1.263A-8(a)(1) and §1.263A-9(e)(2) apply to taxable years beginning on or after [date the Treasury decision adopting these proposed regulations as final is published in the **Federal Register**]. Except as otherwise provided in this paragraph (a)(4), for taxable years beginning before [date the Treasury decision adopting these regulations as final is published in the **Federal Register**], see §1.263A-8(a)(1) and §1.263A-9(e)(2) as contained in 26 CFR part 1, revised April 1, 2019.

\* \* \* \* \*

§1.381(c)(5)-1 [Amended]

Par. 11. Section 1.381(c)(5)-1 is amended:

1. In paragraph (a)(6), by designating *Examples 1* and *2* as paragraphs (a)(6)(i) and (ii), respectively.

2. In newly-designated paragraphs (a)(6)(i) and (ii), by redesignating the paragraphs in the first column as the paragraphs in the second column:

Old Paragraphs	New Paragraphs
(a)(6)(i)(i) and (ii)	(a)(6)(i)(A) and (B)
(a)(6)(ii)(i) and (ii)	(a)(6)(ii)(A) and (B)

3. In newly designated paragraphs (a)(6)(ii)(A) and (B), by removing the language “small reseller” and adding in its place the language “small business taxpayer” everywhere it appears.

Par. 12. §1.446-1 is amended:

1. In paragraph (a)(4)(i), by revising the first sentence.

2. By revising paragraph (c)(2)(i).

3. By adding paragraph (c)(3).

The revisions and addition read as follows:

*§1.446-1 General rule for methods of accounting.*

(a) \* \* \*

(4) \* \* \*

(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. \* \* \*

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(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.

\* \* \* \* \*

(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 [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**]. For taxable years beginning before [date the Treasury Decision adopting these regulations as final is published in the **Federal Register**], see §1.446-1(c) as contained in 26 CFR part 1, revised April 1, 2019.

\* \* \* \* \*

Par. 13. Section 1.448-1 is amended by adding new first and second sentences to paragraphs (g)(1) and (h)(1) to read as follows:

*§1.448-1 Limitation on the use of the cash receipts and disbursements method of accounting.*

\* \* \* \* \*

(g) \* \* \*

(1) \* \* \*The rules provided in paragraph (g) of this section apply to taxable years beginning before January 1, 2018. See §1.448-2 for rules relating to taxable years beginning after December 31, 2017.\* \* \*

\* \* \* \* \*

(h) \* \* \*

(1) \* \* \*The rules provided in paragraph (h) of this section apply to taxable years beginning before January 1, 2018. See §1.448-2 for rules relating to taxable years beginning after December 31, 2017.\* \* \*

\* \* \* \* \*

§1.448-2 [Redesignated as §1.448-3]

Par. 14. Section 1.448-2 is redesignated as §1.448-3.

Par. 15. A new §1.448-2 is added to read as follows:

*§1.448-2 Limitation on the use of the cash receipts and disbursements method of accounting for taxable years beginning after December 31, 2017.*

(a) *Limitation on method of accounting—(1) In general.* The rules of this section relate to the limitation on the use of the cash receipts and disbursements method of accounting (cash method) by certain taxpayers applicable for taxable years beginning after December 31, 2017. For rules applicable to taxable years beginning before January 1, 2018, see §§1.448-1 and 1.448-1T.

(2) *Limitation rule.* Except as otherwise provided in this section, the computation of taxable income using the cash method is prohibited in the case of a:

(i) C corporation;

(ii) Partnership with a C corporation as a partner, or a partnership that had a C corporation as a partner at any time during the partnership’s taxable year beginning after December 31, 1986; or

(iii) Tax shelter.

(3) *Treatment of combination methods—(i) In general.* For purposes of this section, the use of a method of accounting that records some, but not all, items on the cash method is considered the use of the cash method. Thus, a C corporation that uses a combination of accounting methods including the use of the cash method is subject to this section.

(ii) *Example.* The following example illustrates the operation of this paragraph (a)(3). In 2020, A is a C corporation with average annual gross receipts for the prior three taxable years of greater than \$30 million, is not a tax shelter under section 448(a)(3) and does not qualify as a qualified personal service corporation, as defined in paragraph (e) of this section. For the last 20 years, A used an accrual method for items of income and expenses related to purchases and sales of inventory, and the cash method for items related to its provision of services. A is using a combination of accounting methods that



include the cash method. Thus, A is subject to section 448. A is prohibited from using the cash method for any item for 2020 and is required to change to a permissible method.

(b) *Definitions.* For purposes of this section—

(1) *C corporation*—(i) *In general.* The term *C corporation* means any corporation that is not an S corporation (as defined in section 1361(a)(1)). For example, a regulated investment company (as defined in section 851) or a real estate investment trust (as defined in section 856) is a C corporation for purposes of this section. In addition, a trust subject to tax under section 511(b) is treated, for purposes of this section, as a C corporation, but only with respect to the portion of its activities that constitute an unrelated trade or business. Similarly, for purposes of this section, a corporation that is exempt from Federal income taxes under section 501(a) is treated as a C corporation only with respect to the portion of its activities that constitute an unrelated trade or business. Moreover, for purposes of determining whether a partnership has a C corporation as a partner, any partnership described in paragraph (a)(2)(ii) of this section is treated as a C corporation. Thus, if partnership ABC has a partner that is a partnership with a C corporation, then, for purposes of this section, partnership ABC is treated as a partnership with a C corporation partner.

(ii) [Reserved]

(2) *Tax shelter*—(i) *In general.* The term *tax shelter* means any—

(A) Enterprise, other than a C corporation, if at any time (including taxable years beginning before January 1, 1987) interests in such enterprise have been offered for sale in any offering required to be registered with any Federal or state agency having the authority to regulate the offering of securities for sale;

(B) Syndicate, within the meaning of paragraph (b)(2)(iii) of this section, or

(C) Tax shelter, within the meaning of section 6662(d)(2)(C).

(ii) *Requirement of registration.* For purposes of paragraph (b)(2)(i)(A) of this section, an offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to register the offering would result in a violation of the applicable Federal or

state law; this rule applies regardless of whether the offering is in fact registered. In addition, an offering is required to be registered with a Federal or state agency if, under the applicable Federal or state law, failure to file a notice of exemption from registration would result in a violation of the applicable Federal or state law, regardless of whether the notice is in fact filed. However, an S corporation is not treated as a tax shelter for purposes of section 448(d)(3) or this section merely by reason of being required to file a notice of exemption from registration with a state agency described in section 461(i)(3)(A), but only if all corporations offering securities for sale in the state must file such a notice in order to be exempt from such registration.

