

Leg. Finance - Finance Comte Files (1971-72) 8879

HB 512 cont.

Reg. § 1.43-3(b)(4) Example (4) continued

crease in tax, for purposes of computing qualified investment the cost of property 2 is not reduced by any part of the adjusted basis of the property traded in.

(c) Dollar limitation--(1) In general. Section 48(c)(2) provides that the aggregate cost of used section 38 property which may be taken into account for any taxable year in computing qualified investment under section 46(c)(1)(B) shall not exceed \$50,000. If the total cost of used section 38 property exceeds \$50,000, there must be selected, in the manner provided in subparagraph (4) of this paragraph, the particular items of used section 38 property the cost of which is to be taken into account in computing qualified investment. The cost of used section 38 property that may be taken into account by a person in applying the \$50,000 limitation for any taxable year includes not only the cost of used section 38 property placed in service by such person during such taxable year, but also the cost of used section 38 property apportioned to such person. For purposes of this section, the cost of used section 38 property apportioned to any person means the cost of such property apportioned to him by a trust, estate, or electing small business corporation (as defined in section 1371(b)), and his share of the cost of partnership used section 38 property, with respect to the taxable year of such trust, estate, corporation or partnership ending with or within such person's taxable year. Thus, if an individual places in service during his taxable year used section 38 property with a cost of \$25,000, if the cost of used section 38 property apportioned to him by an electing small business corporation such year is \$30,000, and if his share for such year of the cost of used section 38 property placed in service by a partnership is \$20,000, he may select from the used section 38 property with a total cost of \$75,000 the particular used section 38 property the cost of which he wishes to take into account. No part of the excess of \$25,000 (\$75,000 cost minus \$50,000 annual limitation) may be taken into account in any other taxable year. For determining the amount of the cost to be apportioned by an electing small business corporation, see paragraph (a)(2) of § 1.43-5; in the case of estates and trusts, see paragraph (a)(2) of § 1.43-6. See paragraph (e) of this section for application of \$50,000 limitation in the case of affiliated groups.

(2) Married individuals filing separate returns. In the case of a husband or wife who files a separate return, the aggregate cost of used section 38 property which may be taken into account for the taxable year to which such return relates cannot exceed \$25,000. The preceding sentence shall not apply, however, unless the taxpayer's spouse places in service (or is apportioned the cost of) used section 38 property for the taxable year of such spouse which ends with or within the taxpayer's taxable year. Thus, if a husband and wife who file separate returns on a calendar year basis both place in service used section 38 property during the taxable year, the maximum cost of used section 38 property which may be taken into account by each is \$25,000. However, in such case, if only one spouse places in service (or is apportioned the cost of) used section 38 property during the taxable year, such spouse may take into account a maximum of \$50,000 for such year. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(3) Partnerships. In the case of a partnership, the aggregate cost of used section 38 property placed in service by the partnership (or apportioned to the partnership) which may be taken into account by the partners with respect to any taxable year of the partnership may not exceed \$50,000. If such aggregate cost exceeds \$50,000, the partnership must make a selection in the manner provided in subparagraph (4) of this paragraph. The \$50,000 limitation applies to each partner, as well as the partnership.

Reg. § 1.48-3(c) continued.

(4) Selection of \$50,000 cost. (1) If the sum of (a) the cost of used section 38 property placed in service during the taxable year by any person, (b) such person's share of the cost of partnership used section 38 property placed in service during the taxable year of a partnership ending with or within such person's taxable year, and (c) the cost of used section 38 property apportioned to such person for such taxable year by an electing small business corporation, estate, or trust, exceeds \$50,000, such person must make a selection for such taxable year in the manner provided in subdivision (ii) of this subparagraph.

(ii) For purposes of computing qualified investment (or, in the case of a partnership, electing small business corporation, estate, or trust, for purposes of selecting used section 38 property the cost of which may be taken into account by the partners, shareholders, or estate or trust and its beneficiaries) any person to whom subdivision (1) of this subparagraph applies must select a total cost of \$50,000 from (a) the cost of specific used section 38 property placed in service by such person, (b) such person's share of the cost of specific used section 38 property placed in service by a partnership, and (c) the cost of used section 38 property apportioned to such person by an electing small business corporation, estate or trust. When a particular property is selected, the entire cost (or entire share of cost of a particular property in the case of partnership property) of such property must be taken into account unless, as a result of the selection of such particular property, the \$50,000 limitation is exceeded. Likewise, in the case of an apportionment from an electing small business corporation, estate, or trust, when the cost in a particular useful life category is selected, the entire cost in such category must be taken into account unless, as a result of the selection of such cost, the \$50,000 limitation is exceeded. Thus, if a person places in service during the taxable year three items of used section 38 property, each with a cost of \$20,000, he must select the entire cost of two of the items and only \$10,000 of the cost of the third item; he may not select a portion of the cost of each of the three items. The selection by any person shall be made by taking the cost of used section 38 property into account in computing qualified investment (or in selecting the used section 38 property the cost of which may be taken into account by the partners, etc.), and if such property was placed in service by such person, he must maintain records which permit specific identification of any item of used section 38 property selected.

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

Example (1). H, who operates a sole proprietorship, purchases and places in service in 1963 used section 38 property with a cost of \$60,000. His spouse, W, is a shareholder in an electing small business corporation which purchases and places in service during its fiscal year ending June 30, 1963, used section 38 property with a cost of \$50,000. Both spouses file separate returns on a calendar year basis. W, as a 60 percent shareholder on the last day of the taxable year of the corporation, is apportioned \$30,000 (60 percent of \$50,000) of the cost of the used section 38 property placed in service by the corporation. The cost of used section 38 property that may be taken into account by H on his separate return is \$25,000. The cost of used section 38 property that may be taken into account by W on her separate return is \$25,000. On the other hand, if the corporation had made no investment in used section 38 property, H could take \$50,000 of the \$60,000 cost into account.

Example (2). X, Y, and Z share the profits and losses of partnership XYZ in the ratio of 50 percent, 30 percent, and 20 percent, respectively. The partnership and each partner make returns on the basis of the calendar year. Each partner also operates a sole proprietorship. In 1963, the partnership and the partners purchase and place in service the following used section 38 property:

Reg. § 1.48-3(c)(5) Example (2) continued

Property	Estimated useful life	Cost
Partnership XYZ		
Property No. 1	9 years	\$10,000
Property No. 2	7 years	50,000
Property No. 3	7 years	50,000
Property No. 4	5 years	20,000
Partner X		
Property No. 5	6 years	30,000
Property		
Partner Y		
Property No. 6	10 years	60,000
Partner Z		
Property No. 7	4 years	35,000

(i) Selection by partnership. In accordance with subparagraph (4)(i) of this paragraph, the partnership selects property no. 1 and \$40,000 of the cost of property no. 2 to be taken into account. Therefore each partner's share of cost of the property selected by the partnership is as follows:

Property	Estimated useful life	Selected cost	Partner's share of cost		
			X (50%)	Y (30%)	Z (20%)
No. 1	9 years	\$10,000	\$ 5,000	\$ 3,000	\$ 2,000
No. 2	7 years	40,000	20,000	12,000	8,000
Total		\$50,000	\$25,000	\$15,000	\$10,000

(ii) Selection by partners. In accordance with subparagraph (4)(ii) of this paragraph, the partners make the following selections: Partner X selects property no. 5 (\$30,000), his share of the cost of property no. 1 (\$5,000), and \$15,000 of his share of the cost of property no. 2. Partner Y selects \$50,000 of the cost of property no. 6, and no part of his share of the cost of partnership property. Partner Z, having an aggregate cost of used section 38 property of only \$46,000 (partnership property of \$10,000 and individually owned property of \$36,000), takes into account the entire \$46,000.

(iii) Qualified investment of partner X. X's total qualified investment in used section 38 property for 1963 is \$35,000, computed as follows:

Property	Estimated useful life	Selected cost	Applicable percentage	Qualified investment
No. 1	9 years	\$ 5,000	70%	\$ 5,000
No. 2	7 years	15,000	66%	10,000
No. 5	6 years	30,000	68%	20,000
Total		\$50,000		\$35,000

(iv) Qualified investment of partner Y. Y's total qualified investment in used section 38 property for 1963 is \$50,000 (100 percent of \$50,000) since he selected \$50,000 of the cost of property no. 6 which has a useful life of 8 years or more.

Reg. § 1.48-3(c)(5) Example (2) continued

(v) Qualified investment of partner Z. Z's total qualified investment in used section 38 property for 1963 is \$19,333, computed as follows:

Property	Estimated useful life	Selected cost	Applicable percentage	Qualified investment
No. 1	9 years	\$ 2,000	100	\$ 2,000
No. 2	7 years	8,000	66 $\frac{2}{3}$	5,333
No. 7	4 years	36,000	33 $\frac{1}{3}$	12,000
Total		<u>\$46,000</u>		<u>\$19,333</u>

(d) ¹The next paragraph is (e).

(e) Dollar limitation for members of an affiliated group—(1) *In general.* (i) Section 48(c)(2)(C) provides that the \$50,000 limitation on the cost of used section 38 property which may be taken into account for any taxable year shall, in the case of an affiliated group (as defined in subparagraph (6) of this paragraph), be reduced for each member of the group by apportioning the \$50,000 amount among those corporations which are the members of such group in accordance with their respective amounts of used section 38 property which may be taken into account, that is, in accordance with the total cost of used section 38 property placed in service by each member during its taxable year (without regard to the \$50,000 limitation or the applicable percentages to be applied in computing qualified investment).

(ii) Except as otherwise provided in this paragraph, the \$50,000 amount shall be apportioned among those corporations which are members of the affiliated group on the last day of the taxable year of the common parent. For the taxable year of each such member ending with, or within which falls, the last day of the taxable year of the common parent, the cost of used section 38 property taken into account in computing qualified investment under section 46(c)(1)(B) shall not exceed an amount which bears the same ratio to \$50,000 as (a) the cost of used section 38 property placed in service by such member for such taxable year, bears to (b) the total cost of used section 38 property placed in service by all members of the affiliated group for their taxable years ending with, or within which falls, such last day of the taxable year of the common parent.

(iii) There shall be attached to the common parent's income tax return a statement containing the name, address, and taxpayer account number of each member of the affiliated group as of the last day of the common parent's taxable year and a schedule showing the computation of the apportionment of the \$50,000 amount among members of the affiliated group. Each such member of the group shall retain as a part of its records a copy of the statement containing the apportionment schedule which is attached to the common parent's return. If the due date (including extensions of time) of the common parent's return is before July 15, 1964, the required statement may be filed on or before such date with the district director with whom the return was filed.

(iv) If a member of the affiliated group (including the common parent) makes its income tax return on the basis of a 52-53-week taxable year, the principles of section 441(f)(2)(A)(i) and paragraph (b)(1) of § 1.441-2 apply in determining the last day of such a taxable year.

(2) Estimate of used section 38 property to be placed in service. (i) For purposes of subparagraph (1) of this paragraph, if the taxable year of a member of the affiliated group (within which falls the last day of the common parent's

[Footnote § 5971] Matter in *italics* added by TD 6331, which struck out:
(1) "[Reserved]"

Reg. § 1.43-3(o)(2)(1) continued

taxable year) ends later than the 30th day preceding the date on which the common parent's income tax return for such year is due (including extensions of time), such member shall use (if the total cost of used section 38 property actually placed in service during its taxable year is not known), as the cost of used section 38 property placed in service by it during its taxable year, an estimate of the cost of such property to be placed in service by it during such year. Such estimate shall be made on the basis of the facts and circumstances known as of the time of the estimate. Any such estimate shall also be used in determining the total cost of used section 38 property placed in service by all members of the affiliated group for their taxable years ending with, or within which falls, the last day of such taxable year of the common parent.

(ii) If an estimate is used by any member of an affiliated group pursuant to subdivision (i) of this subparagraph, each member may later file an original or amended return in which the apportionment of the \$50,000 amount is based upon the cost of used section 38 property actually placed in service by all members of the affiliated group during their taxable years which end with, or within which falls, the last day of the common parent's taxable year. Such amended apportionment shall be made only if the common parent, and each member of the group whose limitation would be changed, file original or amended returns which reflect the amended apportionment based upon the cost of the used section 38 property actually placed in service by the group. In such case, a new statement (reflecting the amended apportionment) shall be attached to the original or amended return of the common parent and a copy of such statement shall be retained by each such member pursuant to the requirements in subparagraph (1) (iii) of this paragraph.

(3) Short taxable year. If (i) the return of a corporation is for a short period, (ii) such corporation is a member of an affiliated group as of the last day of such period, and (iii) the last day of the taxable year of the common parent of the group does not end with or within such short period, then such corporation's taxable year shall, for purposes of this paragraph, be considered as ending with the last day of the common parent's taxable year within which falls such short period. Such corporation will thus be considered to be a member of the affiliated group as of the last day of the common parent's taxable year and may be apportioned part of the \$50,000 amount under subparagraph (1) (ii) of this paragraph. However, if such corporation's income tax return is due (including extensions of time) before the income tax return of the common parent is filed, then such corporation shall be considered to have placed no used section 38 property in service and no part of the \$50,000 amount shall be apportioned to such corporation unless such corporation files (on or after the date the common parent files its return) an amended return reflecting the cost of used section 38 property placed in service by it during its short period and such cost is taken into account by the common parent in apportioning the \$50,000 amount.

(4) Two or more common parents. If a corporation during its taxable year is a member of two or more affiliated groups as of the last day of the taxable year of the common parent of each such group, such corporation shall be considered to be a member of only the affiliated group whose common parent's taxable year ends earliest in such corporation's taxable year.

(5) Nonresident foreign corporation. (i) A foreign corporation not engaged in trade or business within the United States (hereinafter referred to in this subparagraph as a "nonresident foreign corporation") which is not a common parent need not retain as a part of its records a copy of the statement required by subparagraph (1) (iii) of this paragraph.

Reg. § 1.46-3(e)(5) continued

(ii) A nonresident foreign corporation which is a common parent of an affiliated group shall be considered to have a taxable year ending December 31.

(iii) If a nonresident foreign corporation is a common parent of an affiliated group, the statement required by subparagraph (1) (iii) (or (2) (ii)) of this paragraph shall be filed with the Director, International Operations Division, Internal Revenue Service, Washington, D.C. 20225. The statement required by subparagraph (1) (iii) shall be due on or before the 75th day after the end of its taxable year (as determined under subdivision (ii) of this subparagraph), or on or before July 15, 1964, whichever is later. For purposes of subparagraph (2) of this paragraph, this statement shall be considered the return of such corporation.

(6) Definition of affiliated group. For purposes of this section, an affiliated group means one defined in section 1504(a), except that (i) the phrase "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in section 1504(a), and (ii) all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)). Thus, a foreign corporation or a corporation exempt from taxation under section 501 may be a member of an affiliated group for purposes of this section even though under section 1504(b) neither corporation would be an includible corporation.

(7) Affiliated group filing a consolidated return. For the purpose of apportioning the \$50,000 amount in the case of members of an affiliated group which join in filing a consolidated return, all such members shall be treated as though they were a single member. Thus, in determining the limitation on the cost of used section 38 property which may be taken into account by the group filing the consolidated return, the apportionment provided in subparagraph (1) (ii) of this paragraph shall be made by using the aggregate cost of such property placed in service by all members of the group filing the consolidated return. If all members of the affiliated group join in filing a consolidated return, the group may select the items to be taken into account to the extent of an aggregate cost of \$50,000; if some members of the affiliated group do not join in filing the consolidated return, then the members of the group which join in filing the consolidated return may select the items to be taken into account to the extent of the amount apportioned to such members under subparagraph (1) (ii) of this paragraph.

(8) Examples. This paragraph may be illustrated by the following examples:

Example (1). (i) P, a domestic corporation, files an income tax return for its taxable year ending June 30, 1963, during which year it places in service used section 38 property with a cost of \$100,000. On June 30, 1963, P owns 51 percent of the outstanding stock of S, also a domestic corporation. S files a separate income tax return on the basis of a fiscal year ending July 31, 1963, during which year it places in service used section 38 property with a cost of \$150,000. The membership of the affiliated group is ascertained as of the close of June 30, 1963, the last day of the taxable year of the common parent, P. On that day the affiliated group consists of P and S.

(ii) The cost of used section 38 property taken into account by P for its taxable year ending June 30, 1963, may not exceed \$20,000, that is, an amount which bears the same ratio to \$50,000 as the cost of used section 38 property placed in service by P for its taxable year (\$100,000) bears to the total cost of used section 38 property placed in service by all members of the affiliated group (P and S) for their taxable years containing June 30, 1963 (\$250,000). Similarly, the cost of used section 38 property taken into account by S for its taxable year ending July 31, 1963, may not exceed \$30,000.

Reg. § 1.48-3(e) (8) continued

Example (2). (i) P, a domestic corporation, files an income tax return for its taxable year ending December 31, 1962, during which year it places in service used section 38 property costing \$100,000. On December 31, 1962, P owns all the outstanding stock of S, a domestic corporation which files a separate income tax return for the fiscal year ending September 30, 1963. P receives no extension of time for filing its return due March 15, 1963. Since the taxable year of S within which falls December 31, 1962 (the last day of P's taxable year) ends later than February 14, 1963 (the 30th day preceding the date on which P's return is due), S estimates the cost of used section 38 property which will be placed in service during its year. On the basis of the facts and circumstances known as of the time of the estimate, S estimates that it will place in service during such year used section 38 property costing \$150,000.

(ii) The cost of used section 38 property taken into account by P and S for their respective taxable years may not exceed

$$\$20,000 \left(\frac{\$100,000}{\$250,000} \times \$50,000 \right)$$

and

$$\$30,000 \left(\frac{\$150,000}{\$250,000} \times \$50,000 \right),$$
 respectively. If S actually places in service during

its taxable year used section 38 property costing more or less than \$150,000, its income tax return for the year ending September 30, 1963, may reflect an amended apportionment of the \$50,000 limitation based upon the cost of used section 38 property actually placed in service by the group, provided that P files an amended return to reflect the amended apportionment. For example, if S places in service used section 38 property costing \$200,000, the cost of used section 38 property taken into account by P and S for their respective taxable years could not exceed

$$\$16,667 \left(\frac{\$100,000}{\$300,000} \times \$50,000 \right)$$

and

$$\$35,333 \left(\frac{\$200,000}{\$300,000} \times \$50,000 \right),$$
 respectively, under an amended apportionment.

~~O-8~~ [§ 5972] Regulation.—The Regulation below does not reflect the changes made by P.L. 89-800, 11-8-66, P.L. 90-26, 6-13-67, and the '69 Tax Reform Act in Sec. 48 explained at ¶ 5929 and 5998.

Reg. § 1.48-4 (TD 6731, filed 5-7-64; amended by TD 6838, filed 7-19-65; TD 6953, filed 4-22-68.) Election of lessor of new section 38 property to treat lessee as purchaser.

(a) In general. Under section 48(d), a lessor of property may elect to treat the lessee of such property as having purchased such property for purposes of the credit allowed by section 38 if the following conditions are satisfied:

(1) The property must be "section 38 property" in the hands of the lessor; that is, it must be property with respect to which depreciation (or amortization

Reg. § 1.43-4(a)(1) continued.

in lieu of depreciation) is allowable to the lessor, it must have a useful life of 4 years or more in his hands, and in every other respect it must meet the requirements of § 1.43-1. Thus, for example, property leased by a municipality to a taxpayer for use in what is commonly known as an "industrial park" is not eligible for the election since, under paragraph (k) of § 1.43-1, property used by a governmental unit is not section 38 property. In addition, property used by the lessee predominantly outside the United States is not eligible for the election since, under paragraph (g) of § 1.43-1, such property is not section 38 property. For purposes of this subparagraph, if the lessor is an estate or trust, depreciation (or amortization in lieu of depreciation) will be considered allowable to the estate or trust even if it is apportioned to the beneficiaries or other persons.

(2) The property must be "new section 38 property" (within the meaning of § 1.43-2) in the hands of the lessor; that is, either (i) construction, reconstruction, or erection of the property must be completed by the lessor after December 31, 1961, or (ii) the property must be acquired by the lessor after December 31, 1961, and the original use of such property must commence with the lessor and after such date. See paragraph (b) of this section for the application of the rules relating to "original use" in the case of leased property.

(3) The property would constitute "new section 38 property" to the lessee if such lessee had actually purchased the property. Thus, the election is not available if the lessee is not the original user of the property. See paragraph (b) of this section for the application of the rules relating to "original use" in the case of leased property. See paragraph (d) of this section for the determination of the estimated useful life of leased property in the hands of the lessee.

(4) A statement of election to treat the lessee as a purchaser has been filed in the manner and within the time provided in paragraph (f) or (g) of this section.

(5) The lessor is not a person referred to in section 46(d), that is, a mutual savings bank, cooperative bank, or domestic building and loan association to which section 593 applies; a regulated investment company or real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code; or a cooperative organization described in section 1361(a).

(6) In the case of property possession of which is transferred by a lessor to a lessee before February 26, 1962, the lessor and lessee do not join in filing a consolidated income tax return for a period which includes the date on which possession of such property is transferred to the lessee.