(iii) *Syndicate*—(A) *In general.* For purposes of paragraph (b)(2)(i)(B) of this section, the term *syndicate* means a partnership or other entity (other than a C corporation) if more than 35 percent of the losses of such entity during the taxable year (for taxable years beginning after December 31, 1986) are allocated to limited partners or limited entrepreneurs. For purposes of this paragraph (b)(2)(iii), the term *limited entrepreneur* has the same meaning given such term in section 461(k)(4). In addition, in determining whether an interest in a partnership is held by a limited partner, or an interest in an entity or enterprise is held by a limited entrepreneur, section 461(k)(2) applies in the case of the trade or business of farming (as defined in paragraph (d)(2) of this section), and section 1256(e)(3)(C) applies in all other cases. Moreover, for purposes of paragraph (b)(2) of this section, the losses of a partnership, entity, or enterprise (entities) means the excess of the deductions allowable to the entities over the amount of income recognized by such entities under the entities' method of accounting used for Federal income tax purposes (determined without regard to this section). For this purpose, gains or losses from the sale of capital assets or assets described in section 1221(a)(2) are not taken into account.

(B) *Election to test the allocation of losses from prior taxable year.* For purposes of paragraph (b)(2)(iii)(A) of this section, to determine if more than 35 percent of the losses of a venture are allocated to limited partners or limited entrepreneurs,

instead of using the current taxable year's allocation of losses, entities may elect to use the allocations made in the immediately preceding taxable year instead of using the current taxable year's allocation. An election under this paragraph (b)(2)(iii)(B) applies to the first taxable year for which the election is made and to all subsequent taxable years, unless the Commissioner of Internal Revenue or his delegate (Commissioner) permits a revocation of the election in accordance with this paragraph. An election under this paragraph (b)(2)(iii)(B) may never be revoked earlier than the fifth taxable year following the first taxable year for which the election was made unless extraordinary circumstances are demonstrated to the satisfaction of the Commissioner. Once an election has been revoked, a new election under this paragraph (b)(2)(iii)(B) cannot be made until the fifth taxable year following the taxable year for which the previous election was revoked unless extraordinary circumstances are demonstrated to the satisfaction of the Commissioner. A taxpayer making this election must attach a statement to its timely filed Federal income tax return (including extension) that this election is made beginning with that taxable year. If such a statement is not attached, the election is not valid and has no effect for any purpose. No late elections will be permitted. Further, an election cannot be made by filing an amended Federal income tax return. In addition to section 448, this election also applies for purposes of all provisions of the Code that refer to section 448(a)(3) to define tax shelter. An election made under this paragraph (b)(2)(iii)(B) may only be revoked with the written consent of the Commissioner. Requests for consent must follow the applicable administrative procedures for requesting a letter ruling (for example, see Revenue Procedure 2020-1, 2020-01 IRB 1 (or its successor)).

(C) *Example.* Taxpayer B is a calendar year limited partnership, with no active management from its limited partner. In 2019, B is profitable and allocates 80 percent of its profits to its general partner and 20 percent of its profits to its limited partner. In 2020, B has a loss and allocates 60 percent of losses to its general partner and 40 percent of its losses to its limited partner. In 2020 B makes an election un-

der paragraph (b)(2)(iii)(B) of this section to use its prior year allocated amounts. For 2020, B is not a syndicate because B is treated as having allocated 20 percent of its profits to its limited partner in 2020 for purposes of paragraph (b)(2)(iii) of this section. For 2021, B is a syndicate because B is treated as having allocated 40 percent of its losses to its limited partner for purposes of paragraph (b)(2)(iii) of this section.

(iv) *Presumed tax avoidance.* For purposes of (b)(2)(i)(C) of this section, marketed arrangements in which persons carrying on farming activities using the services of a common managerial or administrative service will be presumed to have the principal purpose of tax avoidance if such persons use borrowed funds to prepay a substantial portion of their farming expenses (for example, payment for farm supplies that will not be used or consumed until a taxable year subsequent to the taxable year of payment).

(v) *Taxable year tax shelter must change accounting method.* A tax shelter must change from the cash method for the taxable year that it becomes a tax shelter, as determined under paragraph (b)(2) of this section.

(vi) *Determination of loss amount.* For purposes of section 448(d)(3), the amount of losses to be allocated under section 1256(e)(3)(B) is calculated without regard to section 163(j).

(c) *Exception for entities with gross receipts not in excess of the amount provided in section 448(c)—(1) In general.* Except in the case of a tax shelter, this section does not apply to any C corporation or partnership with a C corporation as a partner for any taxable year if such corporation or partnership (or any predecessor thereof) meets the gross receipts test of paragraph (c)(2) of this section.

(2) *Gross receipts test—(i) In general.* A corporation meets the gross receipts test of this paragraph (c)(2) if the average annual gross receipts of such corporation for the 3 taxable years (or, if shorter, the taxable years during which such corporation was in existence, annualized as required) ending with such prior taxable year does not exceed the gross receipts test amount provided in paragraph (c)(2)(v) of this section (section 448(c) gross receipts test). In the case of a C corporation

exempt from Federal income taxes under section 501(a), or a trust subject to tax under section 511(b) that is treated as a C corporation under paragraph (b)(1) of this section, only gross receipts from the activities of such corporation or trust that constitute unrelated trades or businesses are taken into account in determining whether the gross receipts test is satisfied. A partnership with a C corporation as a partner meets the gross receipts test of paragraph (c)(2) of this section if the average annual gross receipts of such partnership for the 3 taxable years (or, if shorter, the taxable years during which such partnership was in existence annualized as required) ending with such prior year does not exceed the gross receipts test amount of paragraph (c)(2)(v) of this section. Except as provided in paragraph (c)(2)(ii) of this section, the gross receipts of the corporate partner are not taken into account in determining whether a partnership meets the gross receipts test of paragraph (c)(2) of this section.

(ii) *Aggregation of gross receipts.* The aggregation rules in §1.448-1T(f)(2)(ii) apply for purposes of aggregating gross receipts for purposes of this section.

(iii) *Treatment of short taxable year.* The short taxable year rules in §1.448-1T(f)(2)(iii) apply for purposes of this section.

(iv) *Determination of gross receipts.* The determination of gross receipts rules in §1.448-1T(f)(2)(iv) apply for purposes of this section.

(v) *Gross receipts test amount—(A) In general.* For purposes of paragraph (c) of this section, the term *gross receipts test amount* means \$25,000,000, adjusted annually for inflation in the manner provided in section 448(c)(4). The inflation adjusted gross receipts test amount is published annually in guidance published in the Internal Revenue Bulletin (see §601.601(d)(2)(ii) of this chapter).

(B) *Example.* Taxpayer A, a C corporation, is a plumbing contractor that installs plumbing fixtures in customers' homes or businesses. A's gross receipts for the 2017-2019 taxable years are \$20 million, \$16 million, and \$30 million, respectively. A's average annual gross receipts for the three taxable-year period preceding the 2020 taxable year is \$22 million  $(\$20 \text{ million} + \$16 \text{ million} + \$30 \text{ million}) / 3 =$

\$22 million. A may use the cash method for its trade or business for the 2020 taxable year because its average annual gross receipts for the preceding three taxable years is not more than the gross receipts test amount of paragraph (c)(2)(vi) of this section, which is \$26 million for 2020.

(d) *Exception for farming businesses—(1) In general.* Except in the case of a tax shelter, this section does not apply to any farming business. A taxpayer engaged in a farming business and a separate non-farming business is not prohibited by this section from using the cash method with respect to the farming business, even though the taxpayer may be prohibited by this section from using the cash method with respect to the non-farming business.

(2) *Farming business—(i) In general.* For purposes of paragraph (d) of this section, the term *farming business* means—

(A) The trade or business of farming as defined in section 263A(e)(4) (including the operation of a nursery or sod farm, or the raising or harvesting of trees bearing fruit, nuts or other crops, or ornamental trees),

(B) The raising, harvesting, or growing of trees described in section 263A(c)(5) (relating to trees raised, harvested, or grown by the taxpayer other than trees described in paragraph (d)(2)(i)(A) of this section),

(C) The raising of timber, or

(D) Processing activities which are normally incident to the growing, raising, or harvesting of agricultural products.

(ii) *Example.* Assume a taxpayer is in the business of growing fruits and vegetables. When the fruits and vegetables are ready to be harvested, the taxpayer picks, washes, inspects, and packages the fruits and vegetables for sale. Such activities are normally incident to the raising of these crops by farmers. The taxpayer will be considered to be in the business of farming with respect to the growing of fruits and vegetables, and the processing activities incident to the harvest.

(iii) *Processing activities excluded from farming businesses—(A) In general.* For purposes of this section, a farming business does not include the processing of commodities or products beyond those activities normally incident to the growing, raising, or harvesting of such products.

(B) *Examples. (1) Example 1.* Assume that a C corporation taxpayer is in the business of growing and harvesting wheat and other grains. The taxpayer processes the harvested grains to produce breads, cereals, and similar food products which it sells to customers in the course of its business. Although the taxpayer is in the farming business with respect to the growing and harvesting of grain, the taxpayer is not in the farming business with respect to the processing of such grains to produce breads, cereals, and similar food products which the taxpayer sells to customers.

(2) *Example 2.* Assume that a taxpayer is in the business of raising livestock. The taxpayer uses the livestock in a meat processing operation in which the livestock are slaughtered, processed, and packaged or canned for sale to customers. Although the taxpayer is in the farming business with respect to the raising of livestock, the taxpayer is not in the farming business with respect to the meat processing operation.

(e) *Exception for qualified personal service corporation.* The rules in §1.448-1T(e) relating to the exception for qualified personal service corporations apply for taxable years beginning after December 31, 2017.

(f) *Effect of section 448 on other provisions.* Except as provided in paragraph (b)(2)(iii)(B) of this section, nothing in section 448 shall have any effect on the application of any other provision of law that would otherwise limit the use of the cash method, and no inference shall be drawn from section 448 with respect to the application of any such provision. For example, nothing in section 448 affects the requirement of section 447 that certain corporations must use an accrual method of accounting in computing taxable income from farming, or the requirement of §1.446-1(c)(2) that, in general, an accrual method be used with regard to purchases and sales of inventory. Similarly, nothing in section 448 affects the authority of the Commissioner under section 446(b) to require the use of an accounting method that clearly reflects income, or the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. For example, a taxpayer using the cash method may be required to change to an accrual method of accounting under section 446(b) because such method clearly reflects the taxpayer's income, even though the taxpayer is not prohibited by section 448 from using the cash method. Similarly, a taxpayer using an accrual method of accounting that is not prohibited by section 448 from using the cash method may not change to the cash method unless the

taxpayer secures the consent of the Commissioner under section 446(e).

(g) *Treatment of accounting method change and rules for section 481(a) adjustment—(1) In general.* Any taxpayer to whom section 448 applies must change its method of accounting in accordance with the provisions of this paragraph (g). In the case of any taxpayer required by this section to change its method of accounting for any taxable year, the change shall be treated as a change initiated by the taxpayer. A taxpayer must change to an overall accrual method of accounting for the first taxable year the taxpayer is subject to this section or a subsequent taxable year in which the taxpayer is newly subject to this section after previously making a change in method of accounting that complies with section 448 (mandatory section 448 year). A taxpayer may have more than one mandatory section 448 year. For example, a taxpayer may exceed the gross receipts test of section 448(c) in non-consecutive taxable years. If the taxpayer complies with the provisions of paragraph (g)(3) of this section for its mandatory section 448 year, the change shall be treated as made with the consent of the Commissioner. The change shall be implemented pursuant to the applicable administrative procedures to obtain the automatic consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (See Revenue Procedure 2015-13, 2015-5 IRB 419 (or successor) (see §601.601(d)(2) of this chapter)). This paragraph (g) applies only to a taxpayer who changes from the cash method as required by this section. This paragraph (g) does not apply to a change in method of accounting required by any Code section (or applicable regulation) other than this section.

(2) *Section 481(a) adjustment.* The amount of the net section 481(a) adjustment and the adjustment period necessary to implement a change in method of accounting required under this section are determined under §1.446-1(e) and the applicable administrative procedures to obtain the Commissioner's consent to change a method of accounting as published in the Internal Revenue Bulletin (see also §601.601(d)(2) of this chapter).

(3) *Prior change in overall method of accounting under this section.* A taxpayer

er that otherwise meets the requirements of paragraph (c) of this section, and that had during any of the five taxable years ending with the taxable year changed its overall method of accounting from the cash method because it no longer met the gross receipts test of section 448(c) provided under paragraph (c) of this section or because it was a tax shelter as provided under paragraph (b)(2) of this section, may not change its overall method of accounting back to the cash method without the written consent of the Commissioner. Requests for consent must follow the applicable administrative procedures to obtain the written consent of the Commissioner to change a method of accounting under section 446(e) as published in the Internal Revenue Bulletin (see also §601.601(d)(2) of this chapter). For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1.