The election may be made on a property-by-property basis or a general election may be made with respect to each taxable year of a particular lessee. If the conditions of this paragraph have been met, the lessee shall be treated as though he were the actual owner of the property for purposes of the credit allowed by section 38. Thus, the lessee shall be entitled to the credit allowed by section 38 with respect to such property for the taxable year in which he places such property in service, and the lessor shall not be entitled to a credit allowed by section 38 with respect to such property. Moreover, if the leased property is disposed of by the lessee, or if it otherwise ceases to be section 38 property in his hands, the property will be subject to the provisions of section 47 (relating to early dispositions, etc.)

(b) Original use. For purposes of this section only, the lessor and the lessee may both be considered as the original users of an item of leased property. The determination of whether the lessor qualifies as the original user of leased property shall be made under paragraph (b)(7) of § 1.43-2. The determination of whether the lessee qualifies as the original user of leased property shall be made, under paragraph (b)(7) of § 1.43-2, as if the lessee actually purchased the property. Thus, the lessee would not be considered the original user of the property if it has been previously used by the lessor or another person, or if it is reconstructed, re-

Reg. § 1.48-1(b) continued

built, or reconditioned property. However, the lessee would be considered the original user if he is the first person to use the property for its intended function. Thus, the fact that the lessor may have, for example, tested, stored, or attempted to lease the property to other persons will not preclude the lessee from being considered the original user.

(c) **Basis of leased property--(1) General rule.** If a valid election is made under this section, the amount of qualified investment under section 46(c) with respect to the leased property shall be determined by reference to the basis of such property in the hands of the lessee as determined under subparagraph (2) or (3) of this paragraph, whichever is applicable.

(2) **Property transferred before February 26, 1964.** (i) In the case of leased property possession of which is transferred to the lessee before February 26, 1964, unless subdivision (ii) of this subparagraph applies, the basis of the property in the hands of the lessee shall be the basis of the property in the hands of the lessor.

(ii) If the property was constructed by the lessor (or by a corporation which controls or is controlled by the lessor within the meaning of section 368(c)), the basis of the property in the hands of the lessee shall be an amount equal to the fair market value of such property on the date possession is transferred to the lessee. The term "constructed" shall be given its commonly accepted meaning, that is, to build, manufacture, or erect something which did not theretofore exist. Thus, reconstruction, rebuilding, or reconditioning does not constitute "construction". However, it is not necessary that the materials used in construction be new in use.

(3) **Property transferred after February 25, 1964.** (i) In the case of leased property possession of which is transferred to the lessee after February 25, 1964, unless subdivision (ii) of this subparagraph applies, the basis of the property in the hands of the lessee shall be an amount equal to the fair market value of such property on the date possession is transferred to the lessee.

(ii) If the property is leased by a corporation which is a member of an affiliated group (within the meaning of paragraph (f) (5) of § 1.48-1) to another corporation which is a member of the same affiliated group on the date possession of the property is transferred to the lessee, the basis of the property in the hands of the lessee shall be the basis of the property in the hands of the lessor.

(d) **Estimated useful life of leased property.** The estimated useful life to the lessee of property subject to the election shall be deemed to be the estimated useful life in the hands of the lessor for purposes of computing depreciation, regardless of the term of the lease. The lessor shall determine the estimated useful life of each leased property on an individual basis even though multiple asset accounts (including guideline class accounts described in Revenue Procedure 62-21) are used.

However, in the case of assets similar in kind contained in a multiple asset account, the lessor shall assign to each of such assets the average useful life of such assets used in computing depreciation. Thus, for example, if during a taxable year a lessor leases 10 similar trucks with an average estimated useful life for depreciation purposes of 7 years, based on an estimated range of 6 to 8 years, he must assign a useful life of 7 years to each of the 10 trucks.

(e) **Lessor itself a lessee.** If the lessor of property is itself a lessee who is treated, under this section, as having purchased such property, and such sublessor makes a valid election under this section to treat the sublessee as a purchaser, then the basis and estimated useful life of such property in the hands of the sublessee shall be determined under paragraphs (c) and (d) of this section as if the original lessor had leased the property directly to the sublessee on the date possession of

Reg. § 1.48-4(e) continued

the property is transferred to the sublessee. Thus, for example, if on March 1, 1964, corporation X leases property to corporation Y, which in turn subleases the property to individual A (who is the first person to use the property for its intended function), and if both X and Y make valid elections under this section, the basis of the property to A is equal to its fair market value on the date on which possession is transferred from Y to A (regardless of whether X and Y are members of the same affiliated group), and its estimated useful life to A is the estimated useful life in the hands of X.

(f) **Property-by-property election—(1) Manner of making election.** The election of a lessor with respect to a particular property (or properties) shall be made by filing a statement with the lessee, signed by the lessor and including the written consent of the lessee, containing the following information:

(i) The name, address, and taxpayer account number of the lessor and the lessee;

(ii) The district director's office with which the income tax returns of the lessor and the lessee are filed;

(iii) A description of each property with respect to which the election is being made;

(iv) The date on which possession of the property (or properties) is transferred to the lessee;

(v) The estimated useful life category of the property (or properties) in the hands of the lessor, that is, 4 years or more but less than 6 years, 6 years or more but less than 8 years, or 8 years or more; except that, in the case of property possession of which is transferred to the lessee before January 1, 1964, the lessor may, at his option, use the estimated useful life of the property (or properties) in the hands of the lessor expressed in terms of years;

(vi) The basis of the leased property in the hands of the lessee (or sublessee) as determined under paragraph (c) of this section; and

(vii) If the lessor is itself a lessee, the name, address, and taxpayer account number of the original lessor, and the district director's office with which the income tax return of such original lessor is filed.

(2) **Time for making election.** The statement referred to in subparagraph (1) of this paragraph shall be filed with the lessee on or before the *due date (including any extensions of time) of the lessee's return for lessee's taxable year during which possession of the property is transferred to the lessee, or on or before July 15, 1964, whichever is later.*

(3) **Election is irrevocable.** An election under this paragraph shall be irrevocable as of the time the statement referred to in subparagraph (1) of this paragraph is filed with the lessee.

(g) **General election—(1) In general.** In lieu of making elections on a property-by-property basis in the manner and time prescribed in paragraph (f) of this section, a lessor may, with respect to a particular taxable year of a particular lessee, make a general election to treat such lessee as having purchased all properties possession of which is transferred under lease by the lessor to the lessee during such taxable year of the lessee.

(2) **Manner and time for making general election.** The general election of a lessor with respect to a taxable year of a lessee shall be made by filing a statement

Footnote § 5972] Matter in italics added by TD 6953, which struck out:
(1) "60th day after"

Reg. § 1.48-1(g)(2) continued

with the lessee, signed by the lessor and including the written consent of the lessee, on or before the *due date (including any extensions of time) of the lessee's return for such taxable year*, or on or before July 15, 1964, whichever is later. Such statement of general election shall contain:

- (i) The name, address, and taxpayer account number of the lessor and the lessee;
- (ii) The taxable year of the lessee with respect to which such general election is made;
- (iii) The district director's office with which the income tax returns of the lessor and the lessee are filed;
- (iv) If the lessor is itself a lessee, the name, address, and taxpayer account number of the original lessor, and the district director's office with which the income tax return of such original lessor is filed.

(3) Election is irrevocable. A general election under this paragraph shall be irrevocable as of the time the statement referred to in subparagraph (2) of this paragraph is filed with the lessee and shall be binding on the lessor and the lessee for the entire taxable year of the lessee with respect to which such general election is made.

(4) Information requirement. If a lessor, with respect to a taxable year of a lessee, makes a general election under this paragraph, such lessor shall provide such lessee, on or before the *due date (including any extensions of time) of the lessee's return for such taxable year*, or on or before July 15, 1964, whichever is later, with a statement (or statements) containing the information required by paragraph (f)(1)(iii), (iv), (v), and (vi) of this section with respect to all properties possession of which is transferred under lease by the lessor to the lessee during such taxable year.

(h) Signature. The statement referred to in paragraph (f)(1) or (g)(2) of this section shall not be valid unless signed by both the lessor and the lessee. The signature of the lessee shall constitute the consent of the lessee to the election. The statement shall be signed by the taxpayer or a duly authorized agent of the taxpayer. For purposes of this section, a facsimile signature may be used in lieu of a signature manually executed and, if used, shall be as binding as a signature manually executed.

(i) [Reserved]

(j) Record requirements. The lessor and the lessee shall keep as a part of their records the statement referred to in paragraph (f)(1), or the statements referred to in paragraphs (g)(2) and (g)(4), of this section. The lessor shall attach to his income tax return a summary statement of all property leased during his taxable year with respect to which an election is made. However, if the due date of the return (including extensions of time) is before July 15, 1964, the summary statement may be filed on or before such date with the district director with whom the return has been filed. Such summary statement shall contain the following information: (1) The name, address, and taxpayer account number of the lessor; and (2) in numerical account number order, each lessee's account number, name, and address, the estimated useful life category of the property (or, if applicable, the estimated useful life expressed in years), and the basis or fair market value of the property, whichever is applicable.

[Footnote 1972 continued]

(2) "60th day after the first transfer under lease (during such year) to the lessee of possession of property eligible for the general election under subparagraph (1) of this paragraph"

(5) "60th day after the first day of the lessor's"

Reg. § 1.48-4 continued

(k) Adjustment of rental deductions—(1) In general. The rules of this paragraph apply only to section 38 property placed in service before January 1, 1964, and with respect to any such property only for taxable years of a lessee beginning before January 1, 1964. If a lessor makes a valid election under this section with respect to property placed in service by the lessee before January 1, 1964, section 48(g) and § 1.48-7 (relating to adjustments to basis of property) shall not apply to the lessor with respect to such property. Thus, the lessor is not required to reduce under section 48(g)(1) the basis of such property. However, if such an election is made, the deductions otherwise allowable under section 162 to the lessee for amounts paid or accrued to the lessor under the lease shall be adjusted in the manner provided in this paragraph. For special adjustment for taxable years beginning after December 31, 1963, see paragraph (m) of this section.

(2) Decrease in rental deduction. (i) The deductions otherwise allowable under section 162 to the lessee for amounts paid or accrued to the lessor under the lease with respect to leased property placed in service before January 1, 1964, shall be decreased under subdivision (ii) or (iii) of this subparagraph, whichever is applicable, by an amount determined by reference to the credit earned on the leased property. The "credit earned" on the leased property is determined by multiplying the qualified investment (as defined in section 46(c)) with respect to such property by 7 percent. Thus, the credit earned (and the decrease in deductions) is determined without regard to the limitation based on tax which, under section 46(a)(2), may limit the amount of the credit the lessee may take into account in any one year.

(ii) If, in the case of property placed in service before January 1, 1964, the lessor, under paragraph (k)(1)(v) of this section, supplies the lessee with the useful life of such property expressed in years, then for each taxable year beginning before January 1, 1964, any part of which falls within a period beginning with the month in which the leased property is placed in service by the lessee and ending with the close of the estimated useful life of such property (as determined under paragraph (d) of this section), the lessee shall decrease the deduction otherwise allowable under section 162 for each such taxable year with respect to such property. The decrease for each such taxable year shall be equal to (a) the credit earned, divided by (b) the estimated useful life of the property (expressed in months), multiplied by (c) the number of calendar months in which the leased property was held by the lessee during such taxable year. Thus, if leased property with a basis of \$27,000 in the hands of a calendar-year lessee, and with an estimated useful life of 10 years, is placed in service by the lessee on July 15, 1963, the lessee must decrease his section 162 deduction with respect to the leased property for the taxable year 1963 by \$94.50 (\$1,890 credit earned, divided by 120, multiplied by 6).

(iii) If, in the case of property placed in service before January 1, 1964, the lessor, under paragraph (k)(1)(v) of this section, supplies the lessee with the useful life category of such property, then for each taxable year beginning before January 1, 1964, during a period equal to the shortest life of the useful life category used by the lessee in computing qualified investment under section 46(c) with respect to the leased property, the lessee shall decrease the deduction otherwise allowable under section 162 for such taxable year with respect to such property. The decrease for each such taxable year shall be equal to the credit earned divided by such shortest life, that is, 4, 6, or 8. Such decreases shall begin with the taxable year during which the lessee places the property in service. Thus, if leased property with a basis of \$30,000 to the lessee, and an estimated useful life falling within the 4 years or more but less than 6 years useful life category, is placed in service by the lessee within the lessee's taxable year ending December 31, 1962, the lessee must decrease his section 162 deduction with respect to the leased property for each of the taxable years 1962 and 1963 by \$175 (\$700 credit earned divided by 4).

Reg. § 1.48-4(k)(2) continued

(iv) To the extent that a required decrease, under subdivision (ii) or (iii) of this subparagraph, is not taken into account for any taxable year beginning before January 1, 1964, because the deduction otherwise allowable under section 162 for such taxable year with respect to the leased property is less than the required decrease for such taxable year, then the balance of the required decrease not taken into account for such taxable year shall decrease the amount otherwise allowable as a deduction under section 162 with respect to such property for the next succeeding taxable year (or years) beginning before January 1, 1964, if any, for which a deduction is allowable with respect to such property. Thus, if the required decrease with respect to leased property is \$200 for 1962 but the lessee's deduction otherwise allowable under section 162 for such taxable year with respect to such property is only \$50, the balance of \$150 must be applied in 1963 to decrease the deduction otherwise allowable to the lessee with respect to the leased property for such taxable year.

(v) See paragraph (b) of § 1.48-7 for reduction of basis in the case of an actual purchase of leased property by a lessee (in a taxable year of such lessee beginning before January 1, 1964) who has been treated as a purchaser of such property under this section.

(3) Increase in rental deductions on account of early disposition, etc. (i) If, as a result of an early disposition, etc., in a taxable year beginning before January 1, 1964, with respect to leased property placed in service before such date, the lessee's tax is increased under section 47(c)(1) or (2), or an adjustment in a carryback or carryover is made under section 47(a)(3) by reduction of an unused credit, the rental deduction (if any) otherwise allowable under section 162 to such lessee for amounts paid or accrued to the lessor under the lease with respect to such property shall be increased in an amount equal to the total decreases previously made in the lessee's rental deductions under subparagraph (2) of this paragraph.

(ii) Except as provided in subdivision (iii) of this subparagraph, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account as an increase in rental deductions otherwise allowable under section 162 for the taxable year in which the early disposition, etc., occurred.

(iii) If, after the event which caused section 47(a)(1), (2), or (3) to apply, the lessee continues the use of the property in a trade or business or in the production of income, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken into account ratably over the remaining portion of the useful life of the property which was used in making the decreases in rental deductions with respect to the property under subparagraph (2) of this paragraph.

(iv) If subdivision (iii) of this subparagraph applies, and if, prior to the expiration of the useful life of the property used in making the decreases in rental deductions, the lease is terminated other than by actual purchase of the property by the lessee, any increase in rental deductions not previously taken into account shall be taken into account as an increase in rental deductions for the taxable year in which the lease is terminated. In the case of an actual purchase of the property by the lessee, see paragraph (c) of § 1.48-7.

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

Example (1). X Corporation is engaged in the business of manufacturing and leasing new and reconstructed equipment which in its hands has an estimated useful life of 12 years. After December 31, 1961, X Corporation constructs machine no. 1 at a cost of \$20,000 and reconstructs machine no. 2 at a cost of \$5,000. On Febru-

Reg. § 1.46-4(1) Example (1) continued

ary 15, 1962, Y Corporation, a calendar-year taxpayer, leases both machines from X Corporation and places them in service. The fair market value of machine no. 1 on the date on which possession is transferred to Y is \$25,200. Machine no. 1 would qualify as new section 38 property in Y's hands if it had been purchased by Y. If X elects to treat Y as the purchaser of machine no. 1, under paragraph (c) (2) (ii) of this section such machine will have a basis of \$25,200 in Y's hands. Under paragraph (f) (1) (v) of this section, X supplies Y with an estimated useful life of 12 years (expressed in years rather than useful life category) with respect to machine no. 1 for purposes of determining Y's qualified investment. Y's credit earned with respect to the property is \$1,764 (7 percent of \$25,200). Under paragraph (k) (2) (ii) of this section, Y's deduction attributable to the leased property for 1962 will be decreased by \$134.75 (credit earned of \$1,764, divided by 144, multiplied by 11), and for 1963 such deduction will be decreased by \$147 (\$1,764, divided by 144, multiplied by 12). The election is not available with respect to machine no. 2 since a reconstructed machine would not constitute new section 38 property if Y had purchased it. In such case, while X cannot make the election to treat Y as a purchaser, X would be entitled to a credit under section 38 based on its expenditure of \$5,000 as an investment in new section 38 property, since such amount represents cost of reconstruction after December 31, 1961.

Example (2). Assume the same facts as in example (1) except that under paragraph (f) (1) (v) of this section, X supplies Y with an estimated useful life category of 8 years or more (rather than an estimated useful life expressed in years) with respect to machine no. 1 for purposes of determining Y's qualified investment. Under paragraph (k) (2) (iii) of this section, Y's deduction attributable to the leased property will be decreased by \$220.50 (credit earned of \$1,764, divided by 8) for each of its taxable years 1962 and 1963.

Example (3). Assume the same facts as in example (1) except that the lessee disposes of his interest in the lease on January 1, 1963, and that there is an increase in Y's tax for 1963 under section 47(a)(1) in the amount of \$1,764. Under paragraph (k) (2) of this section, Y's deductions attributable to the leased property are decreased only in 1962, and the amount of such decrease is \$134.75. In 1963 there shall be an increase of \$134.75 in the deductions otherwise allowable under section 162 for such taxable year with respect to the leased property.

Example (4). Assume the same facts as in example (1) except that during the year 1963 the property was used by Y predominantly outside the United States within the meaning of paragraph (g) of § 1.46-1, and thereafter was used in Y's trade or business. Under paragraph (k) (3) of this section, the increase of \$134.75 described in example (3) is taken into account ratably as an increase in rental deductions otherwise allowable under section 162 in the amount of \$12.25 (\$134.75 divided by 11 years) for 1963 and each of the 10 succeeding years.

(m) Increase in rental deductions on account of section 203(a)(2)(B) of the Revenue Act of 1964--(1) In general. (i) Under section 203(a)(2)(B) of the Revenue Act of 1964, if, for any taxable year of a lessee beginning before January 1, 1964, the rental deductions otherwise allowable under section 162 to such lessee for amounts paid or accrued to the lessor under the lease with respect to leased property placed in service before January 1, 1964, were decreased under paragraph (k) (2) of this section, such rental deductions shall be increased.

(ii) The increase in rental deductions described in subdivision (i) of this subparagraph shall be in an amount equal to the total decreases in the lessee's rental deductions previously made under paragraph (k) (2) of this section less any increases in rental deductions made under paragraph (k) (3) of this section.

(iii) Except as provided in subdivision (iv) of this subparagraph, the increase in rental deductions described in subdivision (i) of this subparagraph shall be taken

Reg. § 1.46-4(m)(1)(iii) continued

into account ratably over the remaining portion of the useful life of the property commencing with the first day of the first taxable year beginning after December 31, 1963. For this purpose, the useful life of the property shall be the useful life used in making the decreases in rental deductions with respect to the property under paragraph (k)(2) of this section.

(iv) If the lease is terminated other than by the lessee's actual purchase of the property during a taxable year beginning after December 31, 1963, and before the end of the remaining useful life of the property used in making the decreases in rental deductions, the amount of the increase in rental deductions described in subdivision (i) of this subparagraph and not previously taken into account shall be allowed as a deduction for the taxable year in which such termination occurs.

(v) The rental deductions with respect to any section 38 property are not to be increased under this paragraph if the lessee dies in a taxable year beginning before January 1, 1964.

(vi) The increase in rental deductions described in subdivision (i) of this subparagraph shall ordinarily be taken into account by the lessee treated as the purchaser, that is, the lessee entitled to the credit. However, if the property under the lease is transferred by the lessee to a successor lessee in a transaction described in section 47(b) (other than a transfer by reason of death) under which the successor lessee assumes the lessee's obligations under the lease, such increase in rental deductions shall be taken into account by the successor lessee in the manner prescribed in this paragraph.

(2) Examples. The operation of this paragraph may be illustrated by the following examples:

Example (1). (a) X Corporation acquired on January 1, 1962, an item of new section 38 property with a basis of \$24,000 and with a useful life to the lessor of 10 years. Y Corporation, which makes its returns on the basis of a calendar year, leased such property from X Corporation and placed it in service on January 2, 1962. Under this section, X Corporation made a valid election to treat Y Corporation as having purchased such property for purposes of the credit allowed by section 38 and supplied the lessee with information that the property had a useful life of 10 years. The amount of the credit earned with respect to such property was \$1,680 (7 percent of \$24,000). For each of the taxable years 1962 and 1963, X Corporation decreased, under paragraph (k)(2) of this section, its deductions otherwise allowable under section 162 with respect to such property by \$168 (\$1,680 multiplied by 12/120).

(b) For each of the taxable years 1964 through 1971, Y Corporation increases its deductions otherwise allowable under section 162 for amounts paid to X Corporation under the lease by \$42 (\$336 (that is, \$168 multiplied by 2) divided by the remaining useful life of 8 years).