(h) *Applicability dates.* The rules of this section apply for taxable years beginning on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**].

Par. 16. Newly redesignated § 1.448-3 is amended by revising paragraphs (a)(2) and (h) to read as follows:

*§1.448-3 Nonaccrual of certain amounts by service providers.*

(a) \* \* \*

(2) The taxpayer meets the gross receipts test of section 448(c) and §1.448-1T(f)(2) (in the case of taxable years beginning before January 1, 2018), or §1.448-2(c) (in the case of taxable years beginning after December 31, 2017) for all prior taxable years.

\* \* \* \* \*

(h) *Applicability dates.* (1) Except as provided in paragraph (h)(2) of this section, this section is applicable for taxable years ending on or after August 31, 2006.

(2) The rules of paragraph (a)(2) of this section apply for taxable years beginning on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**]. For taxable years beginning before [date the Treasury Decision adopting these regulations as final is published in the **Federal**



al Register], see §1.448-2 as contained in 26 CFR part 1, revised April 1, 2019.

Par. 17. Section 1.460-0 is amended by:

1. Adding an entry for §1.460-1(h)(3).

2. Revising the entries for §1.460-3(b)(3), §1.460-3(b)(3)(i) and (ii), and adding entries for §1.460-3(b)(3)(ii)(A), (B), (C) and (D).

3. Removing the entry for §1.460-3(b)(3)(iii).

4. Adding entries for §1.460-3(d), §1.460-4(i), and §1.460-6(k).

The additions and revisions read as follows:

*§1.460-0 Outline of regulations under section 460.*

\*\*\*\*\*

*§1.460-1 Long-term contracts.*

\*\*\*\*\*

(h) \*\*\*

(3) Changes made by Tax Cuts and Jobs Act (Pub. L. 115-97).

\*\*\*\*\*

*§1.460-3 Long-term construction contracts.*

\*\*\*\*\*

(b) \*\*\*

(3) Gross receipts test of section 448(c)

(i) In general

(ii) Application of gross receipts test

(A) In general

(B) Gross receipts of individuals, etc.

(C) Partners and S corporation shareholders

(D) Examples

(1) Example 1.

(2) Example 2.

\*\*\*\*\*

(d) Applicability dates.

*§1.460-4 Methods of Accounting for long-term contracts.*

\*\*\*\*\*

(i) Applicability date.

\*\*\*\*\*

*§1.460-6 Look-back method.*

\*\*\*\*\*

(k) Applicability date.

**§ 1.460-1 [Amended]**

Par. 18. Section 1.460-1 is amended by adding three sentences to the end of paragraph (f)(3) and adding paragraph (h)(3) to read as follows:

*§1.460-1 Long-term contracts.*

(f) \*\*\*

(3) \*\*\* A taxpayer may adopt any permissible method of accounting for each classification of contract. Such adoption is not a change in method of accounting under section 446 and the accompanying regulations. For example, a taxpayer that has had only contracts classified as non-exempt long-term contracts and has used the PCM for these contracts may adopt an exempt contract method in the taxable year it first enters into an exempt long-term contract.

\*\*\*\*\*

(h) \*\*\*

(3) *Changes made by Tax Cuts and Jobs Act (Pub. L. 115-97).* Paragraph (f)(3) of this section, and §1.460-5(d)(1) and (d)(3), apply for taxable years beginning on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**].

\*\*\*\*\*

Par. 19. Section 1.460-3 is amended by revising paragraphs (b)(1)(ii) and (b)(3) and adding paragraph (d) to read as follows:

*§1.460-3 Long-term construction contracts.*

\*\*\*\*\*

(b) \*\*\*

(1) \*\*\*

(ii) Other construction contract, entered into after December 31, 2017, in a taxable year ending after December 31, 2017, by a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting (cash method) under section 448(a)(3), who estimates at the time such contract is entered into that such contract will be completed within the 2-year period beginning on the contract commencement date, and who meets the gross receipts test described in paragraph (b)(3) of this section.

\*\*\*\*\*

(3) *Gross receipts test of section 448(c)*—(i) *In general.* A taxpayer, other

than a tax shelter prohibited from using the cash method under section 448(a)(3), satisfies the gross receipts test of this paragraph (b)(3) if it meets the gross receipts test of section 448(c) and §1.448-2(c)(2).

(ii) *Application of gross receipts test*—(A) *In general.* In the case of any taxpayer that is not a corporation or a partnership, and except as provided in paragraphs (b)(3)(ii)(B) and (C) of this section, the gross receipts test of section 448(c) and the accompanying regulations are applied in the same manner as if each trade or business of such taxpayer were a corporation or partnership.

(B) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or business are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W-2.

(C) *Partners and S corporation shareholders.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of partnership gross receipts in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder includes the pro rata share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

(D) *Example.* The operation of this paragraph (b)(3) is illustrated by the following examples:

(1) *Example 1.* Taxpayer A is an individual who operates two separate and distinct trades or business that are reported on Schedule C, *Profit or Loss from Business*, of A's Federal income tax return. For 2020, one trade or business has annual average gross receipts of \$5 million, and the other trade or business has average annual gross receipts of \$35 million. Under paragraph (b)(3)(ii)(B) of this section, for 2020, neither of A's trades or businesses meets the gross receipts test of paragraph (b)(3) of this section (\$5 million + \$35 million = \$40 million, which is greater

than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(2) *Example 2.* Taxpayer B is an individual who operates three separate and distinct trades or businesses that are reported on Schedule C of B's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of \$15 million, Business Y is a dance studio with average annual gross receipts of \$6 million, and Business Z is a car repair shop with average annual gross receipts of \$12 million. Under paragraph (b)(3)(ii)(B) of this section, B's gross receipts are the combined amount derived from all three of B's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (b)(3)(i) of this section (\$15 million + \$6 million + \$12 million = \$33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

\*\*\*\*\*

(d) *Applicability Dates.* Paragraphs (b)(1)(ii) and (b)(3) of this section apply, for taxable years beginning on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**]. For contracts entered into before January 1, 2018, see §1.460-3(b)(1)(ii) and (b)(3) as contained in 26 CFR part 1, revised April 1, 2019.

Par. 20. Section 1.460-4 is amended by revising the first sentence of paragraph (f)(1) and adding paragraph (i) to read as follows:

*§1.460-4 Methods of Accounting for long-term contracts.*

(f) \*\*\*

(1) \*\*\* Under section 56(a)(3), a taxpayer subject to the AMT must use the PCM to determine its AMTI from any long-term contract entered into on or after March 1, 1986, that is not a home construction contract, as defined in §1.460-3(b)(2). \*\*\*

\*\*\*\*\*

(i) *Applicability date.* Paragraph (f)(1) of this section applies for taxable years beginning on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**]. For taxable years beginning before January 1, 2018, see §1.460-4(f)(1) as contained in 26 CFR part 1, revised April 1, 2019.

\*\*\*\*\*

Par. 21. Section 1.460-5 is amended:

1. In paragraph (d)(1), by removing the language “(concerning contracts of homebuilders that do not satisfy the

\$10,000,000 gross receipts test described in §1.460-3(b)(3) or will not be completed within two years of the contract commencement date)”.

2. By revising paragraph (d)(3).

The revision reads as follows:

*§1.460-5 Cost allocation rules.*

\*\*\*\*\*

(d) \*\*\*

(3) *Large homebuilders.* A taxpayer must capitalize the costs of home construction contracts under section 263A, unless the taxpayer estimates, when entering into the contract, that it will be completed within two years of the contract commencement date, and the taxpayer satisfies the gross receipts test of section 448(c) described in §1.460-3(b)(3) for the taxable year in which the contract is entered into.

\*\*\*\*\*

Par. 22. Section 1.460-6 is amended:

1. In paragraph (b)(2) introductory text, by removing the language “section 460(e)(4)” and adding in its place the language “section 460(e)(3)”.

2. By revising the first and last sentences of paragraph (b)(2)(ii).

3. By designating the undesignated text after paragraph (b)(3)(ii) as paragraph (b)(3)(iii).

4. In newly designated paragraph (b)(3)(iii), by adding a sentence to the end of the paragraph.

5. In paragraph (c)(1)(i), by revising the fifth sentence.

6. In paragraph (c)(2)(i), by revising the third sentence.

7. In paragraph (c)(2)(iv), by revising the first sentence.

8. In paragraph (c)(3)(ii), by revising the first sentence.

9. In paragraph (c)(3)(vi), by revising the first sentence.

10. In paragraph (d)(2)(i), by removing the language “whether or not the taxpayer would have been subject to the alternative minimum tax” and adding in its place the language “for taxpayers subject to the alternative minimum tax without regard to whether tentative minimum tax exceeds regular tax for the redetermination year”.

11. By revising paragraph (d)(4)(i)(A).

12. By designating paragraph (h)(8)(ii) *Example 7* as paragraph (h)(8)(iii).

13. By revising newly designated paragraph (h)(8)(iii).

14. By adding paragraph (k).

The revisions and additions read as follows:

*§1.460-6 Look-back method.*

\*\*\*\*\*

(b) \*\*\*

(2) \*\*\*

(ii) is not a home construction contract but is estimated to be completed within a 2-year period by a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3), who meets the gross receipts test of section 448(c) and §1.460-3(b)(3) for the taxable year in which such contract is entered into. \*\*\* The look-back method, however, applies to the alternative minimum taxable income from a contract of this type, for those taxpayers subject to the AMT in taxable years prior to the filing taxable year in which the look-back method is required, unless the contract is exempt from required use of the percentage of completion method under section 56(a)(3).

(3) \*\*\*

(iii) \*\*\* For contracts entered into after December 31, 2017, in a taxable year ending after December 31, 2017, a taxpayer's gross receipts are determined in the manner required by regulations under section 448(c).

\*\*\*\*\*

(c) \*\*\*

(1) \*\*\*

(i) \*\*\* Based on this reapplication, the taxpayer determines the amount of taxable income (and, when applicable, alternative minimum taxable income and modified taxable income under section 59A(c)) that would have been reported for each year prior to the filing year that is affected by contracts completed or adjusted in the filing year if the actual, rather than estimated, total contract price and costs had been used in applying the percentage of completion method to these contracts, and to any other contracts completed or adjusted in a year preceding the filing year. \*\*\*

\*\*\*\*\*

(2) \*\*\*

(i) \*\*\* The taxpayer then must determine the amount of taxable income (and,

when applicable, alternative minimum taxable income and modified taxable income under section 59A(c)) that would have been reported for each affected tax year preceding the filing year if the percentage of completion method had been applied on the basis of actual contract price and contract costs in reporting income from all contracts completed or adjusted in the filing year and in any preceding year. \* \* \*

\* \* \* \* \*

(iv) \* \* \* In general, because income under the percentage of completion method is generally reported as costs are incurred, the taxable income and, when applicable, alternative minimum taxable income and modified taxable income under section 59A(c), are recomputed only for each year in which allocable contract costs were incurred. \* \* \*

\* \* \* \* \*

(3) \* \* \*

(ii) \* \* \* Under the method described in this paragraph (c)(3) (actual method), a taxpayer first must determine what its regular and, when applicable, its alternative minimum tax and base erosion minimum tax liability would have been for each redetermination year if the amounts of contract income allocated in Step One for all contracts completed or adjusted in the filing year and in any prior year were substituted for the amounts of contract income reported under the percentage of completion method on the taxpayer's original return (or as subsequently adjusted on examination, or by amended return). \* \* \*

\* \* \* \* \*

(vi) \* \* \* For purposes of Step Two, the income tax liability must be redetermined by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryovers. Thus, the taxes, if any, imposed under sections 55 and 59A (relating to alternative and base erosion minimum tax, respectively) must be taken into account. \* \* \*

\* \* \* \* \*

(d) \* \* \*

(4) \* \* \*

(i) \* \* \*

(A) *General rule.* The simplified marginal impact method is required to be used with respect to income reported from domestic contracts by a pass-through entity that is either a partnership,

an S corporation, or a trust, and that is not closely held. With respect to contracts described in the preceding sentence, the simplified marginal impact method is applied by the pass-through entity at the entity level. The pass-through entity determines the amount of any hypothetical underpayment or overpayment for a redetermination year using the highest rate of tax in effect for corporations under section 11. However, for redetermination years beginning before January 1, 2018, the pass-through entity uses the highest rates of tax in effect for corporations under section 11 and section 55(b)(1). Further, the pass-through entity uses the highest rates of tax imposed on individuals under section 1 and section 55(b)(1) if, at all times during the redetermination year involved (that is, the year in which the hypothetical increase or decrease in income arises), more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities.