Example (2). (a) The facts are the same as in example (1) except that the lease is terminated on January 3, 1965.

(b) For the taxable year 1964, Y Corporation increases its deductions otherwise allowable under section 162 by \$42.

(c) For the taxable year 1965, Y Corporation increases its deductions otherwise allowable under section 162 for the portion of the increase which had not been taken into account as of the time of the termination of the lease. Thus, the amount of such increase for the taxable year 1965 is \$294 (\$336 minus \$42).

Reg. § 1.49-5 (TD 6731, filed 5-7-64; amended by TD 6931, filed 10-9-67.) Electing small business corporations.

(a) In general. (1) In the case of an electing small business corporation (as defined in section 1371(b)), the basis of "new section 38 property" and the cost of

Reg. § 1.48-5(a)(1) continued

"used section 38 property" placed in service during the taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such corporation's taxable year. Section 38 property shall not (by reason of such apportionment) lose its character as new section 38 property or used section 38 property, as the case may be. The estimated useful life of such property in the hands of a shareholder shall be deemed to be the estimated useful life of such property in the hands of the electing small business corporation. The bases of all new section 38 properties which have a useful life falling within a particular useful life category shall be aggregated; likewise, the cost of all used section 38 properties which have a useful life falling within a particular useful life category shall be aggregated. The total bases of new section 38 properties within each useful life category and the total cost of used section 38 properties within each useful life category shall be apportioned separately. The useful life categories are: (i) 4 years or more but less than 6 years; (ii) 6 years or more but less than 8 years; and (iii) 8 years or more. There shall be apportioned to each person who is a shareholder of the electing small business corporation on the last day of the taxable year of such corporation, for his taxable year in which or with which the taxable year of such corporation ends, his pro rata share of the total bases of new section 38 properties within each useful life category, and his pro rata share of the total cost of used section 38 properties within each useful life category. In determining who are shareholders of an electing small business corporation on the last day of its taxable year, the rules of paragraph (d)(1) of § 1.1371-1 and of paragraph (a)(2) of § 1.1373-1 shall apply.

(2) The total cost of used section 38 property that may be apportioned by an electing small business corporation to its shareholders for any taxable year of such corporation shall not exceed \$50,000. If the total cost of used section 38 property placed in service during the taxable year by the electing small business corporation exceeds \$50,000, such corporation must select, under paragraph (c)(4) of § 1.48-3, the used section 38 property the cost of which is to be apportioned to its shareholders.

(3) A shareholder to whom the basis (or cost) of section 38 property is apportioned shall, for purposes of the credit allowed by section 38, be treated as the taxpayer with respect to such property. Thus, the total cost of used section 38 property apportioned to him by the electing small business corporation must be taken into account as cost of used section 38 property in determining whether the \$50,000 limitation on the cost of used section 38 property which may be taken into account by the shareholder in computing qualified investment for any taxable year is exceeded. If a shareholder takes into account in determining his qualified investment any portion of the basis (or cost) of section 38 property placed in service by an electing small business corporation and if such property subsequently is disposed of or otherwise ceases to be section 38 property in the hands of the corporation, such shareholder shall be subject to the provisions of section 47. See § 1.47-4.

(b) Summary statement. An electing small business corporation shall attach to its return a statement showing the apportionment to each shareholder of the total bases of new, and the total cost of used, section 38 properties within each useful life category.

(c) Example. This section may be illustrated by the following example:

Example. (1) X Corporation, an electing small business corporation which makes its return on the basis of the calendar year, acquires and places in service on June 1, 1962, three new assets which qualify as new section 38 property and three

[Footnote § 5973] Matter in *italics* added by TD 6231.

Reg. § 1.48-5(c) Example (i) continued

used assets which qualify as used section 38 property. The basis of each new, and the cost of each used, section 38 property and the estimated useful life of each property are as follows:

	Basis (or cost)	Estimated useful life
Asset No. 1 (new)	\$30,000	4 years
Asset No. 2 (new)	30,000	4 years
Asset No. 3 (new)	30,000	8 years
Asset No. 4 (used)	12,000	6 years
Asset No. 5 (used)	12,000	6 years
Asset No. 6 (used)	12,000	8 years

On December 31, 1962, X Corporation has 10 shares of stock outstanding which are owned as follows: A owns 3 shares, B owns 2 shares, and C owns 5 shares.

(ii) Under this section, the total bases of the new, and the total cost of the used, section 38 properties are apportioned to the shareholders of X Corporation as follows:

Useful life category	New— 4 to 6 years	New—8 years or more	Used— 6 to 8 years	Used—8 years or more
Total bases or total cost	\$60,000	\$30,000	\$24,000	\$12,000
Shareholder A (3/10)	\$18,000	\$ 9,000	\$ 7,200	\$ 3,600
Shareholder B (2/10)	12,000	6,000	4,800	2,400
Shareholder C (5/10)	30,000	15,000	12,000	6,000

Assume that shareholders A, B, and C did not place in service during their taxable years in which falls December 31, 1962 (the last day of X Corporation's taxable year) any section 38 property and that such shareholders did not own any interests in other electing small business corporations, partnerships, estates, or trusts. Under section 46(c), the qualified investment of shareholder A is \$23,400, of shareholder B is \$15,600, and of shareholder C is \$39,000, computed as follows:

Shareholder A

Basis (or cost)	New or used	Applicable percentage	Qualified investment
\$18,000	(new)	x 33 $\frac{1}{3}$ percent	\$ 6,000
9,000	(new)	x 100 percent	9,000
7,200	(used)	x 66 $\frac{2}{3}$ percent	4,800
3,600	(used)	x 100 percent	3,600
Total			\$23,400

Shareholder B

Basis (or cost)	New or used	Applicable percentage	Qualified investment
\$12,000	(new)	x 33 $\frac{1}{3}$ percent	\$ 4,000
6,000	(new)	x 100 percent	6,000
4,800	(used)	x 66 $\frac{2}{3}$ percent	3,200

Reg. § 1.48-5(c) Example (ii) continued.

2,400	(used)	x 100 percent	2,400
Total			\$15,600

Shareholder C			
Basis (or cost)	New or used	Applicable percentage	Qualified investment
\$30,000	(new)	x 33 $\frac{1}{3}$ percent	\$10,000
15,000	(new)	x 100 percent	15,000
12,000	(used)	x 66 $\frac{2}{3}$ percent	8,000
6,000	(used)	x 100 percent	6,000
Total			\$39,000

Reg. § 1.48-6 (TD 6731, filed 5-7-64; amended by TD 6931, filed 10-9-67; TD 6958, filed 6-20-68.) Estates and trusts.

(a) In general. (1) In the case of an estate or trust, the basis of "new section 38 property" and the cost of "used section 38 property" placed in service during the taxable year shall be apportioned among the estate or trust and its beneficiaries on the basis of the income of such estate or trust allocable to each. Section 38 property shall not (by reason of such apportionment) lose its character as new section 38 property or used section 38 property; as the case may be. The estimated useful life of such property in the hands of a beneficiary shall be deemed to be the estimated useful life of such property in the hands of the estate or trust. The bases of all new section 38 properties which have a useful life falling within a particular useful life category shall be aggregated; likewise, the cost of all used section 38 properties which have a useful life falling within a particular useful life category shall be aggregated. The total bases of new section 38 properties within each useful life category and the total cost of used section 38 properties within each useful life category shall be apportioned separately. The useful life categories are: (i) 4 years or more but less than 6 years; (ii) 6 years or more but less than 8 years; and (iii) 8 years or more. There shall be apportioned to the estate or trust for its taxable year, and to each beneficiary of such estate or trust for his taxable year in which or with which the taxable year of such estate or trust ends, his share (as determined under paragraph (b) of this section) of the total bases of new section 38 properties within each useful life category, and his share of the total cost of used section 38 properties within each useful life category.

(2) The total cost of used section 38 property that may be apportioned among an estate or trust and its beneficiaries for any taxable year of such estate or trust shall not exceed \$50,000. If the total cost of used section 38 property placed in service during the taxable year by the estate or trust exceeds \$50,000, such estate or trust must select, under paragraph (c) (4) of § 1.48-3, the used section 38 property the cost of which is to be apportioned among such estate or trust and its beneficiaries.

(3) A beneficiary to whom the basis (or cost) of section 38 property is apportioned shall, for purposes of the credit allowed by section 38, be treated as the taxpayer with respect to such property. Thus, the total cost of used section 38 property apportioned to him by the estate or trust must be taken into account as cost of used section 38 property in determining whether the \$50,000 limitation on the cost of used property which may be taken into account by the beneficiary in computing qualified investment for any taxable year is exceeded. If a beneficiary takes into account in determining his qualified investment any portion of the basis

Reg. § 1.48-6(a)(2) continued

(or cost) of section 38 property placed in service by an estate or trust and if such property subsequently is disposed of or otherwise ceases to be section 38 property in the hands of the estate or trust, such beneficiary shall be subject to the provisions of section 47. See § 1.47-5.

(4) For purposes of this section, the term "beneficiary" includes heir, legatee, and devisee.

(5) If during the taxable year of an estate or trust a beneficiary's interest in the income of such estate or trust terminates, the basis (or cost) of section 38 property placed in service by such estate or trust after such termination shall not be apportioned to such beneficiary.

(b) Share. A trust's, estate's, or beneficiary's share of the total bases of new section 38 properties, and the total cost of used section 38 properties, within a useful life category shall be—

(1) The total bases of new (or the total cost of used) section 38 properties which have a useful life falling within such useful life category placed in service in the taxable year of the estate or trust, multiplied by

(2) The amount of income allocable to such estate or trust or to such beneficiary for such taxable year, divided by

(3) The sum of the amounts of income allocable to such estate or trust and all its beneficiaries taken into account under subparagraph (2) of this paragraph.

(c) Limitation based on amount of tax. In the case of an estate or trust, the \$25,000 amount specified in section 46(a)(2)¹, relating to limitation based on amount of tax, shall be reduced for the taxable year to—

(1) \$25,000² multiplied by

(2) The qualified investment with respect to the total bases of new section 38 properties plus the qualified investment with respect to the total cost of used section 38 properties, apportioned to such estate or trust under paragraph (a) of this section, divided by

(3) The qualified investment with respect to the total bases of all new section 38 properties plus the qualified investment with respect to the total cost of all used section 38 properties, apportioned among such estate or trust and its beneficiaries. For purposes of subparagraph (3) of this paragraph, cost of used section 38 property shall not be considered as apportioned to any beneficiary to the extent that such cost is not taken into account by such beneficiary in computing qualified investment in used section 38 property.

(d) Summary statement. An estate or trust shall attach to its return a statement showing the apportionment to such estate or trust and to each beneficiary of the total bases of new, and the total cost of used, section 38 properties within each useful life category.

(e) Example. This section may be illustrated by the following example:

Example. (1) XYZ Trust, which makes its return on the basis of the calendar year, acquires and places in service on June 1, 1962, three new assets which qualify as new section 38 property and three used assets which qualify as used section 38 property. The basis of the new, and the cost of the used, section 38 property and the estimated useful life of each property are as follows:

[Footnote 15973] Matter in *italics* added by TD 6359, which struck out:

(1) "Under section 43(f)(3),"

(2) "(A) and (B)"

(3) "10"

Reg. § 1.48-6(e) Example (1) continued

	Basis (or cost)	Estimated useful life
Asset No. 1 (new)	\$20,000	4 years
Asset No. 2 (new)	30,000	4 years
Asset No. 3 (new)	20,000	8 years
Asset No. 4 (used)	12,000	6 years
Asset No. 5 (used)	12,000	6 years
Asset No. 6 (used)	12,000	8 years

For the taxable year 1962 the income of XYZ Trust is \$20,000 which is allocable as follows: \$10,000 to XYZ Trust, \$8,000 to beneficiary A, and \$4,000 to beneficiary B. Beneficiaries A and B make their returns on the basis of a calendar year.

(2) Under this section, the total bases of the new, and the total cost of the used, section 38 properties are apportioned to XYZ Trust and its beneficiaries as follows:

Useful life category	New— 4 to 6 years	New—8 years or more	Used— 6 to 8 years	Used— 8 years or more
Total bases or total cost.....	\$60,000	\$30,000	\$24,000	\$12,000
XYZ Trust				
($\frac{\$10,000}{20,000}$)	\$30,000	\$15,000	\$12,000	\$ 6,000
Beneficiary A				
($\frac{\$ 6,000}{20,000}$)	\$18,000	\$ 9,000	\$7,200	\$3,600
Beneficiary B				
($\frac{\$ 4,000}{20,000}$)	12,000	6,000	4,800	2,400

Assume that beneficiary A placed in service during his taxable year 1962 new section 38 property with a basis of \$10,000 and an estimated useful life of 8 years. Also, assume that beneficiary B did not place in service during his taxable year 1962 any section 38 property and that beneficiaries A and B did not own any interests in other trusts, estates, partnerships, or electing small business corporations. Under section 46(c), the qualified investment of XYZ Trust is \$30,000, of beneficiary A is \$33,400, and of beneficiary B is \$15,600, computed as follows:

XYZ Trust

Basis (or cost)	New or used	Applicable percentage	Qualified investment
\$20,000	(new)	× 33 $\frac{1}{3}$ percent	\$10,000
15,000	(new)	× 100 percent	15,000
12,000	(used)	× 66 $\frac{2}{3}$ percent	8,000
6,000	(used)	× 100 percent	6,000
Total			\$39,000

Beneficiary A

Basis (or cost)	New or used	Applicable percentage	Qualified investment.
\$18,000	(new)	× 33 $\frac{1}{3}$ percent	\$ 6,000

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Credits Against Tax

[2]

Reg. § 1.48-6(o) Example (2) continued.

9,000	(new)	× 100 percent	9,000
7,200	(used)	× 66⅔ percent	4,800
3,600	(used)	× 100 percent	3,600
			<hr/>
			\$23,400
10,000	(new)	× 100 percent	10,000
			<hr/>
Total			\$33,400
			<hr/> <hr/>

Beneficiary B

Basis (or cost)	New or used	Applicable percentage	Qualified investment
\$12,000	(new)	× 33⅓ percent	\$ 4,000
6,000	(new)	× 100 percent	6,000
4,800	(used)	× 66⅔ percent	3,200
2,400	(used)	× 100 percent	2,400
			<hr/>
Total			\$15,600
			<hr/> <hr/>

(3) In the case of XYZ Trust, the \$25,000 amount specified in section 46(a)(2)^a is reduced to \$12,500, computed as follows: (i) \$25,000, multiplied by (ii) \$39,000 (qualified investment apportioned to the trust), divided by (iii) \$78,000 (total qualified investment apportioned among such trust (\$39,000), beneficiary A (\$23,400), and beneficiary B (\$15,600)).

Q-5975 Reg. § 1.48-7 (TD 6731, filed 5-7-64; amended by TD 6338, filed 7-19-65; TD 6931, filed 10-9-67.) Adjustment to basis.

(a) Reduction of basis; general--(1) In general. Under section 48(g)(1), the basis of "section 38 property" placed in service before January 1, 1964, shall be reduced by an amount equal to 7 percent of the "qualified investment" with respect to such property. The reduction in basis shall be made as of the time such property is placed in service by the taxpayer. The basis of such property must be reduced by 7 percent of the qualified investment even though the limitation based on amount of tax under section 46(a)(2) reduces the amount of the credit allowed by section 38 for the taxable year in which the property is placed in service. The reduction in basis of section 38 property placed in service before January 1, 1964, shall be taken into account for all purposes of subtitle A of the Code, except in computing (or recomputing in the case of early dispositions, etc.) the qualified investment with respect to such property. Thus, such reduction in basis is taken into account in determining a reasonable allowance for depreciation under section 167, except that the additional amount allowed under section 179 (relating to additional first-year depreciation allowance for small business) with respect to the cost of certain

[Footnote 15971--continued]

- (4) "(a)"
- (5) "(b)"
- (6) "(c)"

Reg. § 1.48-7(a)(1) continued

property is determined without regard to such reduction in basis. Section 48(g)(1) and this section do not apply to section 38 property placed in service after December 31, 1963. For increase in basis of property to which this section applies, see paragraphs (c), (d), and (e) of this section.

(2) Special rules. For purposes of applying subparagraph (1) of this paragraph—

(i) If, under § 1.45-4, the lessor of new section 38 property makes a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the basis of such property shall not be reduced.

(ii) If property is used section 38 property and if the cost, or any part thereof, of such property is not, because of the application of the \$50,000 limitation on the cost of used section 38 property, taken into account in computing qualified investment (see paragraph (c) of § 1.48-3) by the person who placed such property in service or by a person to whom the cost of such property was apportioned, no reduction shall be made to the basis of such property to the extent such cost, or any part thereof, is not so taken into account.

(iii) In the case of used section 38 property within a particular useful life category the cost of which is apportioned by an electing small business corporation, estate, or trust; if any part of such cost is not taken into account in computing qualified investment (because of the \$50,000 limitation) by a shareholder or beneficiary, the electing small business corporation, estate, or trust shall choose, to the extent such cost is not so taken into account, the item (or items) of used section 38 property, within such useful life category, with respect to which no reduction in basis shall be made.

(iv) The basis of section 38 property, which is disposed of or otherwise ceases to be section 38 property in the taxable year in which it is placed in service (except where ¹ § 1.47-3 applies), shall not be reduced. See paragraph (a)(2) of § 1.46-3.

(3) Examples. This paragraph may be illustrated by the following examples:

Example (1). (i) X Corporation, which makes its return on the basis of the calendar year, acquires and places in service on January 2, 1962, an item of new section 38 property with a basis of \$10,000 and a useful life of 10 years. The amount of qualified investment with respect to such asset is \$10,000 (\$10,000 basis multiplied by 100% applicable percentage). For the taxable year 1962, X Corporation is allowed under section 38 a credit of \$700 (7 percent of \$10,000) against its liability for tax of \$1,000.

(ii) Under section 48(g)(1), the basis of the property is reduced to \$9,300 (\$10,000 minus \$700). Thus, for purposes of determining a reasonable allowance for depreciation under section 167 with respect to such property for the taxable year 1962, its adjusted basis is \$9,300.

Example (2). (i) The facts are the same as in example (1) except that for the taxable year 1962 X Corporation's liability for tax under section 45(a)(3) is \$500. Therefore, the credit allowed by section 38 against X Corporation's liability for tax for 1962 is limited to \$500 and the excess of \$200 (\$700 credit earned minus \$500 limitation) is an investment credit carryover.

(ii) The result is the same as in example (1), that is, under section 48(g)(1), the basis of the property is reduced to \$9,300 (\$10,000 minus \$700).

Example (3). (i) The facts are the same as in example (1) except that the property is, for purposes of depreciation, placed in a multiple asset account. On January 1, 1962, the cost or other basis of the property in such account amounted to \$50,000 and no other additions or retirements were reflected in such account during 1962.

[Footnote 159751 Matter in *italics* added by TD 6931, which struck out:

(1) "section 47(b) or 48(a)(4)"

Reg. § 1.48-7(a)(3) Example (3) continued

(ii) Under section 48(g)(1), since the basis of the property is reduced to \$9,300 (\$10,000 minus \$700), the cost or other basis of the property in the multiple asset account is increased to \$59,300 (\$50,000 plus \$9,300) for purposes of computing depreciation under section 167.

Example (4). (i) The facts are the same as in example (1) except that X Corporation makes a valid election under paragraph (e) of § 1.179-4 to claim an additional first-year depreciation allowance with respect to the entire cost of the property.

(ii) Under section 48(g)(1), the basis of the property is reduced to \$9,300 (\$10,000 minus \$700). In addition, \$2,000 (20 percent of \$10,000) is allowed as an additional first-year depreciation allowance. Thus, for purposes of determining a reasonable allowance for depreciation under section 167 (in addition to the \$2,000 computed under section 179) for the taxable year 1962 with respect to such property, its adjusted basis is \$7,300 (\$9,300 minus \$2,000).

Example (5). (i) X Corporation acquires and places in service on January 1, 1962, used assets nos. 1, 2, and 3. Each asset has a cost of \$25,000 and a useful life of 10 years. Such used assets qualify as used section 38 property. X Corporation selects the \$25,000 cost of used asset no. 1 and the \$25,000 cost of used asset no. 2 to be taken into account in computing qualified investment.

(ii) Under section 43(g)(1), the basis of asset no. 1 is reduced to \$23,250, that is, basis of \$25,000 minus \$1,750 (7 percent of \$25,000 qualified investment). Likewise, the basis of asset no. 2 is reduced to \$23,250. The basis of asset no. 3 is not reduced.

Example (6). (i) X Corporation acquires and places in service on January 1, 1962, used assets nos. 1, 2, and 3 which qualify as used section 38 property. Each asset has a cost of \$20,000 and a useful life of 10 years. X Corporation selects the \$20,000 cost of used asset no. 1, the \$20,000 cost of used asset no. 2, and \$10,000 of the cost of used asset no. 3 to be taken into account in computing qualified investment.