\* \* \* \* \*

(h) \* \* \*

(8) \* \* \*

(iii) *Example 7.* X, a calendar year C corporation, is engaged in the construction of real property under contracts that are completed within a 24-month period. Its average annual gross receipts for the prior 3-taxable-year period does not exceed \$25,000,000. As permitted by section 460(e)(1)(B), X uses the completed contract method (CCM) for regular tax purposes. However, X is engaged in the construction of commercial real property and, for years beginning before January 1, 2018, is required to use the percentage of completion method (PCM) for alternative minimum tax (AMT) purposes. Assume that for 2017, 2018, and 2019, X has only one long-term contract, which is entered into in 2017 and completed in 2019 and that in 2017 X's average annual gross receipts for the prior 3-taxable-years do not exceed \$10,000,000. Assume further that X estimates gross income from the contract to be \$2,000, total contract costs to be \$1,000, and that the contract is 25 percent complete in 2017 and 70 percent complete in 2018, and 5 percent complete in 2019. In 2019, the year of completion, gross income from the contract is actually \$3,000, instead of \$2,000, and costs are actually \$1,000. Because X was required to use the PCM for 2017 for AMT purposes, X must apply the look-back method to its AMT reporting for that year. X has elected to use the simplified marginal impact method. For 2017, X's income using estimated contract price and costs is as follows:

Table 1 to paragraph (h)(8)(iii)

Estimates	2017
Gross Income	\$500 = (\$2,000 x 25%)
Deductions	\$(250) = (\$1,000 x 25%)
Contract Income-PCM	\$250

(A) When X files its federal income tax return for 2019, the contract completion year, X applies the look-back method. For 2017, X's income using actual contract price and costs is as follows:

Table 2 to paragraph (h)(8)(iii)(A)

Actual	2017
Gross Income	\$750 = (\$3,000 x 25%)
Deductions	\$(250) = (\$1,000 x 25%)
Contract Income-PCM	\$500

(B) Accordingly, the reallocation of contract income under the look-back method results in an increase of income for AMT purposes for 2017 of \$250 (\$500-\$250). Under the simplified marginal impact method, X applies the highest rate of tax under section 55(b)(1) to this increase, which produces a hypothetical underpayment for 2017 of \$50 (.20 x \$250). Interest is charged to X on this \$50 underpayment from the due date of X's 2017 return until the due date of X's 2019 return. X, a C corporation, is not subject to the AMT in 2018. X does not compute alternative minimum taxable income or use the PCM in that year. Accordingly, look-back does not apply to 2018.

\* \* \* \* \*

(k) *Applicability date.* Paragraphs (b) (2), (b)(2)(ii), (b)(3)(ii), (c)(1)(i), (c)(2) (i), (c)(2)(iv), (c)(3)(ii), (c)(3)(vi), (d) (2)(i), (d)(4)(i)(A), and (h)(8)(iii) of this section, apply for taxable years beginning on or after [date the Treasury decision adopting these proposed regulations as final is published in the **Federal Register**]. For taxable years beginning before January 1, 2018, see §§1.460-6(b)(2), 1.460-6(b)(2)(ii), 1.460-6(b)(3)(ii), 1.460-6(c) (1)(i), 1.460-6(c)(2)(i) and (iv), 1.460-6(c)(3)(ii) and (vi), 1.460-6(d)(2)(i), 1.460-6(d)(4)(i)(A), and 1.460-6(h)(8) (iii) as contained in 26 CFR part 1, revised April 1, 2019.

Par. 23. §1.471-1 is amended by:

1. Designating the undesignated paragraph as paragraph (a).

2. Adding a heading to newly designated paragraph (a) and revising the first sentence.

3. Adding paragraph (b).

The revision and addition read as follows:

*§1.471-1 Need for inventories.*

(a) *In general.* Except as provided in paragraph (b) of this section, in order to reflect taxable income correctly, inventories at the beginning and end of each taxable year are necessary in every case in which the production, purchase, or sale of merchandise is an income-producing factor. \* \* \*



(b) *Exemption for certain small business taxpayers*—(1) *In general.* Paragraph (a) of this section shall not apply to a taxpayer, other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting (cash method) under section 448(a)(3), in any taxable year if the taxpayer meets the gross receipts test provided in paragraph (b)(2) of this section, and uses as a method of accounting for its inventory a method that is described in paragraph (b)(3) of this section.

(2) *Gross receipts test*—(i) *In general.* A taxpayer, other than a tax shelter prohibited from using the cash method under section 448(a)(3), meets the gross receipts test of paragraph (b)(1) of this section if it meets the gross receipts test of section 448(c) and §1.448-2(c). The gross receipts test applies to determine whether a taxpayer is eligible to use the exemption provided in paragraph (b) of this section even if the taxpayer is not otherwise subject to section 448(a).

(ii) *Application of the gross receipts test*—(A) *In general.* In the case of any taxpayer that is not a corporation or partnership, and except as otherwise provided in paragraphs (b)(2)(ii)(B) and (C) of this section, the gross receipts test of section 448(c) and the accompanying regulations are applied in the same manner as each trade or business of the taxpayer were a corporation or partnership.

(B) *Gross receipts of individuals, etc.* Except when the aggregation rules of section 448(c)(2) apply, the gross receipts of a taxpayer other than a corporation or partnership are the amount derived from all trades or businesses of such taxpayer. Amounts not related to a trade or businesses are excluded from the gross receipts of the taxpayer. For example, an individual taxpayer's gross receipts do not include inherently personal amounts, such as: personal injury awards or settlements with respect to an injury of the individual taxpayer, disability benefits, Social Security benefits received by the taxpayer during the taxable year, and wages received as an employee that are reported on Form W-2.

(C) *Partners and S corporation shareholders*—(1) *In general.* Except when the aggregation rules of section 448(c)(2) apply, each partner in a partnership includes a share of the partnership's gross receipts

in proportion to such partner's distributive share (as determined under section 704) of items of gross income that were taken into account by the partnership under section 703. Similarly, a shareholder includes the *pro rata* share of S corporation gross receipts taken into account by the S corporation under section 1363(b).

(2) [Reserved]

(D) *Examples.* The operation of this paragraph (b)(2) is illustrated by the following examples:

(1) *Example 1.* Taxpayer A, a calendar year S corporation, is a reseller and maintains inventories. In 2017, 2018, and 2019, S's gross receipts were \$10 million, \$11 million, and \$13 million respectively. A is not prohibited from using the cash method under section 448(a)(3). For 2020, A meets the gross receipts test of paragraph (b)(2) of this section.