(ii) Under section 48(g)(1), the basis of asset no. 1 is reduced to \$18,600, that is, basis of \$20,000 minus \$1,400 (7 percent of \$20,000 qualified investment). Likewise, the basis of asset no. 2 is reduced to \$18,600. The basis of asset no. 3 is reduced to \$19,300, that is, basis of \$20,000 minus \$700 (7 percent of \$10,000 qualified investment).

Example (7). (i) X Corporation, an electing small business corporation which makes its return on the basis of the calendar year, acquires and places in service on January 1, 1962, five used assets which qualify as used section 38 property. The cost of each used section 38 property and the estimated useful life of each property are as follows:

	Cost	Estimated useful life
Asset No. 1	\$20,000	8 years
Asset No. 2	24,000	6 years
Asset No. 3	3,000	4 years
Asset No. 4	6,000	4 years
Asset No. 5	3,000	4 years

On December 31, 1962, X Corporation has 10 shares of stock outstanding which are owned as follows: A owns 3 shares, B owns 2 shares, and C owns 5 shares. All the shareholders make their returns on the basis of a calendar year. X Cor-

Reg. § 1.48-7(a)(3) Example (7)(i) continued

poration selects the \$20,000 cost of asset no. 1, the \$24,000 cost of asset no. 2, the \$8,000 cost of asset no. 3, and \$3,000 of the cost of asset no. 4 to be apportioned to its shareholders. Under § 1.48-5, the total cost of the used section 38 property selected is apportioned to the shareholders of X Corporation as follows:

Useful life category	Used— 4 to 6 years	Used— 6 to 8 years	Used— 8 years or more
Total cost	\$6,000	\$24,000	\$20,000
Shareholder A (8/10)	\$1,800	\$ 7,200	\$ 6,000
Shareholder B (2/10)	1,200	4,800	4,000
Shareholder C (5/10)	3,000	12,000	10,000

Assume that shareholders A, B, and C did not place in service during their taxable years ending December 31, 1962, any section 38 property and that such shareholders did not own any interests in other electing small business corporations, partnerships, estates, or trusts. Under section 46(c)(1)(B) each shareholder computes his qualified investment as follows:

Shareholder A		
Cost	Applicable percentage	Qualified investment
\$1,800 ×	33½ percent	\$ 600
7,200 ×	66⅔ percent	4,800
6,000 ×	100 percent	6,000
		<u>\$11,400</u>

Shareholder B		
Cost	Applicable percentage	Qualified investment
\$1,200 ×	33½ percent	\$ 400
4,800 ×	66⅔ percent	3,200
4,000 ×	100 percent	4,000
		<u>\$ 7,600</u>

Shareholder C		
Cost	Applicable percentage	Qualified investment
\$ 3,000 ×	33½ percent	\$ 1,000
12,000 ×	66⅔ percent	8,000
10,000 ×	100 percent	10,000
		<u>\$19,000</u>

(ii) Under section 48(g)(1), the basis of each asset (except asset no. 5) is reduced by 7 percent of the qualified investment with respect to such asset, as follows:

Asset	Basis before reduction	Qualified investment	Basis after reduction
No. 1	\$20,000 minus 7% of \$20,000 =		\$18,600
No. 2	24,000 minus 7% of 16,000 =		22,880
No. 3	3,000 minus 7% of 1,000 =		2,930
No. 4	6,000 minus 7% of 1,000 =		5,930

The basis of asset no. 5 is not reduced.

Example (3). (i) The facts are the same as in example (7) except that share-

Reg. § 1.48-7(a) (3) Example (8) (i) continued

holder C acquired and placed in service on June 1, 1962, in his individual proprietorship, used asset no. 6 with a cost of \$27,000 and an estimated useful life of 10 years. In computing his qualified investment, shareholder C selects the \$27,000 cost of asset no. 6, the \$10,000 cost of used section 38 property within the 8 years or more useful life category apportioned to him by X Corporation, the \$12,000 cost of used section 38 property within the 6 to 8 years useful life category apportioned to him by X Corporation, and \$1,000 of the cost of used section 38 property within the 4 to 6 years useful life category apportioned to him by X Corporation. Under section 46(c) (1) (B), he computes his qualified investment as follows:

Proprietorship	Cost	Applicable percentage	Qualified investment
Asset No. 6	\$27,000	X 100%	\$27,000
Apportioned by X Corporation			
8 years or more	10,000	X 100%	10,000
6 to 8 years	12,000	X 66 $\frac{2}{3}$ %	8,000
4 to 6 years	1,000	X 33 $\frac{1}{3}$ %	333
			\$45,333

(ii) Since only \$4000 of the \$6000 cost of used section 38 property in the 4 to 6 years useful life category apportioned by X Corporation was taken into account by shareholders A, B, and C in computing their qualified investment, only \$4000 of the bases of the assets in such category is subject to reduction. Under subparagraph (2) (iii) of this paragraph, X must choose an item of property in such category, \$2000 of the basis of which will not be subject to the reduction. Therefore, X Corporation chooses to reduce the basis of asset no. 4 by 7 percent of qualified investment with respect to only \$1000 of the cost of such asset (in lieu of the \$3000 previously selected). The bases of assets nos. 1, 2, and 3 are reduced by 7 percent of the qualified investment with respect to each such asset. The basis of each asset is reduced as follows:

Asset	Basis before reduction	Qualified investment	Basis after reduction
No. 1	\$20,000	minus 7% of \$20,000	= \$18,600
No. 2	24,000	minus 7% of 16,000	= 22,880
No. 3	3,000	minus 7% of 1,000	= 2,930
No. 4	6,000	minus 7% of 333	= 5,977

The basis of asset no. 5 is not reduced.

(iii) The basis of asset no. 6, in the hands of shareholder C, is reduced to \$25,110, that is, basis of \$27,000 minus \$1890 (7 percent of \$27,000 qualified investment).

Example (9). (i) ABC Partnership, which makes its return on the basis of the calendar year, acquires and places in service on January 1, 1962, five used assets which qualify as used section 38 property. The cost of each used section 38 property and the estimated useful life of each property are as follows:

Asset No.	Cost	Estimated useful life
Asset No. 1	\$20,000	8 years
Asset No. 2	24,000	6 years
Asset No. 3	3,000	4 years
Asset No. 4	6,000	4 years
Asset No. 5	3,000	4 years

Reg. § 1.46-7(a)(3) Example (9)(1) continued

Partners A, B, and C share the profits and the losses of partnership ABC in the ratio of 50 percent, 30 percent, and 20 percent, respectively. ABC Partnership selects the \$20,000 cost of asset no. 1, the \$24,000 cost of asset no. 2, the \$3,000 cost of asset no. 3, and \$3,000 of the cost of asset no. 4, to be taken into account by its members in computing qualified investment. Under paragraph (f)(2) of § 1.46-3, each partner's share of the cost of the partnership used section 38 property to be taken into account in computing qualified investment is as follows:

	Estimated useful life	Cost	Partner's share of cost		
			A(50%)	B(30%)	C(20%)
Asset No. 1	8 yrs.	\$20,000	\$10,000	\$6,000	\$4,000
Asset No. 2	6 yrs.	24,000	12,000	7,200	4,800
Asset No. 3	4 yrs.	3,000	1,500	900	600
Asset No. 4	4 yrs.	3,000	1,500	900	600

Each partner makes his return on the basis of the calendar year. Assume that partners A, B, and C did not place in service during their taxable years ending December 31, 1962, any section 38 property and that such partners did not own any interests in other partnerships, estates, trusts, or electing small business corporations. Under section 46(c), each partner computes his qualified investment as follows:

Partner A			
	Share of cost	Applicable percentage	Qualified investment
Asset No. 1	\$10,000	× 100%	\$10,000
Asset No. 2	12,000	× 66⅔%	8,000
Asset No. 3	1,500	× 33⅓%	500
Asset No. 4	1,500	× 33⅓%	500
			<u>\$10,000</u>

Partner B			
	Share of cost	Applicable percentage	Qualified investment
Asset No. 1	\$ 6,000	× 100%	\$ 6,000
Asset No. 2	7,200	× 66⅔%	4,800
Asset No. 3	900	× 33⅓%	300
Asset No. 4	900	× 33⅓%	300
			<u>\$11,400</u>

Partner C			
	Share of cost	Applicable percentage	Qualified investment
Asset No. 1	\$ 4,000	× 100%	\$ 4,000
Asset No. 2	4,800	× 66⅔%	3,200
Asset No. 3	600	× 33⅓%	200
Asset No. 4	600	× 33⅓%	200
			<u>\$7,600</u>

(ii) Under section 48(g)(1), the basis of each asset selected by the partnership is reduced by 7 percent of the qualified investment with respect to such asset, as follows:

Reg. § 1.48-7(a)(3) Example (9) (ii) continued

Asset	Basis before reduction	Qualified investment	Basis after reduction
No. 1	\$20,000 minus 7% of \$20,000	=	\$18,600
No. 2	24,000 minus 7% of 16,000	=	22,880
No. 3	3,000 minus 7% of 1,000	=	2,930
No. 4	6,000 minus 7% of 1,000	=	5,930

The basis of asset no. 5 is not reduced.

Example (10). (i) The facts are the same as in example (9) except that partner A acquired and placed in service on June 1, 1962, in his individual proprietorship, used asset no. 6 with a cost of \$26,000 and an estimated useful life of 10 years. Partner A selects the \$26,000 cost of asset no. 6, his \$10,000 share of the cost of asset no. 1, his \$12,000 share of the cost of asset no. 2, his \$1,500 share of the cost of asset no. 3, and \$500 of his share of the cost of asset no. 4, to be taken into account in computing his qualified investment. Under section 48(c), he computes his qualified investment as follows:

Proprietorship property	Cost	Applicable percentage	Qualified investment
Asset No. 6	\$26,000	× 100%	\$26,000
Partnership property	Share of cost		
Asset No. 1	\$10,000	× 100%	10,000
Asset No. 2	12,000	× 66⅔%	8,000
Asset No. 3	1,500	× 33⅓%	500
Asset No. 4	500	× 33⅓%	167
			\$44,667

(ii) Under section 48(g)(1), the basis of each asset selected by the partnership is reduced by 7 percent of the qualified investment with respect to such asset as follows:

Asset	Basis before reduction	Qualified investment	Basis after reduction
No. 1	\$20,000 minus 7% of \$20,000	=	\$18,600
No. 2	24,000 minus 7% of 16,000	=	22,880
No. 3	3,000 minus 7% of 1,000	=	2,930
No. 4	6,000 minus 7% of 667	=	5,958

The basis of asset no. 5 is not reduced.

(iii) The basis of asset no. 6, in the hands of partner A, is reduced to \$24,180, that is, basis of \$26,000 minus \$1820 (7 percent of \$26,000 qualified investment).

(b) Reduction of basis; purchase of leased property by lessee treated as purchaser. (1) If a lessor of property placed in service before January 1, 1964, makes a valid election under § 1.48-4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38 and if such lessee at a later date (in a taxable year of the lessee beginning before January 1, 1964) actually purchases such property, the basis of such property shall be reduced, as of the time of the actual purchase, by an amount equal to the excess of—

(i) The credit earned (as defined in paragraph (k)(2)(i) of § 1.48-4) with respect to such property, over

(ii) The sum of the amounts by which the lessee-purchaser has decreased, under paragraph (k)(2) of § 1.48-4, his deductions otherwise allowable under section 162 for amounts paid or accrued to the lessor-vendor under the lease with respect to such property.

Reg. § 1.48-7(b) continued

(2) The operation of this paragraph may be illustrated by the following example:

Example. (1) X Corporation acquires on January 1, 1962, an item of new section 38 property with a basis of \$12,000 and with a useful life of 8 years. Y Corporation, which makes its return on the basis of a calendar year, leases such property from X Corporation and places it in service on February 1, 1962. Under § 1.48-4, X Corporation makes a valid election to treat Y Corporation as having purchased such property for purposes of the credit allowed by section 38. Under paragraph (k)(2)(i) of § 1.48-4, the amount of the credit earned with respect to such property is \$840 (7 percent of \$12,000). For the taxable year 1962 Y Corporation decreases, under paragraph (k)(2)(ii) of § 1.48-4, its deductions otherwise allowable under section 162 for amounts paid to X Corporation under the lease with respect to such property by \$96.25 (\$840 multiplied by 11/96). On January 1, 1963, Y Corporation actually purchases such property from X Corporation for \$9,000.

(ii) As of January 1, 1963, Y Corporation must reduce the basis of the property by \$743.75 (\$840 minus \$96.25). Thus, for purposes of determining a reasonable allowance for depreciation under section 167 with respect to such property for the taxable year 1963, its adjusted basis is \$8,256.25 (\$9,000 minus \$743.75).

(c) Increase in basis on account of early disposition, etc.—(1) In general. If, as a result of an early disposition, etc., in a taxable year beginning before January 1, 1964, with respect to section 38 property placed in service before such date, the tax imposed under chapter 1 of the Code is increased under section 47(a)(1) or (2), or an adjustment is an unused credit carryback or carryover is made under section 47(a)(3), then the basis of such property shall be increased. Such increase shall be in an amount equal to the sum of the portion of such increase in tax and the portion of such adjustment in carrybacks or carryovers attributable to such property but not in excess of the reduction in basis made under paragraph (a) of this section or, in the case of leased property purchased by a lessee treated as the purchaser, the reduction in basis under paragraph (b) of this section plus the decrease in rental deductions made under paragraph (k)(2) of § 1.48-4. See paragraph (a)(2) of this section for rules indicating when basis is not reduced under paragraph (a) of this section. The increase in basis of such property shall be made immediately before the event which causes section 47(a)(1), (2), or (3) to apply, and this increase in basis shall be taken into account for all purposes of subtitle A of the Code. If, after the event described in the preceding sentence, the taxpayer continues the use of the property in a trade or business or in the production of income, the principles described in paragraph (d)(1) of this section shall be applied in computing the allowances for depreciation over the remaining useful life of the property.

(2) Examples. The operation of this paragraph may be illustrated by the following examples:

Example (1). (a) The facts are the same as those in example (1) of paragraph (a)(3) of this section except that on June 15, 1963, corporation X sold the property causing section 47(a)(1) to apply.

(b) Section 48(g)(2) requires that the basis of said property be increased immediately before the sale by the amount of \$700, which amount is equal to the increase in tax for the taxable year 1963 arising under section 47(a)(1) (\$700 credit allowed less credit allowable of 0).

Example (2). (a) The facts are the same as in example (1) of this subparagraph except that for the taxable year 1962 X Corporation's liability for tax was only \$500, and a \$200 unused credit carryover to 1963 resulted.

(b) The result is the same as in example (1) of this subparagraph, that is, the basis of the property is increased under section 48(g)(2) by the amount of \$700

Reg. § 1.43-7(c)(2) Example (2)(b) continued

(\$500 credit allowed plus \$200 adjustment in carryover to 1963 less credit allowable of 0).

Example (3). (a) The facts are the same as those in example (1) of paragraph (a)(3) of this section except that the property was physically located outside of the United States during more than 50 percent of the taxable year 1963 within the meaning of paragraph (g) of § 1.43-1, and section 47(a)(1) therefore became applicable.

(b) The basis of the property is increased by \$700 as of the first day of the taxable year 1963.

Example (4). (a) The facts are the same as example (5) of paragraph (a)(3) of this section. Assume also that on January 1, 1963, there is an early disposition, etc., of the three assets as described under section 47(a)(1).

(b) Section 48(g)(2) requires that the basis of asset No. 1 be increased immediately before such early disposition, etc., by the amount of \$1,750 (\$1,750 credit allowed less credit allowable of 0). Likewise, the basis of asset No. 2 is increased by the amount of \$1,750. There is no increase in the basis of asset No. 3 since the basis of such asset was not reduced.

(d) Increase in basis of property placed in service before January 1, 1964—(1) In general. Under section 203(a)(2)(A) of the Revenue Act of 1964, the basis of section 38 property placed in service before January 1, 1964, shall be increased by an amount equal to 7 percent of the qualified investment with respect to such property (determined as of the date the property was placed in service) but not in excess of the net reduction in basis under section 48(g). For this purpose, the net reduction in basis under section 48(g) is the reduction in basis under section 43(g)(1) and paragraph (a) of this section less any increase in basis under section 48(g)(2) and paragraph (c) of this section. The increase in basis described in this paragraph shall be made as of the first day of the taxpayer's first taxable year beginning after December 31, 1963. For taxable years beginning after December 31, 1963, this increase in basis shall be taken into account for all purposes of subtitle A of the Code. Thus, for example, during that part of the remaining useful life of the property falling within the taxable years beginning after December 31, 1963, such increase in basis shall be taken into account in determining reasonable allowances for depreciation under section 167. In determining depreciation allowances with respect to the property for periods after such increase in basis, appropriate adjustments shall be made (except as otherwise provided in this paragraph), whenever necessary, to the rate or other factors previously applied for taxable years beginning before January 1, 1964, so that the total depreciation allowances made during the remaining useful life of the property, plus the allowances for the expired useful life, will equal or approximate the allowances which would have resulted if section 48(g)(1) had not applied. In the case of section 38 property contained in a multiple asset account, the taxpayer may reflect the increase in basis by adjusting the basis of the account and by adjusting the rate of depreciation applied to the entire account. In lieu of that, he may continue to apply to the entire account (reflecting the basis increase) the rate previously employed. As a third alternative, solely for the purposes of determining the depreciation adjustment occasioned by the increase in basis (and not for the purposes of determining method of depreciation, effect of retirements, application of sections 1245 and 1250, or other purposes), he may continue to utilize the previous rate for the main account (not reflecting the increase in basis) and treat the increase in basis as a separate account to be depreciated over the remaining useful life of the assets to which the increase in basis relates. Except as provided in section 167 and the regulations thereunder, no change may be made in the method of depreciation to be applied during the remaining life of the property. For purposes of section 167(d), any increase in basis under this paragraph

Reg. § 1.48-7(d)(1) continued

shall constitute a fact not taken into consideration in the adoption of any agreement under that section fixing the rate of depreciation. In no event shall an adjustment be made which would result in recovery of the increase in basis through depreciation allowances prior to expiration of the remaining useful life.

(2) Special rules. (i) The increase in basis provided by subparagraph (1) of this paragraph shall be taken into account ordinarily by the person in whose hands the basis of the property was reduced under section 48(g)(1). However, if the property is transferred in a transaction described in section 47(b) (other than a transfer by reason of death) prior to the first day of the first taxable year of the transferor beginning after December 31, 1963, then, to the extent that the basis of such property reflects the net reduction in basis described in subparagraph (1) of this paragraph in the hands of the transferor, the increase in basis provided for in this paragraph shall be taken into account by the transferee.

(ii) The basis of any section 38 property is not to be increased under subparagraph (1) of this paragraph if the taxpayer dies in a taxable year beginning before January 1, 1964.

(3) Examples. The application of this paragraph may be illustrated by the following examples:

Example (1). (a) A, an individual who makes his return on the basis of the calendar year, acquired and placed in service on January 1, 1962, asset No. 1 and asset No. 2, both of which assets qualified as new section 38 property. Each asset had a basis of \$10,000, a salvage value of \$1,000, and an estimated useful life of 10 years. Depreciation for each asset was computed under the straight line method. For the taxable year 1962, A was allowed under section 38 a credit of \$1,400 (7 percent of \$20,000). On January 2, 1963, A took asset No. 1 out of his business and on said date commenced to use such property entirely for personal purposes. Thus, for purposes of section 48(g)(2), there was an early disposition, etc., as described under section 47(a)(1).

(b) Under section 48(g)(1), the basis of each asset in 1962 was reduced to \$9,300. Thus, depreciation with respect to each asset for the taxable year 1962 was \$830 (adjusted basis of \$9,300 minus salvage value of \$1,000 divided by estimated useful life of 10 years).

(c) Immediately before the early disposition, etc., with respect to asset No. 1, the basis of such asset was increased by \$700 to \$9,170 (cost of \$10,000 minus reduction in 1962 under section 48(g)(1) of \$700, minus depreciation of \$830, and plus the addition to basis in 1963 under section 48(g)(2) of \$700). As of December 31, 1963, the adjusted basis of asset No. 2 was \$7,640 (original cost of \$10,000 minus reduction in 1962 under section 48(g)(1) of \$700, minus depreciation of \$830 in 1962, and minus depreciation of \$830 in 1963).

(d) The basis of asset No. 1 is not increased under this section since the basis of such asset had previously been increased under section 48(g)(2) in the amount of \$700, the full amount of the reduction previously made under section 48(g)(1). The basis of asset No. 2 is increased under this paragraph as of January 1, 1964, by \$700 to \$8,340 (\$7,640 plus 7 percent of \$10,000). The rate of depreciation to be applied to the adjusted basis of asset No. 2 for the remaining useful life of 8 years is adjusted in order to produce a total depreciation allowance of \$9,000 at the end of the asset's useful life. Depreciation with respect to such asset for the taxable year 1964 and for each of the succeeding 7 years is \$917.50 (adjusted basis of \$8,340 minus salvage value of \$1,000 divided by estimated remaining useful life of 8 years).

Example (2). (a) X Corporation, which makes its return on the basis of the calendar year, acquired and placed in service on January 1, 1962, an asset which

Reg. § 1.48-7(d)(2) Example (2)(a) continued

qualified as new section 38 property. The asset had a basis of \$165,000, a salvage value of \$15,000, and an estimated useful life of 5 years. Depreciation was computed under the declining-balance method at a rate of 200 percent of the straight line rate. The qualified investment with respect to such asset was \$55,000 (33½ percent of \$165,000). For the taxable year 1962, X Corporation was allowed under section 38 a credit of \$3,850 (7 percent of \$55,000).

(b) Under section 48(g)(1), the basis of such property in 1962 was reduced to \$161,150 (\$165,000 minus \$3,850). Thus, depreciation with respect to such asset for the taxable year 1962 was \$64,460 (adjusted basis of \$161,150 multiplied by 40 percent). Depreciation for the taxable year 1963 was \$38,676 (\$161,150 minus \$64,460 multiplied by 40 percent).

(c) As of January 1, 1964, the basis of such property is increased by \$3,850 to \$61,864 (\$161,150 minus \$64,460, minus \$38,676, and plus \$3,850). No adjustment in the rate of the allowance for depreciation is necessitated by the increase in basis under this section since the rate and method applied in 1962 and 1963 will produce a total allowance of \$150,000 over the entire estimated useful life of the property. Thus, depreciation with respect to such asset for 1964 is \$24,746 (\$61,864 multiplied by 40 percent), for 1965 is \$14,847 (\$61,864 minus \$24,746 multiplied by 40 percent), and for 1966 is \$7,271, since such property cannot be depreciated below its salvage value of \$15,000.

Example (3). (a) The facts are the same as in example (2) except that depreciation was computed under the sum of the years-digits method. Thus, depreciation with respect to such asset for the taxable year 1962 was \$42,717 (adjusted basis of \$161,150 minus \$15,000 multiplied by 5/15). For the taxable year 1963 depreciation was \$38,973 (\$161,150 minus \$15,000 multiplied by 4/15).

(b) As of January 1, 1964, the basis of such property is increased in the amount of \$3,850. In order to produce a total allowance of \$150,000 over the entire useful life, it is necessary to adjust the annual allowance. Thus, as of January 1, 1964, under the taxpayer's method of depreciation, a new rate of 3/6 is determined for the taxable year 1964. Commencing with such taxable year, this new rate is applied against the asset's adjusted basis of \$77,310 minus salvage value of \$15,000. The adjusted basis as of January 1, 1964, is determined as follows:

Original cost to taxpayer	\$165,000
Less: Reduction for investment credit as prescribed by paragraph (a)	\$ 3,850
Depreciation for 1962	42,717
Depreciation for 1963	38,973
	<u>91,540</u>
	\$ 73,430
Add: increase prescribed by this paragraph	3,850
	<u>77,310</u>

Depreciation for the taxable year 1964 is \$31,155 (adjusted basis of \$77,310 minus salvage value of \$15,000 multiplied by 3/6). Likewise, depreciation for the taxable year 1965 shall be \$20,770 (\$77,310 minus \$15,000 multiplied by 2/6).

Example (4). (a) The facts are the same as in example (2) except that the useful life was estimated in terms of units of production and depreciation was computed under the unit-of-production method. The estimated total production of the property was 150,000 units, and 30,000 units were produced annually. Thus,

Reg. § 1.48-7(d)(3) Example (4)(a) continued

depreciation for the taxable year 1962 was \$29,230 (adjusted basis of \$161,150 minus \$15,000 multiplied by 30,000/150,000). For the taxable year 1963 depreciation was again \$29,230.

(b) As of January 1, 1964, the basis of such property is increased in the amount of \$3,850. In order to permit a total allowance of \$150,000 over the entire useful life of the property, it is necessary to adjust the annual allowance for depreciation over its remaining life. Thus, as of January 1, 1964, under the taxpayer's method of depreciation, a new rate of \$30,000/90,000 is determined for the taxable year 1964. Commencing with such taxable year, this new rate is applied against the adjusted basis of the property of \$106,540 minus salvage value of \$15,000. The adjusted basis as of January 1, 1964, is determined as follows:

Original cost to taxpayer	\$165,000	
Less: Reduction for investment credit as prescribed by paragraph (a)	\$ 3,850	
Depreciation for 1962	29,230	
Depreciation for 1963	29,230	62,310
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		\$102,690
Add: Increase prescribed by this paragraph		3,850
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Adjusted basis as of January 1, 1964		\$106,540
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Depreciation for the taxable year 1964 is \$30,513 (adjusted basis of \$106,540 minus salvage value of \$15,000 multiplied by 30,000/90,000). Likewise, for the taxable year 1965 depreciation shall be \$30,513 (\$106,540 minus \$15,000 multiplied by 30,000/90,000).

Example (5). (a) X Corporation, a calendar year basis taxpayer, acquired and placed in service on January 1, 1962, a number of assets which qualified as new section 38 property. Such assets had a total basis of \$180,000, a total salvage value of \$18,000 and were accounted for in a multiple asset account containing other assets similar in kind, but not qualifying as section 38 property. Depreciation was computed under the straight line method over an average estimated useful life of 10 years.

For the taxable year 1962, X Corporation was allowed under section 38 a credit of \$12,600 (7 percent of \$180,000). Under section 48(g)(1), the basis of such property in 1962 was reduced to \$167,400.

(b) As of January 1, 1964, the basis of the assets is increased in the amount of \$12,600. To produce a total allowance equal to the allowance which would have resulted if section 48(g)(1) had not applied, an adjustment in the rate of depreciation would be necessary. If the taxpayer selects the third alternative described for multiple asset accounts in subparagraph (1) of this paragraph, the amount of the adjustment will be determined with reference to the increase in basis alone. In that case, under the taxpayer's method of depreciation, depreciation with respect to the increase in basis for the taxable year 1964 and for each of the seven succeeding years is \$1,575 (increase in basis of \$12,600 divided by estimated remaining useful life of 8 years).

(c) Increase in basis; purchase of leased property by lessee treated as purchaser —(1) In general. If a lessor of property placed in service before January 1, 1964, made a valid election under § 1.48-4 to treat the lessee as having purchased such property for purposes of the credit allowed by section 38 and if the lessee actually purchased the property at a later date prior to the expiration of the useful life used

Reg. § 1.48-7(e)(1) continued

in computing the credit, the basis of the property shall be increased. If the property was purchased by the lessee in a taxable year beginning before January 1, 1964, the increase shall be made as of the first day of the lessee's first taxable year beginning after December 31, 1963, in an amount equal to 7 percent of the qualified investment in the property (determined as of the date the property was placed in service), but not in excess of the reduction in basis made under paragraph (b) of this section plus the decrease in rental deductions made under paragraph (k)(2) of § 1.48-4. If the property was purchased by the lessee in a taxable year beginning after December 31, 1963, the increase shall be made to the basis of the property as of the date of purchase by an amount equal to any decrease in rental deductions actually made under paragraph (k)(2) of § 1.48-4 minus any increase in rental deductions taken into account by the lessee under paragraph (m) of § 1.48-4. Any increase in basis under this paragraph shall be reduced to the extent of any increase in basis previously made under paragraph (c) of this section on account of early disposition, etc., of the property. For taxable years of a lessee beginning after December 31, 1963, such increase in basis shall be taken into account for all purposes of subtitle A of the Code.

(2) Special rules. (i) The increase in basis provided by this paragraph shall be taken into account ordinarily by the lessee treated as the purchaser. However, if the property under the lease is transferred before the purchase by the lessee to a successor lessee in a transaction described in section 47(b) (other than a transfer by reason of death) under which the successor lessee assumes the lessee's obligations under the lease, or if the property is purchased by the lessee in a taxable year beginning before January 1, 1964, and subsequently transferred in a transaction described in section 47(b) (other than a transfer by reason of death), the increase in basis provided for in this paragraph shall be taken into account by the transferee.

(ii) The basis of any section 38 property is not to be increased under subparagraph (1) of this paragraph if the taxpayer dies in a taxable year beginning before January 1, 1964.

(3) Examples. The application of this paragraph may be illustrated by the following examples:

Example (1). (a) X Corporation acquired on January 1, 1962, an item of new section 38 property with a basis of \$10,000, an estimated useful life of 10 years, and a salvage value of \$1,000. Y Corporation, which makes its return on the basis of a calendar year, leased such property from X Corporation and placed it in service on January 2, 1963. Under § 1.48-4, X Corporation made a valid election to treat Y Corporation as having purchased such property for purposes of the credit allowed by section 38. The amount of the credit earned with respect to such property was \$700 (7 percent of \$10,000). For the taxable year 1962, Y Corporation decreased, under paragraph (k)(2) of § 1.48-4, its deductions otherwise allowable under section 162 for amounts paid to X Corporation under the lease with respect to such property by \$70 (\$700 multiplied by 12/120). On January 1, 1963, Y Corporation purchased such property from X Corporation for \$8,830.

(b) As of January 1, 1963, Y Corporation in accordance with paragraph (b) of this section reduced the basis of the property by the amount of \$630 (\$700 minus \$70). The adjusted basis of the property for the taxable year 1963 for purposes of determining a reasonable allowance for depreciation under section 167 was \$8,200 (\$8,830 minus \$630). Depreciation under the straight line method for such taxable year amounted to \$800 (adjusted basis of \$8,200 minus salvage value of \$1,000 and divided by estimated remaining useful life of 9 years). As of December 31, 1963, the adjusted basis had been reduced to \$7,400 (\$8,200 minus depreciation of \$800 for the taxable year 1963).

(c) As of January 1, 1964, the basis of such property is increased to \$8,100

Reg. § 1.48-7(e)(3) Example (1)(c) continued

(\$7,400 plus \$700). To permit a total allowance of \$7,900 over the entire useful life of the property (treating as a part of the depreciable basis of the property the decrease of \$70 made in the taxpayer's rental deductions for the taxable year 1962), it is necessary to recompute the annual allowance for depreciation. Thus, depreciation for the taxable year 1964 and for each of the 7 succeeding years is \$887.50 (adjusted basis of \$8,100 minus salvage value of \$1,000 and divided by estimated remaining useful life of 8 years).

Example (2). (a) The facts are the same as in example (1) of paragraph (m) (2) of § 1.48-4 except that X Corporation purchased the property on January 3, 1965, for \$20,000.

(b) For the taxable year 1964 Y Corporation increases its deductions otherwise allowable under section 162 by \$42.

(c) As of January 3, 1965, Y Corporation increases the basis of the property (\$20,000) by \$294 (\$336 decrease in rental deductions made in 1962 and 1963 minus \$42 increased rental deductions taken into account in 1964).

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A [§ 5977] CODE REG. 49. TERMINATION OF CREDIT.

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(a) General Rule.—For purposes of this subpart, the term "section 86 property" does not include property—

(1) the physical construction, reconstruction, or erection of which is begun after April 18, 1969, or

(2) which is acquired by the taxpayer after April 18, 1969, other than pre-termination property.

(b) Pre-Termination Property.—For purposes of this section—

(1) Binding contracts.—Any property shall be treated as pre-termination property to the extent that such property is constructed, reconstructed, erected, or acquired pursuant to a contract which was, on April 18, 1969, and at all times thereafter, binding on the taxpayer.

(2) Equipped building rule.—If—

(A) pursuant to a plan of the taxpayer in existence on April 18, 1969 (which plan was not substantially modified at any time after such date and before the taxpayer placed the equipped building in service), the taxpayer has constructed, reconstructed, erected, or acquired a building and the machinery and equipment necessary to the planned use of the building by the taxpayer, and

(B) more than 50 percent of the aggregate adjusted basis of all the property of a character subject to the allowance for depreciation making up such building as so equipped is attributable to either property the construction, reconstruction, or erection of which was begun by the taxpayer before April 19, 1969, or property the acquisition of which by the taxpayer occurred before such date,

then all property comprising such building as so equipped (and any incidental property adjacent to such building which is necessary to the planned use of the building) shall be pre-termination property. For purposes of subparagraph (B) of the preceding sentence, the rules of paragraphs (1) and (2) shall be applied. For purposes of this paragraph, a special purpose structure shall be treated as a building.

(3) Plant facility rule.—

(A) General rule.—If—

(i) pursuant to a plan of the taxpayer in existence on April 18, 1969 (which plan was not substantially modified at any time after such date and before the taxpayer placed the plant facility in service), the taxpayer has constructed, reconstructed, or erected a plant facility, and either

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(ii) the construction, reconstruction, or erection of such plant facility was commenced by the taxpayer before April 19, 1969, or

(iii) more than 50 percent of the aggregate adjusted basis of all the property of a character subject to the allowance for depreciation making up such plant facility is attributable to either property the construction, reconstruction, or erection of which was begun by the taxpayer before April 19, 1969, or property the acquisition of which by the taxpayer occurred before such date,

then all property comprising such plant facility shall be pre-termination property. For purposes of clause (iii) of the preceding sentence, the rules of paragraphs (1) and (4) shall be applied.

(B) Plant facility defined.—For purposes of this paragraph, the term "plant facility" means a facility which does not include any building (or of which buildings constitute an insignificant portion) and which is—

(i) a self-contained, single operating unit or processing operation,

(ii) located on a single site, and

(iii) identified, on April 18, 1969, in the purchasing and internal financial plans of the taxpayer as a single unitary project.

(C) Special rule.—For purposes of this subsection, if—

(i) a certificate of convenience and necessity has been issued before April 19, 1969, by a Federal regulatory agency with respect to two or more plant facilities which are included under a single plan of the taxpayer to construct, reconstruct, or erect such plant facilities, and

(ii) more than 50 percent of the aggregate adjusted basis of all the property of a character subject to the allowance for depreciation making up such plant facilities is attributable to either property the construction, reconstruction, or erection of which was begun by the taxpayer before April 19, 1969, or property the acquisition of which by the taxpayer occurred before such date,

such plant facilities shall be treated as a single plant facility.

(D) Commencement of construction.—For purposes of subparagraph (A) (ii), the construction, reconstruction, or erection of a plant facility shall not be considered to have commenced until construction, reconstruction, or erection has commenced at the site of such plant facility. The preceding sentence shall not apply if the site of such plant facility is not located on land.

(4) Machinery or equipment rule.—Any piece of machinery or equipment—

(A) more than 50 percent of the parts and components of which (determined on the basis of cost) were held by the taxpayer on April 18, 1969, or are acquired by the taxpayer pursuant to a binding contract which was in effect on such date, for inclusion or use in such piece of machinery or equipment, and

(B) the cost of the parts and components of which is not an insignificant portion of the total cost,

shall be treated as property which is pre-termination property.

(5) Certain lease-back transactions, etc.—

(A) Where a person who is a party to a binding contract described in paragraph (1) transfers rights in such contract (or in the property to which such contract relates) to another person but a party to such contract retains a right to use the property under a lease with such other person, then to the extent of the transferred right such other person shall, for purposes of

[Footnote 75917] Sec. 49 added by section 703(a), Tax Reform Act of 1969.

Effective date (Code Sec. 49).—General rule.—The investment credit is not available as to property, the physical construction, reconstruction or erection of which is begun after April 18, 1969, or which is acquired by the taxpayer after that date, as provided in Code Sec. 49(a)(1) and (2).

Exceptions: The credit is available as to property covered by the general rule to extent it is "pre-termination property" covered by Code Sec. 49(b), as provided in Sec. 49(a). Excluded from the above exception is property placed in service after 1975 (as provided in Sec. 49(d)). The credit is also not available as to certain leased property as provided in Sec. 49(e).

Relevant limiting dates are provided in Code provisions involved.

paragraph (1), succeed to the position of the transferor with respect to such binding contract and such property. In any case in which the lessor does not make an election under section 48(d)—

(i) the preceding sentence shall apply only if a party to the contract retains the right to use the property under a lease for a term of at least 1 year; and

(ii) if such use is retained (other than under a long-term lease), the lessor shall be deemed for the purposes of section 47 as having made a disposition of the property at such time as the lessee loses the right to use the property.

For purposes of clause (ii), if the lessee transfers the lease in a transfer described in paragraph (7), the lessee shall be considered as having the right to use of the property so long as the transferee has such use.

(B) For purposes of subparagraph (A)—

(i) a person who holds property (or rights in property) which is pre-termination property by reason of the application of paragraph (4) shall, with respect to such property, be treated as a party to a binding contract described in paragraph (1), and

(ii) a corporation which is a member of the same affiliated group (as defined in paragraph (8)) as the transferor described in subparagraph (A) and which simultaneously with the transfer of property to another person acquires a right to use such property under a lease with such other person shall be treated as the transferor and as a party to the contract.

(6) Certain lease and contract obligations.—

(A) Where, pursuant to a binding lease or contract to lease in effect on April 18, 1969, a lessor or lessee is obligated to construct, reconstruct, erect, or acquire property specified in such lease or contract or in a related document filed before April 19, 1969, with a Federal regulatory agency, or property the specifications of which are readily ascertainable from the terms of such lease or contract or from such related document, any property so constructed, reconstructed, erected, or acquired by the lessor or lessee shall be pre-termination property. In the case of any project which includes property other than the property to be leased to such lessee, the preceding sentence shall be applied, in the case of the lessor, to such other property only if the binding leases and contracts with all lessees in effect on April 18, 1969, cover real property constituting 25 percent or more of the project (determined on the basis of rental value). For purposes of the preceding sentences of this paragraph, in the case of any project where one or more vendor-vendee relationships exist, such vendors and vendees shall be treated as lessors and lessees.

(B) Where, in order to perform a binding contract or contracts in effect on April 18, 1969, (i) the taxpayer is required to construct, reconstruct, erect, or acquire property specified in any order of a Federal regulatory agency for which application was filed before April 19, 1969, (ii) the property is to be used to transport one or more products under such contract or contracts, and (iii) one or more parties to the contract or contracts are required to take or to provide more than 50 percent of the products to be transported over a substantial portion of the expected useful life of the property, then such property shall be pre-termination property.

(C) Where, in order to perform a binding contract in effect on April 18, 1969, the taxpayer is required to construct, reconstruct, erect, or acquire property specified in the contract to be used to produce one or more products and (unless the other party to the contract is a State or a political subdivision of a State which is required by the contract to make substantial expenditures which benefit the taxpayer) the other party to the contract is required to take substantially all of the products to be produced over a substantial portion of the expected useful life of the property, then such property shall be pre-termination property. For purposes of applying the preceding sentence in the case of a contract for the extraction of minerals, property shall be treated as specified in the contract if (i) the specifications

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for such property are readily ascertainable from the location and characteristics of the mineral properties specified in such contract from which the minerals are to be extracted; (ii) such property is necessary for and is to be used solely in the extraction of minerals under such contract; (iii) the physical construction, reconstruction, or erection of such property is begun by the taxpayer before April 18, 1970, such property is acquired by the taxpayer before April 18, 1970, or such property is constructed, reconstructed, erected, or acquired pursuant to a contract which was, on April 18, 1970, and at all times thereafter, binding on the taxpayer; (iv) such property is placed in service on or before December 31, 1972; (v) such contract is a fixed price contract (except for provisions for price changes under which the loss of the credit allowed by section 38 would not result in a price change); and (vi) such property is not placed in service to replace other property used in extracting minerals under such contract.

(7) Certain transfers to be disregarded.—

(A) If property or rights under a contract are transferred in—

(i) a transfer by reason of death,

(ii) a transaction as a result of which the basis of the property in the hands of the transferee is determined by reference to its basis in the hands of the transferor by reason of the application of section 232, 251, 331, 371(a), 374(a), 721, or 781, or

(iii) a sale of substantially all of the assets of the transferor pursuant to the terms of a contract, which was on April 18, 1969, and at all times thereafter, binding on the transferee,

and such property (or the property acquired under such contract) would be treated as pre-termination property in the hands of the decedent or the transferor, such property shall be treated as pre-termination property in the hands of the transferee.

(B) If—

(i) property or rights under a contract are acquired in a transaction to which section 334(b)(2) applies,

(ii) the stock of the distributing corporation was acquired before April 19, 1969, or pursuant to a binding contract in effect April 18, 1969, and

(iii) such property (or the property acquired under such contract) would be treated as pre-termination property in the hands of the distributing corporation,

such property shall be treated as pre-termination property in the hands of the distributee.

(8) Property acquired from affiliated corporation.—In the case of property acquired by a corporation which is a member of an affiliated group from another member of the same group—

(A) such corporation shall be treated as having acquired such property on the date on which it was acquired by such other member,

(B) such corporation shall be treated as having entered into a binding contract for the construction, reconstruction, erection, or acquisition of such property on the date on which such other member entered into a contract for the construction, reconstruction, erection, or acquisition of such property, and

(C) such corporation shall be treated as having commenced the construction, reconstruction, or erection of such property on the date on which such other member commenced such construction, reconstruction, or erection.

For purposes of this subsection and subsection (c), a contract between two corporations which are members of the same affiliated group shall not be treated as a binding contract as between such corporations, unless, at all times after June 30, 1969, and prior to the completion of performance of such contract, such corporations are not members of the same affiliated group. For purposes of the preceding sentences, the term "affiliated group" has the meaning assigned to it by section 1504(a), except that all corporations shall be treated as includible corporations (without any exclusion under section 1504(b)).