(2) *Example 2.* Taxpayer B operates two separate and distinct trades or businesses that are reported on Schedule C, *Profit or Loss from Business*, of B's Federal income tax return. For 2020, one trade or business has annual average gross receipts of \$5 million, and the other trade or business has average annual gross receipts of \$35 million. Under paragraph (b)(2)(ii)(B) of this section, for 2020, neither of B's trades or businesses meets the gross receipts test of paragraph (b)(2) of this section (\$5 million + \$35 million = \$40 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(3) *Example 3.* Taxpayer C is an individual who operates three separate and distinct trades or businesses that are reported on Schedule C of C's Federal income tax return. For 2020, Business X is a retail store with average annual gross receipts of \$15 million, Business Y is a dance studio with average annual gross receipts of \$6 million, and Business Z is a car repair shop with average annual gross receipts of \$12 million. Under paragraph (b)(2)(ii)(B) of this section, C's gross receipts are the combined amount derived from all three of C's trades or businesses. Therefore, for 2020, X, Y and Z do not meet the gross receipts test of paragraph (b)(2)(i) of this section (\$15 million + \$6 million + \$12 million = \$33 million, which is greater than the inflation-adjusted gross receipts test amount for 2020, which is \$26 million).

(3) *Methods of accounting under the small business taxpayer exemption.* A taxpayer eligible to use, and that chooses to use, the exemption described in paragraph (b) of this section may account for its inventory by either:

(i) Accounting for its inventory items as non-incidental materials and supplies, as described in paragraph (b)(4) of this section; or

(ii) Using the method for each item that is reflected in the taxpayer's applicable financial statement (AFS) (AFS section 471(c) inventory method); or, if the tax-

payer does not have an AFS for the taxable year, the books and records of the taxpayer prepared in accordance with the taxpayer's accounting procedures, as defined in paragraph (b)(6)(ii) of this section (non-AFS section 471(c) inventory method).

(4) *Inventory treated as non-incidental materials and supplies*—(i) *In general.* Inventory treated as non-incidental materials and supplies (section 471(c) materials and supplies) is recovered through costs of goods sold only in the taxable year in which such inventory is actually used or consumed in the taxpayer's business, or in the taxable year in which the taxpayer pays for or incurs the costs of the items, whichever is later. Section 471 materials and supplies are used or consumed in the taxable year in which the taxpayer provides the items to its customer. Inventory treated as non-incidental materials and supplies under this paragraph (b)(4) is not eligible for the de minimis safe harbor election under §1.263(a)-1(f)(2).

(ii) *Identification and valuation of section 471(c) materials and supplies.* A taxpayer may determine the amount of the section 471(c) materials and supplies that are recoverable through costs of goods sold by using either a specific identification method, a first-in, first-out (FIFO) method, or an average cost method, provided that method is used consistently. See §1.471-2(d). A taxpayer that uses the section 471 materials and supplies method may not use any other method described in the regulations under section 471, or the last-in, first-out (LIFO) method described in section 472 and the accompanying regulations, to either identify section 471(c) materials and supplies, or to value those section 471(c) materials and supplies. The inventory costs includible in the section 471(c) materials and supplies method are the direct costs of the property produced or property acquired for resale. However, an inventory cost does not include a cost for which a deduction would be disallowed, or that is not otherwise recoverable but for paragraph (b)(4) of this section, in whole or in part, under a provision of the Internal Revenue Code.

(iii) *Allocation methods.* The section 471 materials and supplies method may allocate the costs of such inventory items

by using specific identification or using any reasonable method.

(iv) *Example.* Taxpayer D is a baker that reports its baking trade or business on Schedule C, *Profit or Loss From Business*, of the Form 1040, *Individual Tax Return*, and D's baking business has average annual gross receipts for the 3-taxable years prior to 2019 of less than \$100,000. D meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) in 2019. Therefore, D qualifies as a small business taxpayer under paragraph (b)(2) of this section. D uses the overall cash method, and the section 471(c) non-incidental materials and supplies method. D purchases \$50 of peanut butter in November 2019. In December 2019, D uses all of the peanut butter to bake cookies available for immediate sale. D sells the peanut butter cookies to customers in January 2020. The peanut butter cookies are used or consumed under paragraph (b)(4)(i) of this section in January 2020 when the cookies are sold to customers, and D may recover the cost of the peanut butter in 2020.

(5) *AFS section 471(c) method—(i) In general.* A taxpayer that meets the gross receipts test described in paragraph (b) (2) of this section and that has an AFS for such taxable year may use the AFS section 471(c) method described in this paragraph to account for its inventory costs for the taxable year. For purposes of the AFS section 471(c) method, an inventory cost is a cost that a taxpayer capitalizes to property produced or property acquired for resale in its AFS. However, an inventory cost does not include a cost that is neither deductible nor otherwise recoverable but for paragraph (b)(5) of this section, in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g), or 274). In lieu of the inventory method described in section 471(a), a taxpayer using the AFS section 471(c) method recovers its inventory costs in accordance with the inventory method used in its AFS.

(ii) *Definition of AFS.* The term AFS is defined in section 451(b)(3) and the accompanying regulations. See §1.451-3(c)(1). The rules relating to additional AFS issues provided in §1.451-3(h) apply to the AFS section 471(c) method. A taxpayer has an AFS for the taxable year if all of

the taxpayer's taxable year is covered by an AFS.

(iii) *Timing of inventory costs.* Notwithstanding the timing rules used in the taxpayer's AFS, the amount of any inventoriable cost may not be capitalized or otherwise taken into account for Federal income tax purposes any earlier than the taxable year during which the amount is paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1). For example, in the case of an accrual method taxpayer, inventoriable costs must satisfy the all events test, including economic performance, of section 461. See §1.446-1(c)(1)(ii) and section 461 and the accompanying regulations.

(iv) *Example.* H is a calendar year C corporation that is engaged in the trade or business of selling office supplies and providing copier repair services. H meets the gross receipts test of section 448(c) and is not prohibited from using the cash method under section 448(a)(3) for 2019 or 2020. For Federal income tax purposes, H chooses to account for purchases and sales of inventory using an accrual method of accounting and for all other items using the cash method. For AFS purposes, H uses an overall accrual method of accounting. H uses the AFS section 471(c) method of accounting. In H's 2019 AFS, H incurred \$2 million in purchases of office supplies held for resale and recovered the \$2 million as cost of goods sold. On January 5, 2020, H makes payment on \$1.5 million of these office supplies. For purposes of the AFS section 471(c) method of accounting, H can recover the \$2 million of office supplies in 2019 because the amount has been included in cost of goods sold in its AFS inventory method and section 461 has been satisfied.