Fiscal Note

Introduced: 1/14/72
Referred: Finance

1 IN THE HOUSE

BY THE RULES COMMITTEE BY
REQUEST OF THE GOVERNOR

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HOUSE BILL NO. 512
IN THE LEGISLATURE OF THE STATE OF ALASKA
SEVENTH LEGISLATURE - SECOND SESSION

A BILL

For an Act entitled: "An Act relating to computation of taxable income under the Alaska net income tax; and providing for an effective date."

BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

* Section 1. AS 43.20.010(c) is amended by adding a new paragraph to read:

(9) For purposes of calculating the income tax payable under this section, the taxpayer may not apply as a credit against his tax liability the job development investment credit allowed as to federal taxes under Internal Revenue Code sec. 50.

* Sec. 2. This Act is retroactive to January 1, 1972 and takes effect on the day after its passage and approval or on the day it becomes law without approval.



RECORDS CERTIFICATION



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James D. Smith
Signature of Camera Operator

4/4/89
Date

"An Act relating to computation of taxable income under the Alaska net income tax; and providing for an effective date."

Committee Report

HOUSE OF REPRESENTATIVES

1/14/72
Mr. Speaker

February 26, 1972
Date

The Committee on FINANCE has had HB 512
under consideration. A majority of the members of the Committee

- recommends it do pass
- recommends it do not pass
- recommends it do pass with attached amendment(s)
- recommends it be replaced with CS for _____ and that
CS for _____ do pass
- (and) recommends it be referred to the _____
committee
- reports it back without recommendation
- (other) _____

MEMBERS SIGNING THE MAJORITY REPORT:

Hohman _____

Wassenaar _____

Rob. Aitman _____

Ed. DeGroot _____

MEMBERS NOT CONCURRING IN THE MAJORITY REPORT:

_____ recommends:

_____ recommends:

_____ recommends:

_____ recommends:

_____ recommends:

George H. Hohman Jr.
CHAIRMAN

Introduced: 1/14/72
Referred: Finance

1 IN THE HOUSE

BY THE RULES COMMITTEE BY
REQUEST OF THE GOVERNOR

2 HOUSE BILL NO. 512

3 IN THE LEGISLATURE OF THE STATE OF ALASKA

4 SEVENTH LEGISLATURE - SECOND SESSION

5 A BILL

6 For an Act entitled: "An Act relating to computation of taxable income
7 under the Alaska net income tax; and providing for an
8 effective date."

9 BE IT ENACTED BY THE LEGISLATURE OF THE STATE OF ALASKA:

10 * Section 1. AS 43.20.010(c) is amended by adding a new paragraph to
11 read:

12 (9) For purposes of calculating the income tax payable under
13 this section, the taxpayer may not apply as a credit against his tax
14 liability the job development investment credit allowed as to federal
15 taxes under Internal Revenue Code sec. 50.

16 * Sec. 2. This Act is retroactive to January 1, 1972 and takes effect
17 on the day after its passage and approval or on the day it becomes law
18 without approval.
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FISCAL NOTE
HB 512

The Legislature of the State of Alaska
FISCAL NOTE
Second Session - Seventh State Legislature

I. REQUEST

Bill Identification: House Bill No. 512
 Title: Relating to computation of taxable income under the Alaska Net Income
 Requested by: Legislative Finance Date: 1-17-72 Tax
 Return Date Requested: 1-31-72
 Agency: Revenue Program: Fiscal Services

II. FISCAL DETAIL

Budget Request Unit(s) Affected: _____

A. EXPENDITURES: (Thousands of dollars)

OBJECT	FY 72	FY 73	FY 74	FY 75	FY 76	FY 77
100 PERSONAL SERVICES						
200 TRAVEL						
300 CONTRACTUAL						
400 COMMODITIES						
500 EQUIPMENT						
600 LAND & STRUCTURES						
700 GRANTS, CLAIMS, ETC.						
TOTAL	NONE	NONE	NONE	NONE	NONE	NONE

B. FUNDING: (Thousands of dollars)

GENERAL FUND						
FEDERAL FUNDS						
OTHER						

C. POSITIONS:

PERMANENT/TEMPORARY	-0- /	/	/	/	/	/
MAN MONTHS (P./T.)	-0- /	/	/	/	/	/

III. ANALYSIS (See Fiscal Note Preparation Instructions, Section III)

See attached memorandum from A. L. Bue, Supervisor, Corporate Income Tax Unit, Audit Division, Department of Revenue concerning additional revenues to be gained under the provisions of House Bill 512 which does not allow the taxpayer to apply as a credit against his tax liability the job development investment credit allowed as to Federal taxes under Internal Revenue Code Sec. 50.

IV. ATTACHMENTS

V. DATE: January 27, 1972

PREPARED BY: _____

R. D. Stevenson
 R. D. Stevenson
 Deputy Commissioner
 Department of Revenue

Original: Legislative Finance
 cc: Budget and Management
 Prime Sponsor (First Legislator Named)

MEMORANDUM

TO: R. D. Stevenson
Deputy Commissioner

Through: T. L. File, Chief
Income Tax Section

FROM: *T. L. File*
A. L. Bue, Supervisor
Corporate Income Tax Unit

DATE: January 26, 1972

FILE NO:

SUBJECT: Fiscal Note Request--
HB 512

Following are revised Corporate Income Tax Unit revenue projections (which take into consideration HB 512) compared with current projections:

(Thousands of dollars)

	<u>FY 73</u>	<u>FY 74</u>	<u>FY 75</u>	<u>FY 76</u>	<u>FY 77</u>
HB 512 projection	\$7,072.6	\$8,454.0	\$8,893.3	\$8,930.7	\$8,776.3
Current projection	6,906.9	8,288.3	8,726.6	8,708.7	8,563.1
Net gain in revenues	<u>\$ 165.7</u>	<u>\$ 165.7</u>	<u>\$ 166.7</u>	<u>\$ 222.0</u>	<u>\$ 213.2</u>

BASIS FOR PROJECTIONS: (Percentages)

	<u>FY 73</u>	<u>FY 74</u>	<u>FY 75</u>	<u>FY 76</u>	<u>FY 77</u>
HB 512 growth rate	8.4	22.4	23.2	16.2	7.2
Projected growth rate	<u>6.0</u>	<u>20.0</u>	<u>20.0</u>	<u>13.0</u>	<u>4.0</u>
Growth rate increase	<u>2.4</u>	<u>2.4</u>	<u>3.2</u>	<u>3.2</u>	<u>3.2</u>

These growth rates take into consideration the new accelerated depreciation, the North Slope Pipeline, the advent of increased activity centered around oil feeder and gathering system construction in 1977, and the provisions of HB 512 which does not allow the taxpayer to apply as a credit against his tax liability the job development investment credit allowed as to Federal taxes under Internal Revenue Code Sec. 50.

ALB:mbc

- Sec. 207. Waiver of penalty for underpayment of 1971 estimated income tax.
- Sec. 208. Adjustment of withholding.
- Sec. 209. Changes in requirements of declaration of estimated income tax by individuals.
- Sec. 210. Expenses to enable individuals to be gainfully employed.
- Sec. 211. Levies on salaries and wages.

TITLE III—STRUCTURAL IMPROVEMENTS

- Sec. 301. Unearned income of taxpayers who are dependents of other taxpayers.
- Sec. 302. Limitation on carryovers of unused credits and capital losses.
- Sec. 303. Amortization of certain expenditures for on-the-job training and for child care centers.
- Sec. 304. Excess investment interest.
- Sec. 305. Farm losses of electing small business corporations.
- Sec. 306. Capital gain distributions of certain trusts.
- Sec. 307. Application of Western Hemisphere Trade Corporation provision under the Virgin Islands tax laws.
- Sec. 308. Capital gains and stock options.
- Sec. 309. Certain treaty cases.
- Sec. 310. Bribes, kickbacks, medical referral payments, etc.
- Sec. 311. Activities not engaged in for profit.
- Sec. 312. Certain distributions to foreign corporations.
- Sec. 313. Original issue discount.
- Sec. 314. Income from certain aircraft and vessels.
- Sec. 315. Industrial development bonds.
- Sec. 316. Disclosure or use of information by preparers of income tax returns.

TITLE IV—EXCISE TAX

- Sec. 401. Repeal or suspension of manufacturer excise tax on passenger automobiles, light-duty trucks, etc.
- Sec. 402. Credit against tax on coin-operated gaming devices.

TITLE V—DOMESTIC INTERNATIONAL SALES CORPORATIONS

- Sec. 501. Domestic international sales corporations.
- Sec. 502. Deductions, credits, etc.
- Sec. 503. Source of income.
- Sec. 504. Procedure and administration.
- Sec. 505. Export trade corporations.
- Sec. 506. Submission of annual reports to Congress.
- Sec. 507. General effective date of title.

TITLE VI—JOB DEVELOPMENT RELATED TO WORK INCENTIVE PROGRAM

- Sec. 601. Tax credit for certain expenses incurred in work incentive program.

TITLE VII—TAX INCENTIVES FOR CONTRIBUTIONS TO CANDIDATES FOR PUBLIC OFFICE

- Sec. 701. Allowance of credit.
- Sec. 702. Deduction in lieu of credit.
- Sec. 703. Effective date.

TITLE VIII—FINANCING OF PRESIDENTIAL ELECTION CAMPAIGNS

- Sec. 801. Presidential Election Campaign Fund Act.
- Sec. 802. Miscellaneous amendments.

(c) AMENDMENT OF 1954 CODE.—Except as otherwise expressly provided, whenever in this Act an amendment is expressed in terms of an amendment to a section or other provision, the reference is to a section or other provision of the Internal Revenue Code of 1954.

TITLE I—JOB DEVELOPMENT INVESTMENT CREDIT; DEPRECIATION REVISION

SEC. 101. RESTORATION OF INVESTMENT CREDIT.

(a) Subpart B of part IV of subchapter A of chapter 1 (relating to rules for computing credit for investment in certain depreciable property) is amended by adding at the end thereof the following new section:

“SEC. 50. RESTORATION OF CREDIT.

“(a) GENERAL RULE.—Section 49 (a) (relating to termination of credit) shall not apply to property—

“(1) The construction, reconstruction, or erection of which—

“(A) is completed by the taxpayer after August 15, 1971, or

“(B) is begun by the taxpayer after March 31, 1971, or

“(2) which is acquired by the taxpayer—

“(A) After August 15, 1971, or

“(B) after March 31, 1971, and before August 16, 1971, pursuant to an order which the taxpayer establishes was placed after March 31, 1971.

“(b) TRANSITIONAL RULE.—In applying section 46(c) (1) (A) in the case of property described in subsection (a) (1) (A) the construction, reconstruction, or erection of which is begun before April 1, 1971, there shall be taken into account only that portion of the basis which is properly attributable to construction, reconstruction, or erection after August 15, 1971. This subsection shall not apply to pre-termination property (within the meaning of section 49(b)).”

(b) CONFORMING AMENDMENTS.—

(1) Section 49(a) (relating to termination of credit) is amended by add-

ing at the end thereof the following new sentence: “This subsection shall not apply to property described in section 50.”

(2) Section 49(b) (defining pre-termination property) is amended by striking out “For purposes of this section” and inserting in lieu thereof “For purposes of this subpart”.

(3) Section 49(d) (relating to property placed in service after 1975) is hereby repealed.

(4) The heading for section 49 is amended to read as follows:

“SEC. 49. TERMINATION FOR PERIOD BEGINNING APRIL 19, 1969, AND ENDING DURING 1971.”

(5) The table of sections for subpart B of part IV of subchapter A of chapter 1 is amended by striking out the item relating to section 49 and inserting in lieu thereof the following:

“Sec. 49. Termination for period beginning April 19, 1969, and ending during 1971.

“Sec. 50. Restoration of credit.”

(c) ACCOUNTING FOR INVESTMENT CREDIT IN CERTAIN FINANCIAL REPORTS AND REPORTS TO FEDERAL AGENCIES.—

(1) IN GENERAL.—It was the intent of the Congress in enacting, in the Revenue Act of 1962, the investment credit allowed by section 38 of the Internal Revenue Code of 1954, and it is the intent of the Congress in restoring that credit in this Act, to provide an incentive for modernization and growth of private industry. Accordingly, notwithstanding any other provision of law, on and after the date of the enactment of this Act—

(A) no taxpayer shall be required to use, for purposes of financial reports subject to the jurisdiction of any Federal agency or reports made to any Federal agency, any particular method of accounting for the credit allowed by such section 38,

(B) a taxpayer shall disclose, in any such report, the method of accounting for such credit used by him for purposes of such report, and

(C) a taxpayer shall use the same method of accounting for such credit in all such reports made by him, unless the Secretary

of the Treasury or his delegate consents to a change to another method.

(2) EXCEPTIONS. — Paragraph (1) shall not apply to taxpayers who subject to the provisions of section 46(e) of the Internal Revenue Code of 1954 (as added by section 105(c) of this Act) or to section 203(e) of the Revenue Act of 1964 (as modified by section 105(e) of this Act).

SEC. 102. DETERMINATION OF QUALIFIED INVESTMENT.

(a) CHANGE IN USEFUL LIFE BRACKETS.—

(1) Section 46(c)(2) (relating to applicable percentage for purposes of determining qualified investment) is amended—

(A) by striking out "4 years" and inserting in lieu thereof "3 years",

(B) by striking out "6 years" each place it appears and inserting in lieu thereof "5 years", and

(C) by striking out "8 years" each place it appears and inserting in lieu thereof "7 years".

(2) The second sentence of section 48(a)(1) (defining section 38 property) is amended by striking out "4 years" and inserting in lieu thereof "3 years".

(b) USEFUL LIFE FOR INVESTMENT CREDIT PURPOSES.—The second sentence of section 46(c)(2) is amended to read as follows:

"For purposes of this subpart, the useful life of any property shall be the useful life used in computing the allowance for depreciation under section 167 for the taxable year in which the property is placed in service."

(c) TECHNICAL AMENDMENT.—Section 47(a)(6)(A) (relating to aircraft used outside the United States after April 18, 1969) is amended by striking out "4 years" and inserting in lieu thereof "3½ years".

(d) EFFECTIVE DATES.—

(1) The amendments made by subsections (a) and (b) shall apply to property described in section 50 of the Internal Revenue Code of 1954.

(2) In redetermining qualified investment for purposes of section 47(a) of the Internal Revenue Code of

1954 in the case of any property which ceases to be section 38 property with respect to the taxpayer after August 15, 1971, or which becomes public utility property after such date, section 46(c)(2) of such Code shall be applied as amended by subsection (a).

(3) The amendment made by subsection (c) shall apply to leases executed after April 18, 1969.

SEC. 103. LIMITATION OF CREDIT TO DOMESTIC PRODUCTS.

Section 48(a) (relating to definition of section 38 property) is amended by adding after paragraph (6) the following new paragraph:

"(7) PROPERTY COMPLETED ABROAD OR PREDOMINANTLY OF FOREIGN ORIGIN.—

"(A) IN GENERAL.—Property (other than pre-termination property) shall not be treated as section 38 property if—

(i) such property was completed outside the United States, or

(ii) less than 50 percent of the basis of such property is attributable to value added within the United States.

"For purposes of this subparagraph, the term 'United States' includes the Commonwealth of Puerto Rico and the possessions of the United States.

"(B) PERIOD OF APPLICATION OF PARAGRAPH.—Except as provided in subparagraph (D), subparagraph (A) shall apply only with respect to property described in section 50—

(i) the construction, reconstruction, or erection of which by the taxpayer is begun after August 15, 1971, and on or before the date of termination of Proclamation 4074, or

(ii) which is acquired pursuant to an order placed on or before the date of termination of Proclamation 4074, unless acquired pursuant to an order which the taxpayer establishes was placed before August 16, 1971.

"(C) PRESIDENT MAY EXEMPT ARTICLES.—If the President of the United States shall at any time

determine that the application of subparagraph (A) to any article or class of articles is not in the public interest, he may by Executive order specify that subparagraph (A) shall not apply to such article or class of articles. Subparagraph (A) shall not apply to an article or class of articles for the period specified in such Executive order. Any period specified under the preceding sentence shall not apply to property ordered before (or to property the construction, reconstruction, or erection of which began before) the date of the Executive order specifying such period, except that, if the President determines it to be in the public interest, such period shall apply to property ordered (or property the construction, reconstruction, or erection of which began) after a date (before the date of the Executive order) specified in the Executive order.

"(D) COUNTRIES MAINTAINING TRADE RESTRICTIONS OR ENGAGING IN DISCRIMINATORY ACTS.—If, on or after the date of the termination of Proclamation 4074, the President determines that a foreign country—

(i) maintains nontariff trade restrictions, including variable import fees, which substantially burden United States commerce in a manner inconsistent with provisions of trade agreements, or

(ii) engages in discriminatory or other acts (including tolerance of international cartels) or policies unjustifiably restricting United States commerce,

he may provide by Executive order for the application of subparagraph (A) to any article or class of articles manufactured or produced in such foreign country for such period as may be provided by Executive order."

SEC. 104. DEFINITION OF SECTION 38 PROPERTY.

(a) STORAGE FACILITIES.—

(1) IN GENERAL.—Section 48(a)(1)(B) (relating to other tangible property constituting section 38

property) is amended by striking out clause (ii) and inserting in lieu thereof the following:

"(ii) constitutes a research facility used in connection with any of the activities referred to in clause (i), or

"(iii) constitutes a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state), or".

(2) **CONFORMING AMENDMENT.**—Section 1245(a)(3)(B) (relating to other property constituting section 1245 property) is amended by striking out "or" at the end of clause (i), and by striking out clause (ii) and inserting in lieu thereof the following:

"(ii) constituted a research facility used in connection with any of the activities referred to in clause (i), or

"(iii) constituted a facility used in connection with any of the activities referred to in clause (i) for the bulk storage of fungible commodities (including commodities in a liquid or gaseous state)".

(b) **COIN-OPERATED MACHINES IN APARTMENT BUILDINGS.**—Section 48(a)(3) (relating to property used for lodging) is amended—

(1) by striking out "and" at the end of subparagraph (A),

(2) by striking out the period at the end of subparagraph (B) and inserting in lieu thereof ", and", and

(3) by adding after subparagraph (B) the following new subparagraph:

"(C) coin-operated vending machines and coin-operated washing machines and dryers."

(c) **CERTAIN PROPERTY USED IN FURNISHING COMMUNICATION SERVICES.**—

(1) Section 48(a)(5) (relating to property used by governmental units) is amended by inserting after "international organization" the following: "(other than the International Telecommunications Satellite Consortium or any successor organization)".

(2) Section 48(a)(2)(B) (relating to exceptions from rule for prop-

erty used outside the United States) is amended by striking out "and" at the end of clause (vi), by striking out the period at the end of clause (vii) and inserting in lieu thereof a semicolon, and by adding at the end thereof the following new clause:

"(viii) any communications satellite (as defined in section 103(3) of the Communications Satellite Act of 1962, 47 U.S.C., sec. 702(3)), or any interest therein, of a United States person;"

(3) Section 48(a)(2)(B) (relating to exceptions from rule for property used outside the United States) is amended by inserting after clause (viii) (as added by paragraph (2)) the following new clause:

"(ix) any cable, or any interest therein, of a domestic corporation engaged in furnishing telephone service to which section 46(c)(3)(B)(iii) applies (or of a wholly owned domestic subsidiary of such a corporation), if such cable is part of a submarine cable system which constitutes part of a communication link exclusively between the United States and one or more foreign countries; and".

(d) **CERTAIN PROPERTY USED TO EXPLORE FOR, DEVELOP, REMOVE, AND TRANSPORT RESOURCES FROM OCEAN WATERS AND SUBMARINE DEPOSITS.**—Section 48(a)(2)(B) (relating to exceptions from rule for property used outside the United States) is amended by inserting after clause (ix) (as added by subsection (c)(3)) the following new clause:

"(x) any property (other than a vessel or an aircraft) of a United States person which is used in international or territorial waters for the purpose of exploring for, developing, removing, or transporting resources from ocean waters or deposits under such waters."

(e) **LIVESTOCK.**—Section 48(a)(6) (relating to livestock) is amended to read as follows:

"(6) **LIVESTOCK.** — Livestock (other than horses) acquired by the taxpayer shall be treated as section 38 property, except that if substantially identical livestock is sold or otherwise disposed of by the taxpayer

during the one-year period beginning 6 months before the date of such acquisition and if section 47(a) (relating to certain dispositions, etc., of section 38 property) does not apply to such sale or other disposition, then, unless such sale or other disposition constitutes an involuntary conversion (within the meaning of section 1033), the cost of the livestock acquired shall, for purposes of this subpart, be reduced by an amount equal to the amount realized on such sale or other disposition. Horses shall not be treated as section 38 property."

(f) **AMORTIZED PROPERTY.**—

(1) **IN GENERAL.**—Section 48(a) (relating to definition of section 38 property) is amended by adding after paragraph (7) (as added by section 103 of this Act) the following new paragraph:

"(8) **AMORTIZED PROPERTY.**— Any property with respect to which an election under section 167(k), 169, 184, 187, or 188 applies shall not be treated as section 38 property. In the case of any property to which section 169 applies, the preceding sentence shall apply only to so much of the adjusted basis of the property as (after the application of section 169(f) constitutes the amortizable basis for purposes of section 169."

(2) **CONFORMING AMENDMENT.**—Section 169 (relating to amortization of pollution control facilities) is amended by striking out subsection (h).

(g) **RAILROAD TRACK.**—Section 48(a) (relating to definition of section 38 property) is amended by inserting after paragraph (8) (as added by subsection (f)) the following new paragraph:

"(9) **RAILROAD TRACK.**—In the case of a railroad (including a railroad switching or terminal company) which uses the retirement-replacement method of accounting for depreciation of its railroad track, the term 'section 38 property' includes replacement track material, if—

"(A) the replacement is made pursuant to a scheduled program for replacement,

"(B) the replacement is made pursuant to observations by maintenance-of-way personnel of spe-

cific track material needing replacement,

"(C) the replacement is made pursuant to the detection by a rail-test car of specific track material needing replacement, or

"(D) the replacement is made as a result of a casualty.

"Replacements made as a result of a casualty shall be section 38 property only to the extent that, in the case of each casualty, the qualified investment with respect to the replacement track material exceeds \$50,000. For purposes of this paragraph, the term 'track material' includes ties, rail, other track material, and ballast."

(h) EFFECTIVE DATES.—The amendments made by this section (other than by subsections (c) (1), (c) (2), and (g)) shall apply to property described in section 50 of the Internal Revenue Code of 1954. The amendments made by subsections (c) (1), (c) (2), and (g) shall apply to taxable years ending after December 31, 1961.

SEC. 105. REGULATED COMPANIES.

(a) INCREASE IN QUALIFIED INVESTMENT FOR PUBLIC UTILITY PROPERTY.—Section 46(c) (3) (A) (relating to qualified investment in case of public utility property) is amended by striking out "3/7" and inserting in lieu thereof "4/7".

(b) DEFINITION OF PUBLIC UTILITY PROPERTY, ETC.—Section 46(c) (3) (relating to public utility property) is amended—

(1) by inserting "or" at the end of clause (ii) of subparagraph (B), and by striking out clauses (iii) and (iv) of such subparagraph and inserting in lieu thereof the following:

"(iii) telephone service, telegraph service by means of domestic telegraph operations (as defined in section 222(a) (5) of the Communications Act of 1934, as amended; 47 U.S.C., sec. 222(a) (5)), or other communication services (other than international telegraph service);"

(2) by adding at the end of subparagraph (B) the following new sentence: "Such term also means communication property of the type used by persons engaged in providing telephone or microwave com-

munication services to which clause (iii) applies, if such property is used predominantly for communication purposes."; and

(3) by adding after subparagraph (B) the following new subparagraph:

"(C) In the case of any interest in a submarine cable circuit used to furnish telegraph service between the United States and a point outside the United States of a taxpayer engaged in furnishing international telegraph service (if the rates for such furnishing have been established or approved by a governmental unit, agency, instrumentality, commission, or similar body described in subparagraph (B)), the qualified investment shall not exceed the qualified investment attributable to so much of the interest of the taxpayer in the circuit as does not exceed 50 percent of all interests in the circuit."

(c) CREDIT NOT AVAILABLE IN CERTAIN CASES.—Section 46 (relating to amount of credit) is amended by adding at the end thereof the following new subsection:

"(e) LIMITATION IN CASE OF CERTAIN REGULATED COMPANIES.—

"(1) GENERAL RULE.—Except as otherwise provided in this subsection, no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

"(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection); or

"(B) RATE BASE REDUCTION.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

Subparagraph (B) shall not apply

if the reduction in the rate base is restored not less rapidly than ratably. If the taxpayer makes an election under this sentence within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, the immediately preceding sentence shall not apply to property described in paragraph (5) (B) if any agency or instrumentality of the United States having jurisdiction for ratemaking purposes with respect to such taxpayer's trade or business referred to in paragraph (5) (B) determines that the natural domestic supply of the product furnished by the taxpayer in the course of such trade or business is insufficient to meet the present and future requirements of the domestic economy.

"(2) SPECIAL RULE FOR RATABLE FLOW-THROUGH.—If the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraph (1) shall not apply, but no credit shall be allowed by section 38 with respect to any property described in section 50 which is public utility property (as defined in paragraph (5)) of the taxpayer—

"(A) COST OF SERVICE REDUCTION.—If the taxpayer's cost of service for ratemaking purposes or in its regulated books of account is reduced by more than a ratable portion of the credit allowable by section 38 (determined without regard to this subsection); or

"(B) RATE BASE REDUCTION.—If the base to which the taxpayer's rate of return for ratemaking purposes is applied is reduced by reason of any portion of the credit allowable by section 38 (determined without regard to this subsection).

"(3) SPECIAL RULE FOR IMMEDIATE FLOW-THROUGH IN CERTAIN CASES.—In the case of property to which section 167(1)

(2) (C) applies, if the taxpayer makes an election under this paragraph within 90 days after the date of the enactment of this paragraph in the manner prescribed by the Secretary or his delegate, paragraphs (1) and (2) shall not apply to such property.

“(4) LIMITATION.—

“(A) IN GENERAL.—The requirements of paragraphs (1) and (2) regarding cost of service and rate base adjustments shall not be applied to public utility property of the taxpayer to disallow the credit with respect to such property before the first final determination which is inconsistent with paragraph (1) or (2) (as the case may be) is put into effect with respect to public utility property (to which this subsection applies) of the taxpayer. Thereupon, paragraph (1) or (2) shall apply to disallow the credit with respect to public utility property (to which this subsection applies) placed in service by the taxpayer—

“(i) before the date that the first final determination, or a subsequent determination, which is inconsistent with paragraph (1) or (2) (as the case may be) is put into effect, and

“(ii) on or after the date that a determination referred to in clause (i) is put into effect and before the date that a subsequent determination thereafter which is consistent with paragraph (1) or (2) (as the case may be) is put into effect.

“(B) DETERMINATIONS.—

For purposes of this paragraph, a determination is a determination made with respect to public utility property (to which this subsection applies) by a governmental unit, agency, instrumentality, or commission or similar body described in subsection (c) (3) (B) which determines the effect of the credit allowed by section 38 (de-

termined without regard to this subsection)—

“(i) on the taxpayer's cost of service or rate base for ratemaking purposes, or

“(ii) in the case of a taxpayer which made an election under paragraph (2), on the taxpayer's cost of service for ratemaking purposes or in its regulated books of account or rate base for ratemaking purposes.

“(C) SPECIAL RULES.—For purposes of this paragraph—

“(i) a determination is final if all rights to appeal or to request a review, a rehearing, or a redetermination, have been exhausted or have lapsed,

“(ii) the first final determination is the first final determination made after the date of the enactment of this subsection, and

“(iii) a subsequent determination is a determination subsequent to a final determination.

“(5) PUBLIC UTILITY PROPERTY.—For purposes of this subsection, the term ‘public utility property’ means—

“(A) property which is public utility property within the meaning of subsection (c) (3) (B), and

“(B) property used predominantly in the trade or business of the furnishing or sale of (i) steam through a local distribution system or (ii) the transportation of gas or steam by pipeline, if the rates for such furnishing or sale are established or approved by a governmental unit, agency, instrumentality, or commission described in subsection (c) (3) (B).

“(6) RATABLE PORTION.—For purposes of determining ratable restorations to base under paragraph (1) and for purposes of determining ratable portions under paragraph (2) (A), the period of time used in computing deprecia-

tion expense for purposes of reflecting operating results in the taxpayer's regulated books of account shall be used.

“(7) REORGANIZATIONS, ASSETS ACQUISITIONS, ETC.—If by reason of a corporate reorganization, by reason of any other acquisition of the assets of one taxpayer by another taxpayer, by reason of the fact that any trade or business of the taxpayer is subject to ratemaking by more than one body, or by reason of other circumstances, the application of any provisions of this subsection to any public utility property does not carry out the purposes of this subsection, the Secretary or his delegate shall provide by regulations for the application of such provisions in a manner consistent with the purposes of this subsection.”

(d) EFFECTIVE DATE.—The amendments made by this section shall apply to property described in section 50 of the Internal Revenue Code of 1954.

(e) APPLICATION OF SECTION 203 (e) OF REVENUE ACT OF 1964.—Section 203(e) of the Revenue Act of 1964 shall not apply to public utility property to which section 46(e) of the Internal Revenue Code of 1954 (as added by subsection (c)) applies.

SEC. 106. INVESTMENT CREDIT CARRYOVERS AND CARRYBACKS.

(a) PRIORITY OF APPLICATION.—Section 46(b) relating to carryback and carryover of unused credits) is amended by inserting after paragraph (2) the following new paragraph:

“(3) SPECIAL RULES FOR CARRYOVERS FROM PRE-1971 UNUSED CREDIT YEARS.—The extent to which an investment credit carryover from an unused credit year ending before January 1, 1971, may be added under paragraph (1) for a taxable year beginning after December 31, 1970, shall be determined without regard to paragraph (2) (A). In determining the excess under paragraph (1) for any taxable year beginning after December 31, 1970, the limitation provided by subsection (a) (2) for such taxable year shall be reduced by the investment credit carryovers from such unused credit

years (to the extent such unused credit may not be added for a prior taxable year)."

(b) **EXTENSION OF CARRYOVER PERIOD.**—Section 46(b)(1) (relating to allowance of carryback and carryover of unused credits) is amended by adding at the end thereof the following new sentence: "In the case of an unused credit for an unused credit year ending before January 1, 1971, which is an investment credit carryover to a taxable year beginning after December 31, 1970 (determined without regard to this sentence), this paragraph shall be applied by substituting '10 taxable years' for '7 taxable years' in subparagraph (B) and by substituting '13 taxable years' for '10 taxable years' and '12 taxable years' for '9 taxable years' in the preceding sentence."

(c) **REMOVAL OF 20-PERCENT LIMITATION ON USE OF CARRYOVERS AND CARRYBACKS.**—

(1) **REMOVAL OF LIMITATION.**—Section 46(b)(5) (relating to carryback and carryover of unused credits to taxable years beginning after December 31, 1968, and ending after April 18, 1969) is amended—

(A) by striking out the heading and inserting:

"(5) **CERTAIN TAXABLE YEARS ENDING IN 1969, 1970, OR 1971.**—", and

(B) by striking out "ending after April 18, 1969," and inserting in lieu thereof "ending after April 18, 1969, and before January 1, 1972," and

(C) by adding at the end thereof the following new sentence:

"In the case of a taxable year ending after August 15, 1971, and before January 1, 1972, the percentage contained in the preceding sentence shall be increased by 6 percentage points for each month (or portion thereof) in the taxable year after August 15, 1971."

(2) **CONFORMING AMENDMENT TO ADDITIONAL 3-YEAR CARRYOVER PROVISION.**—Section 46(b)(6) (relating to additional 3-year carryover period in certain cases) is amended—

(A) by striking out "ending after April 18, 1969," and insert-

ing in lieu thereof "ending after April 18, 1969, and before January 1, 1971," and

(B) by striking out "following the last taxable year for which such portion may be added under paragraph (1)" and inserting in lieu thereof "following the 7th taxable year after the unused credit year".

(d) **EFFECTIVE DATES.**—The amendments made by subsections (a), (b), and (c)(2) shall apply to taxable years beginning after December 31, 1970. The amendments made by subsection (c)(1) shall apply to taxable years ending after August 15, 1971.

SEC. 107. TREATMENT OF CASUALTIES AND CERTAIN REPLACEMENTS.

(a) **CASUALTIES TREATED AS DISPOSITIONS.**—

(1) Sections 46(c)(4) (relating to certain replacements of section 38 property) and 47(a)(4) (relating to property destroyed by casualty, etc.) are hereby repealed.

(2) The repeals made by paragraph (1) shall apply to casualties and thefts occurring after August 15, 1971.

(b) **CERTAIN REPLACEMENTS DURING TERMINATION PERIOD.**—

(1) Section 47(a)(5) (relating to certain property replaced after April 18, 1969) is hereby repealed.

(2) The repeal made by paragraph (1) shall not apply if replacement property described in subparagraph (B) of such section 47(a)(5) is not property described in section 50 of the Internal Revenue Code of 1954.

SEC. 108. AVAILABILITY OF CREDIT TO CERTAIN LESSORS.

(a) **IN GENERAL.**—Section 46(d) (relating to limitations with respect to certain persons) is amended by adding at the end thereof the following new paragraph:

"(3) **NONCORPORATE LESSORS.**—A credit shall be allowed by section 38 to a person which is not a corporation with respect to property of which such person is the lessor only if—

"(A) the property subject to

the lease has been manufactured or produced by the lessor, or

"(B) the term of the lease (taking into account options to renew) is less than 50 percent of the useful life of the property, and for the period consisting of the first 12 months after the date on which the property is transferred to the lessee the sum of the deductions with respect to such property which are allowable to the lessor solely by reason of section 162 (other than rents and reimbursed amounts with respect to such property) exceeds 15 percent of the rental income produced by such property.

In the case of property of which a partnership is the lessor, the credit otherwise allowable under section 38 with respect to such property to any partner which is a corporation shall be allowed notwithstanding the first sentence of this paragraph. For purposes of this paragraph, an electing small business corporation (as defined in section 1371) shall be treated as a person which is not a corporation."

(b) **CREDIT MAY BE USED BY LESSEE.**—Section 48(d) (relating to certain leased property) is amended by striking out "section 46(d)" and inserting in lieu thereof "section 46(d)(1)".

(c) **CERTAIN PROPERTY LEASED FOR SHORT TERM.**—Section 48(d) (relating to investment credit for certain leased property) is amended to read as follows:

"(d) **CERTAIN LEASED PROPERTY.**—

"(1) **GENERAL RULE.**—A person (other than a person referred to in section 46(d)(1)) who is a lessor of property may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary or his delegate) elect with respect to any new section 38 property (other than property described in paragraph (4)) to treat the lessee as having acquired such property for an amount equal to—

"(A) except as provided in subparagraph (B), the fair market value of such property, or

"(B) if the property is leased by a corporation which is a component member of a controlled group (within the meaning of section 46(a)(5)) to another corporation which is a component member of the same controlled group, the basis of such property to the lessor.

"(2) SPECIAL RULE FOR CERTAIN SHORT TERM LEASES.—

"(A) IN GENERAL.—A person (other than a person referred to in section 46(d)(1)) who is a lessor of property described in paragraph (4) may (at such time, in such manner, and subject to such conditions as are provided by regulations prescribed by the Secretary or his delegate) elect with respect to such property to treat the lessee as having acquired a portion of such property for the amount determined under subparagraph (B).

(B) DETERMINATION OF LESSEE'S INVESTMENT.—The amount for which a lessee of property described in paragraph (4) shall be treated as having acquired a portion of such property is an amount equal to a fraction, the numerator of which is the term of the lease and the denominator of which is the class life of the property leased (determined under section 167(m)), of the amount for which the lessee would be treated as having acquired the property under paragraph (1).

"(C) DETERMINATION OF LESSOR'S QUALIFIED INVESTMENT.—The qualified investment of a lessor of property described in paragraph (4) in any such property with respect to which he has made an election under this paragraph is an amount equal to his qualified investment in such property (as determined under section 46(c)) multiplied by a fraction equal to the excess of one over the fraction used under subparagraph (B) to determine the lessee's investment in such property.

"(3) LIMITATIONS.—The elections provided by paragraphs (1) and (2) may be made with respect

to property which would be new section 38 property if acquired by the lessee. For purposes of the preceding sentence and section 46(c), the useful life of property in the hands of the lessee is the useful life of such property in the hands of the lessor. If a lessor makes the election provided by paragraph (1) with respect to any property, the lessee shall be treated for all purposes of this subpart as having acquired such property. If a lessor makes the election provided by paragraph (2) with respect to any property, the lessee shall be treated for all purposes of this subpart as having acquired a fractional portion of such property equal to the fraction determined under paragraph (2)(B) with respect to such property.

"(4) PROPERTY TO WHICH PARAGRAPH (2) APPLIES.—Paragraph (2) shall apply only to property which—

"(A) is new section 38 property,

"(B) has a class life (determined under section 167(m)) in excess of 14 years,

"(C) is leased for a period which is less than 80 percent of its class life, and

"(D) is not leased subject to a net lease (within the meaning of section 57(c)(2))."

(d) EFFECTIVE DATES.—The amendments made by subsections (a) and (b) shall apply to leases entered into after September 22, 1971. The amendment made by subsection (c) shall apply to leases entered into after November 8, 1971.

SEC. 109. REASONABLE ALLOWANCE FOR DEPRECIATIONS; REPAIR ALLOWANCE

(a) Section 167 (relating to depreciation) is amended by redesignating subsection (m) as subsection (n) and by inserting after subsection (l) the following new subsection:

"(m) CLASS LIVES.—

"(1) IN GENERAL.—In the case of a taxpayer who has made an election under this subsection for the taxable year, the term 'reasonable allowance' as used in subsection (a) means (with respect to property

which is placed in service during the taxable year and which is included in any class for which a class life has been prescribed) only an allowance based on the class life prescribed by the Secretary or his delegate which reasonably reflects the anticipated useful life of that class of property to the industry or other group. The allowance so prescribed may (under regulations prescribed by the Secretary or his delegate) permit a variance from any class life by not more than 20 percent (rounded to the nearest half year) of such life.

"(2) CERTAIN FIRST-YEAR CONVENTIONS NOT PERMITTED.—No convention with respect to the time at which assets are deemed placed in service shall be permitted under this section which generally would provide greater depreciation allowances during the taxable year in which the assets are placed in service than would be permitted if all assets were placed in service ratably throughout the year and if depreciation allowances were computed without regard to any convention.

"(3) MAKING OF ELECTION.—An election under this subsection for any taxable year shall be made at such time, in such manner, and subject to such conditions as may be prescribed by the Secretary or his delegate by regulations."

(b) REASONABLE REPAIR ALLOWANCE.—Section 263 (relating to capital expenditures) is amended by adding at the end thereof the following new subsection:

"(f) REASONABLE REPAIR ALLOWANCE.—The Secretary or his delegate may by regulations provide that the taxpayer may make an election under which amounts representing either repair expenses or specified repair, rehabilitation, or improvement expenditures for any class of depreciable property—

"(1) are allowable as a deduction under section 162(a) or 212 (whichever is appropriate) to the extent of the repair allowance for that class, and

"(2) to the extent such amounts exceed for the taxable year such re-

pair allowance, are chargeable to capital account.

Any allowance prescribed under this subsection shall reasonably reflect the anticipated repair experience of the class of property in the industry or other group."

RAILROAD ROLLING STOCK.—Section 263(e) (relating to expenditures in connection with certain railroad rolling stock) is amended—

(1) by striking out "shall be treated" and inserting in lieu thereof "shall, at the election of the taxpayer, be treated", and

(2) by adding at the end thereof the following new sentences: "An election under this subsection shall be made for any taxable year at such time and in such manner as the Secretary or his delegate prescribes by regulations. An election may not be made under this subsection for any taxable year to which an election under subsection (f) applies to railroad rolling stock (other than locomotives)."

(d) **EFFECTIVE DATES.**—

(1) The amendments made by subsection (a) shall apply to property placed in service after December 31, 1970.

(2) The amendment made by subsection (b) shall apply to taxable years ending after December 31, 1970.

(3) The amendments made by subsection (c) shall apply to taxable years beginning after December 31, 1969.

(e) **TRANSITIONAL RULES.**—

(1) **REAL PROPERTY.**—In the case of buildings and other items of section 1250 property for which a separate guideline life is prescribed in Revenue Procedure 62-21 (as amended and supplemented), the class lives first prescribed by the Secretary of the Treasury or his delegate under section 167(m) of the Internal Revenue Code of 1954 shall be the same as the guideline lives for such property in effect on December 31, 1970. Any such property which is placed in service by the taxpayer during the period beginning on January 1, 1971, and ending on December 31, 1973 (or

such earlier date on which a class life subsequently prescribed by the Secretary of the Treasury or his delegate under such section becomes effective for such property) may, in accordance with regulations prescribed by the Secretary of the Treasury or his delegate, be excluded by the taxpayer from an election under such section if a life for such property shorter than the class life prescribed in accordance with the preceding sentence is justified under Revenue Procedure 62-21 (as amended and supplemented).

(2) **SUBSIDIARY ASSETS.**—If a significant portion of a class of property first prescribed by the Secretary of the Treasury or his delegate under section 167(m) of the Internal Revenue Code of 1954 consists of subsidiary assets, all such subsidiary assets in such class placed in service by the taxpayer during the period beginning on January 1, 1971, and ending on December 31, 1973 (or such earlier date on which a class which includes such subsidiary assets subsequently prescribed by the Secretary of the Treasury or his delegate under such section becomes effective), may, in accordance with regulations prescribed by the Secretary of the Treasury or his delegate, be excluded by the taxpayer from an election under such section.

TITLE II—CHANGES IN PERSONAL EXEMPTIONS, MINIMUM STANDARD DEDUCTION, WITHHOLDING, ETC.