(6) *Non-AFS section 471(c) method—(i) In general.* A taxpayer that meets the gross receipts test described in paragraph (b)(2) of this section for a taxable year and that does not have an AFS, as defined in paragraph (b)(5)(ii) of this section, for such taxable year may use the non-AFS section 471(c) method to account for its inventories for the taxable year in accordance with this paragraph (b)(6). The non-AFS section 471(c) method is the method of accounting used for inventory in the taxpayer's books and records that

properly reflect its business activities for non-tax purposes and are prepared in accordance with the taxpayer's accounting procedures. For purposes of the non-AFS section 471(c) method, an inventory cost is a cost that the taxpayer capitalizes to property produced or property acquired for resale in its books and records, except as provided in paragraph (b)(6)(ii) of this section. In lieu of the inventory method described in section 471(a), a taxpayer using the non-AFS section 471(c) method recovers its costs through its book inventory method of accounting. A taxpayer that has an AFS for such taxable year may not use the non-AFS section 471(c) method.

(ii) *Timing and amounts of costs.* Notwithstanding the timing of costs reflected in the taxpayer's books and records, a taxpayer may not deduct or recover any costs that have not been paid or incurred under the taxpayer's overall method of accounting, as described in §1.446-1(c)(1), or that are neither deductible nor otherwise recoverable but for the application of this paragraph (b)(6), in whole or in part, under a provision of the Internal Revenue Code (for example, section 162(c), (e), (f), (g) or 274). For example, in the case of an accrual method taxpayer or a taxpayer using an accrual method for purchases and sales, inventory costs must satisfy the all events test, including economic performance, under section 461(h). See §1.446-1(c)(1)(ii), and section 461 and the accompanying regulations.

(iii) *Examples.* The following examples illustrate the rules of paragraph (b)(6) of this section.

(A) *Example 1.* Taxpayer E is a C corporation that is engaged in the retail trade or business of selling beer, wine, and liquor. In 2019, E has average annual gross receipts for the prior 3-taxable-years of less than \$15 million, and is not otherwise prohibited from using the cash method under section 448(a)(3). E does not have an AFS for the 2019 taxable year. E is eligible to use the non-AFS section 471(c) method of accounting. E uses the overall cash method, and the non-AFS section 471(c) method of accounting for Federal income tax purposes. In E's electronic bookkeeping software, E treats all costs paid during the taxable year as presently deductible. As part of its regular business practice, E's employees take a physical count of inventory on E's selling floor and its warehouse on December 31, 2019, and E also makes representations to its creditor of the amount of inventory on hand for specific categories of product it sells. E may not expense all of its costs paid during the 2019 taxable year because its books and records do not accurately reflect the inventory records used for non-tax purposes in its regular business activity.

E must use the physical inventory count taken at the end of 2019 to determine its ending inventory. E may include in cost of goods sold for 2019 those inventory costs that are not properly allocated to ending inventory.

(B) *Example 2.* F is a C corporation that is engaged in the manufacture of baseball bats. In 2019, F has average annual gross receipts for the prior 3-taxable-years of less than \$25 million, and is not otherwise prohibited from using the cash method under section 448(a)(3). F does not have an AFS for the 2019 taxable year. For Federal income tax purposes, F uses the overall cash method of accounting, and the non-AFS section 471(c) method of accounting. For its books and records, F uses an overall accrual method and maintains inventories. In December 2019, F's financial statements show \$500,000 of direct and indirect material costs. F pays its supplier in January 2020. Under paragraph (b)(6)(ii) of this section, F recovers its direct and indirect material costs in 2020.

(7) *Effect of section 471(c) on other provisions.* Nothing in section 471(c) shall have any effect on the application of any other provision of law that would otherwise apply, and no inference shall be drawn from section 471(c) with respect to the application of any such provision. For example, a taxpayer that includes inventory costs in its AFS is required to

satisfy section 461 before such cost can be included in cost of goods sold for the taxable year. Similarly, nothing in section 471(c) affects the requirement under section 446(e) that a taxpayer secure the consent of the Commissioner before changing its method of accounting. If an item of income or expense is not treated consistently from year to year, that treatment may not clearly reflect income, notwithstanding the application of this section.

(8) *Method of accounting.* A change in the method of treating inventory under this paragraph (b) is a change in method of accounting under section 446 and the accompanying regulations. A taxpayer may change its method of accounting only with the consent of the Commissioner as required under section 446(e) and §1.446-1. For example, if a taxpayer is using the AFS section 471(c) method or non-AFS section 471(c) method, and that taxpayer changes the method of accounting for inventory in its AFS, or its books and records, respectively, is required to secure the consent of the Commissioner before using this new

method for Federal income tax purposes. However, a change from having an AFS to not having an AFS, or vice versa, without a change in the underlying method for inventory for financial reporting purposes is not a change in method of accounting under section 446(e). For rules relating to the clear reflection of income and the pattern of consistent treatment of an item, see section 446 and §1.446-1.

(c) *Applicability dates.* This section applies for taxable years beginning on or after [date the Treasury Decision adopting these proposed regulations as final is published in the **Federal Register**]. For taxable years beginning before January 1, 2018, see §1.471-1 as contained in 26 CFR part 1, revised April 1, 2019.

Sunita Lough  
*Deputy Commissioner of Services and Enforcement.*

(Filed by the Office of the Federal Register on July 30, 2020, 4:15 p.m., and published in the issue of the Federal Register for August 5, 2020, 85 F.R. 47508)



# Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the

new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

## Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.  
E.O.—Executive Order.  
ER—Employer.

ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contributions Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
FR—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign corporation.  
G.C.M.—Chief Counsel's Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.  
PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.  
PRS—Partnership.

PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statement of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2019–27 through 2019–52 is in Internal Revenue Bulletin 2019–52, dated December 27, 2019.

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<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2019–27 through 2019–52 is in Internal Revenue Bulletin 2019–52, dated December 27, 2019.



# **Internal Revenue Service**

## **Washington, DC 20224**

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## **INTERNAL REVENUE BULLETIN**

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at [www.irs.gov/irb/](http://www.irs.gov/irb/).

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## **We Welcome Comments About the Internal Revenue Bulletin**

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page ([www.irs.gov](http://www.irs.gov)) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.