SEC. 201. INCREASE IN PERSONAL EXEMPTION.

(a) **INCREASE IN PERSONAL EXEMPTION TO \$675 FOR 1971.**—Effective with respect to taxable years beginning after December 31, 1970, and before January 1, 1972—

(1) section 151 (relating to allowance of deductions for personal exemptions) is amended by striking out "\$650" each place it appears and inserting in lieu thereof "\$675"; and

(2) section 6013(b)(3)(A) (relating to assessment and collection in case of certain returns of husband and wife) is amended by striking out "\$650" each place it appears and

inserting in lieu thereof "\$675"; and by striking out "\$1,300" each place it appears and inserting in lieu thereof "\$1,350".

(b) **INCREASE IN PERSONAL EXEMPTION TO \$750 FOR 1972 AND SUBSEQUENT YEARS.**—Effective with respect to taxable years beginning after December 31, 1971—

(1) section 151 (relating to allowance of deductions for personal exemptions) is amended by striking out "\$675" each place it appears and inserting in lieu thereof "\$750"; and

(2) section 6013(b)(3)(A) (relating to assessment and collection in the case of certain returns of husband and wife) is amended by striking out "\$675" each place it appears and inserting in lieu thereof "\$750"; and by striking out "\$1,350" each place it appears and inserting in lieu thereof "\$1,500".

(c) **TECHNICAL AMENDMENT.**—Subsections (c) and (d) of section 801 of the Tax Reform Act of 1969 are hereby repealed.

SEC. 202. INCREASE IN PERCENTAGE STANDARD DEDUCTION.

Effective with respect to taxable years beginning after December 31, 1971, the last two lines in the table in section 141(b) (relating to percentage standard deduction) are amended to read as follows:

SEC. 203. LOW INCOME ALLOWANCE.

(a) **ELIMINATION OF PHASEOUT FOR 1971.**—Effective with respect to taxable years beginning after December 31, 1970, and before January 1, 1972, section 141(c) (relating to low income allowance) is amended to read as follows:

"(c) **LOW INCOME ALLOWANCE.**—The low income allowance is \$1,050 (\$525 in the case of a married individual filing a separate return)."

(b) **INCREASE OF LOW INCOME ALLOWANCE FOR 1972 AND THEREAFTER.**—Effective with respect to taxable years beginning after December 31, 1971, section 141(c) (relating to low income allowance) is amended to read as follows:

"(c) **LOW INCOME ALLOWANCE.**—The low income allowance is \$1,300

¶ 5897 Community income.—A spouse in a community property state should treat his share of income earned by the other spouse as earned income received by him. Social security benefits, as well as taxable pensions, attributable to earnings which constitute community income, are similarly handled.

For addition to maximum limitation for married taxpayers both 65 or over, see ¶ 5895-A.

Example.—A husband and wife each qualify for the credit, as explained at ¶ 5892(e). Both are over 65, but under 72.

In the calendar year, the husband received earned income of \$800, social security benefits of \$600, and a fully taxable employee's pension of \$1,600.

In the same year, the wife received earned income of \$200, social security benefits of \$300, and a fully taxable employee's pension of \$600.

The retirement income of each is \$1,100 or $\frac{1}{2}$ of (\$1,600 + \$600).

The limitation on the retirement income of each is \$1,074, and each is entitled to a credit of \$161.10 (15% of \$1,074). The limitation is computed as follows:

1.			\$1,524
2. Amount (under Sec. 37(d)(2)(B)) by which earned income (\$550)* exceeds \$1,200		\$ 0	
3. Social security benefits— $\frac{1}{2}$ of (\$600 + \$300)	450		450
4. Retirement income may not exceed			\$1,074

* $\frac{1}{2}$ of (\$800 + \$200)

(5) Community share in spouse's earned income. — Retirement income credit of wife reduced by her community share in husband's earned income. Retirement income and earned income community property; both must be equally divided between spouses. *Warren R. Miller, Sr.*, 51 TC 755.

(10) Retirement annuity as community property.—Federal employee's re-

tirement annuity was community property in proportion that domicile of community in community property state bears to his entire period of employment. Character of retirement income isn't determined by marital status and domicile at time retirement income is received. Taxpayer acquired rights in fund throughout employment period not after it. *W. F. Williams*, 51 TC 346.

¶ 5898 Retirement income—additional references.—

Credit for retirement income does not affect requirement for withholding on such income ¶ 34,598

INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY

¶ 5901 Basic rules.—For taxable years ending after 1961, Sec. 38, ¶ 5902, allowed a credit against tax for investment in certain depreciable property. This investment credit was terminated, with certain exceptions, by the '69 Tax Reform Act. Generally, the credit is not available as to property constructed or acquired after 4-18-69. For extended discussion, see ¶ 5921.

¶ 5902 CODE SEC. 38. INVESTMENT IN CERTAIN DEPRECIABLE PROPERTY.

(a) General Rule.—There shall be allowed, as a credit against the tax imposed by this chapter, the amount determined under subpart B of this part.

(b) Regulations.—The Secretary or his delegate shall prescribe such regulations as may be necessary to carry out the purposes of this section and subpart B.

[Footnote ¶ 5902] Added by section 2(a) Revenue Act of 1962, which redesignated former Code Sec. 38 as Sec. 39.

Effective date (Sec. 2(b), Revenue Act of 1962).—Applies to taxable years ending after December 31, 1961.

0-7 ¶ 5903 Reg. § 1.38-1 (TD 6931, filed 10-9-67.) Investment in certain depreciable property.

Sections 1.40-1 through 1.48-7, inclusive, are prescribed under the authority granted the Secretary or his delegate by section 38 (b) of the Code to prescribe such regulations as may be necessary to carry out the purposes of section 38 and subpart B, part IV, subchapter A, chapter 1 of the Code.

GASOLINE, SPECIAL FUELS, AND LUBRICATING OIL TAX CREDITS

¶ 5905 Basic rules.—The Airport and Airway Revenue Act of 1970 (P.L. 91-258, 5-21-70) changed the method of claiming refunds or credits of taxes for certain uses of gasoline, special fuel, and lubricating oil. For taxable years ending after 6-30-70, claims for refunds under Secs. 6420, 6421, 6424, and 6427, or credits under Sec. 39 for amounts payable under such provisions, must be filed not later than the time prescribed by law for filing a claim for credit or refund for the taxable year involved. ¶ 36,571. The refund is ordinarily taken as a direct credit on the income tax return. This is a 3-year extension of the rule under prior law: individual taxpayers now have 39½ months, rather than 3½ months (corporations 38½ months, rather than 2½) after the close of the taxable year of overpayment in which to file a claim for refund or credit. However, refund claims of \$1,000 or more per quarter will continue to be filed within 3 months of the close of the quarter for which the refund is sought. Refund claims by governmental bodies and organizations exempt under Sec. 501(a) which don't file income tax returns may also be filed within the time for claiming income tax refund claims.

A claim for refund or credit of the tax on gasoline imposed by Sec. 4081 may be filed for: gasoline used during the taxable year for farming purposes (Sec. 6420) and gasoline used otherwise than as a fuel in a highway vehicle, or in vehicles while engaged in furnishing certain public passenger land transportation service (Sec. 6421). Refund or credit of the tax on lubricating oil imposed by Sec. 4091 may be claimed for lubricating oil not used during the taxable year in a highway motor vehicle (Sec. 6424). The tax on special fuels imposed by Sec. 4041(a) and (b), and the tax on fuel and gasoline used in noncommercial aviation imposed by Sec. 4041(c) are refunded or credited if the fuels aren't used for taxable purposes, or are resold during a taxable year ending after 6-30-70 (Sec. 6427).

The total Sec. 39 credit is the sum of the amounts payable as refunds to the taxpayer in the above situations. Exempt organizations and governments (U.S., State and local) can't use the credit as they receive direct payment of the refund from IRS. Sec. 39(c).

For transitional rules involving certain credits for taxable years beginning after 6-30-65, see Sec. 39(b).

Any individual, estate, trust, or corporation, including a small business corporation, claiming the credit must file and attach Form 4136 to the income tax return. See ¶ 5911(10).

L ¶ 5906 CODE SEC. 39. CERTAIN USES OF GASOLINE, SPECIAL FUELS, A AND LUBRICATING OIL.

W (a) General Rule.—There shall be allowed as a credit against the tax imposed by this subtitle for the taxable year an amount equal to the sum of the amounts payable to the taxpayer—

on gasoline used after 6-30-65, for certain nonhighway purposes. *Rev. Rul. 67-28, 1967-1 CB 359*, supplementing *Rev. Rul. 66-48, above*, and *Rev. Rul. 68-876, above*.

Interest is payable on an overpayment of income tax resulting from a credit allowed on certain uses of gasoline and lubricating oil. *Rev. Rul. 67-314, 1967-2 CB 418*.

(10) Revised Form 4136 is used to claim credit on income tax return for excise tax: (1) on gasoline used for nonhighway purposes, by certain local transit systems, and on a farm for farming purposes; (2) on lubricating oil used otherwise than in a highway motor vehicle; and (3) on special fuels used after June 30, 1970, on a farm for farming purposes, by certain local transit systems, and for certain other nontaxable purposes (for

example, aviation fuels used in aircraft in other than noncommercial aviation). *TIR-1047, ¶ 55,414 P-H Fed. 1970*.

Credit under Sec. 6421(a) for tax paid on gasoline by non-resident must be made on income tax return (with Form 4136) even though return not otherwise required. *Rev. Rul. 69-406, 1969-2 CB 261*.

(15) Small business corporations. — Procedures are provided for small business corp. to file claim for credit of Federal excise tax on gasoline used for nonhighway purposes during taxable year beginning after 6-30-65, and ending before 12-31-68. *Rev. Proc. 67-5 (TIR 569), 1967-1 CB 575*.

(20) Timely filing.—Both return and request for extension untimely; credit not allowed. *Robert E. Kennedy, ¶ 70,058 P-H Memo TC (pending before 3 Cir.)*.

TERMINATION OF INVESTMENT CREDIT

[[5921]] Basic rules.—The investment credit, established by the '62 Revenue Act, was repealed by Sec. 49, ¶ 5977, added by the '69 Tax Reform Act. However, a taxpayer may still use the credit provided the following conditions are met:

- (1) property which would qualify for the investment credit is acquired on or before April 18, 1969, or
- (2) the physical construction, reconstruction, or erection of such property is begun on or before April 18, 1969, or
- (3) such property is constructed, reconstructed, erected, or acquired after April 18, 1969 pursuant to a contract which was, on April 18, 1969, and at all times thereafter binding on the taxpayer, or
- (4) the property is "pre-termination" property (defined below), and
- (5) in each case, the property is placed in service on or before December 31, 1975. Sec. 49(a), (d).

For property qualifying for the investment credit, see ¶ 5925 and ¶ 5926.

Binding contract rule. The investment credit remains available for property which is constructed, reconstructed, erected, or acquired pursuant to a contract that was binding on the taxpayer on April 18, 1969 and thereafter. The contract must be between taxpayer and the builder or supplier of the property, and the construction or acquisition of the property must be the subject of the contract. The determination of whether an arrangement between taxpayer and a builder is a "contract" is left to local law. An oral contract may be enough to preserve the investment credit, if taxpayer can prove, by memorandums or other evidence, that the contract was actually entered into by April 18. Sec. 49(b)(1).

A contract may be considered binding even though (a) the price is to be determined later, (b) it is subject to conditions under the control of a third party, or (c) it is subject to minor modifications. But, even though a contract is binding on a taxpayer on April 18, 1969, it is not considered binding if it is substantially modified later. An option is treated as a binding contract only if the amount paid for the option (a) will be forfeited by the option holder upon failure to exercise it, (b) is more than nominal in relation to the total purchase price of the property, and (c) is to be applied against the purchase price if the option is exercised, or was taken into account in setting the price.

Example.—On April 1, 1969, X Corp. got an option to buy a generator which the seller-manufacturer generally sells for \$200,000. X paid \$30,000 for the option and agreed to pay \$170,000 for the generator if it exercises the option. If X doesn't exercise the option, no part of the \$30,000 will be returned to it. As X, upon failure to exercise the option, would forfeit an amount which is more than nominal, and since the amount paid for the option was taken into account in fixing the purchase price, X has a binding contract and the entire cost of the generator qualifies for the credit.

If taxpayer is bound under a contract to buy two or more specified items, the credit is available only for the least costly of the items which he could purchase.

Example.—Smith's contract requires him to buy either machine A for \$25,000 or machine B for \$20,000. The contract is binding only as to machine B.

Pre-termination property. Sec. 49(b) defines pre-termination property to which the repeal of the investment credit doesn't apply, if the property is placed in service before 1976. The following rules make up the definition:

(1) *Equipped building rule.*—The taxpayer may use the investment credit if, (a) pursuant to a plan existing on April 18, 1969, and not substantially modified thereafter, he constructs (reconstructs or erects) or acquires a building and the machinery and equipment necessary to the planned use of the building, and (b) more than 50% of the cost of the entire project (building and equipment) is attributable to property on which construction was begun by taxpayer before April 19, 1969, or which was acquired by taxpayer or was under binding order before that date. The credit is then available for the building and necessary equipment and for any incidental adjacent property which is necessary to the planned use of the building (the so-called "appurtenances"). However, these appurtenances are not to be included in the computation of the entire cost of the project which determines whether the equipped building rule will apply. Nor does the equipped building rule apply to any building, machinery, equipment, or appurtenances which don't otherwise qualify for the credit. Sec. 49(b)(2).

Example.—A taxpayer's expansion plans included the building of a new factory costing \$400,000 and equipping it with new machinery costing \$300,000. Construction of the building began on April 1, 1969, but there were no binding contracts on April 18, 1969 for any of the equipment. Result: The entire \$300,000 cost of the equipment qualifies for the investment credit. The reason: Starting construction on the building (\$400,000) is a binding commitment which covers more than 50% of the total cost (\$700,000) of the entire project. (Of course, the reverse situation would also be true, where you had contracts on equipment for more than 50% of the entire cost of the project but construction had not commenced as of the cutoff date.)

If the equipped building rule doesn't apply, taxpayer should consider whether each piece of machinery or equipment separately qualifies for the credit. In determining the cost of the machinery or equipment, whether or not the equipped building rule applies, the machinery and equipment rule (see (3) below) may prove helpful.

(2) *Plant facility rule.*—The investment credit is available to a taxpayer who, pursuant to a definite plan existing on April 18, 1969, which remains substantially unchanged, constructs, reconstructs or erects a plant facility. The term plant facility means a facility which doesn't include any building (or in which buildings are an insignificant portion) and which is (i) a self-

contained, single operating unit or processing operation, (ii) located on a single site, and (iii) identified on April 18, 1969, in the purchasing and internal financial plans of the taxpayer as a single unitary project. Sec. 49(b)(3)(B). If taxpayer had begun construction of such a facility at its site before April 19, 1969, the credit will apply to all property making up the facility (if otherwise eligible). If construction wasn't begun before the cut-off date, the credit still applies to the plant facility if more than 50% of the cost of the depreciable property making up the facility is attributable either to property, the construction of which was begun before April 19, 1969, or to property acquired before that date. Again, property subject to a binding contract, and property qualifying under the machinery and equipment rule (in (3) below) is included in determining whether the facility meets the 50% requirement.

For rules where a Federal regulatory agency has issued a certificate of convenience and necessity for two or more plant facilities, see Sec. 49(b)(3)(C), ¶ 5977.

(3) *Machinery and equipment rule.*—An entire piece of machinery or equipment qualifies for the investment credit if more than 50% of its parts were held by taxpayer on April 18, 1969, or were acquired later pursuant to a binding contract in effect on that date. The 50% rule is determined on the basis of cost, and the parts and components must not be an "insignificant portion" of total cost. This rule applies both to separate pieces of machinery and to machinery and equipment used in an equipped building or plant facility (see above), as well as to certain leaseback transactions. Sec. 49(b)(4).

(4) *Certain lease-back transactions.*—When a party to a contract for the building or buying of property which was binding on April 18, 1969, transfers his rights in the contract (or property) to another person, but retains, under a lease-back situation, the right to use the property, the transferee of the contract or property rights succeeds to the position of the transferor (the original party to the contract). Sec. 49(b)(5)(A). As a lessor, the transferee may elect, under Sec. 48(d), ¶ 5965, to have the lessee take the investment credit. If the lessor decides to take the credit himself, the lease-back must run at least one year, and the termination of the lease (except if it is for a term of 8 years or more) will be deemed a disposition by the lessor subject to recapture under Sec. 47(a), ¶ 5953.

This provision applies not only to parties to binding contracts but also to persons holding property entitled to the investment credit through the application of special machinery and equipment rule (discussed at (3) above), if the above lease-back rules are followed. There are also special rules for corporations which are members of the same affiliated group. Sec. 49(b)(5)(B), ¶ 5977.

(5) *Certain lease and contract obligations.*—The investment credit is available to parties to leases and contracts which were binding on April 18, 1969 if:

(i) the taxpayer was required to construct (reconstruct or erect) or acquire property specified in such lease or contract, or specified in related documents filed with a Federal regulatory agency before April 19, or property the specifications of which are easily ascertainable from such contract, lease, or document. Such otherwise eligible property qualifies for the investment credit. If a project includes property not covered by a specific agreement, the credit applies to this other property only if binding leases and contracts in effect on April 18, covered real property constituting at least 25% of the project;

(ii) the taxpayer was required to construct (reconstruct or erect) or acquire property specified in an order of a Federal regulatory agency for which application was filed before April 19, 1969, where the property was to be used to transport one or more products under binding contracts. This rule applies where a company had a binding contract to buy or sell fuel and was required to construct a pipeline to transport it. The investment credit applies to the property constructed (e.g., the pipeline) only if one or more parties to the contract or contracts were required, as of April 18, to take or provide more than 50% of the products (e.g., the fuel) to be transported over a substantial portion of the useful life of the property;

(iii) the taxpayer was required to construct or acquire property specified in the contract to be used to produce one or more products, and the other party to the contract was required to take substantially all of the products to be produced over a substantial portion of the expected useful life of the property. In such a case, the investment credit is available for the property. For special rules in the case of a contract with a State or local government, and in the case of a contract for the extraction of minerals, see Sec. 49(b)(6)(C).

(6) *Certain transfers to be disregarded.*—If property or rights under a contract would be treated as pre-termination property in the hands of a transferor or decedent, the fact that any of the following transfers occurred is disregarded in determining the eligibility of property for the credit:

(i) a transfer by reason of death,

(ii) a transfer where the transferee's basis is determined by the basis of the property in the hands of the transferor because of the application of sections 332, 351, 361, 371(a), 374(a), 721, or 731, or

(iii) a Sec. 334(b)(2) distribution to a purchasing corporation, if the liquidated corporation was able to use the investment credit, or

(iv) a sale of substantially all of the assets of the transferor under a pre-April 19 binding contract. Sec. 49(b)(7).

(7) *Property acquired from affiliated corporation.*—When a corporation which is a member of an affiliated group as defined in Sec. 1504(a) acquires property from another member of the same group, the acquirer generally steps into the shoes of the corporation from which the property was acquired. A contract between members of an affiliated group is not treated as a binding contract, unless the corporations have disaffiliated by June 30, 1969, and prior to the completion of the performance of the contract. Sec. 49(b)(8).

(8) *Barges for ocean-going vessels.*—Barges specifically constructed or acquired for use with ocean-going vessels which are designed to carry barges are entitled to the investment credit, along with the necessary machinery and equipment installed on such barges, if the ocean-going vessels are eligible for the credit, and if the conditions of Sec. 49(b)(9), are met.

(9) *Certain new-design products.*—A taxpayer can still use the investment credit if, on April 18, 1969:

(i) he had a binding fixed-price contract to produce a product of a new design which covered more than 50% of the entire production of such design to be delivered by the taxpayer before January 1, 1973, and

(ii) more than 50% of all depreciable property required to be constructed (reconstructed or erected) or acquired to carry out the binding contracts was either constructed by the taxpayer, acquired by him, or was under a binding contract for such construction or acquisition.

However, the credit will remain unavailable, unless the tangible personal property required to carry out the binding contracts is placed in service before January 1, 1972. For special rules relating to jigs, dies, templates, and other similar items, see Sec. 49(b)(10).

Prohibition of certain lease transactions. A taxpayer may not obtain an investment credit by changing his ordinary course of business from sales to lease transactions. Sec. 49(c). If property which is eligible for the credit while in the hands of the lessor, but ineligible for the credit if sold to the lessee, is leased after April 18, 1969 (other than pursuant to a binding contract to lease), the credit is not available either to the lessor or to the lessee, if the property is of the kind which the lessor before April 19, sold to customers. Likewise, the credit remains unavailable to either party, where it was the lessor's custom, before April 19, to lease the property and allow the lessee to use the investment credit under Sec. 48(d).

Other rules. In situations where the investment credit remains available, the '69 Tax Reform Act made certain changes in its operation for taxable years beginning after December 31, 1968, and ending after April 18, 1969. Further limitations on the use of carryovers and carrybacks are discussed at ¶ 5924. Changes as to investment credit recapture are at ¶ 5927.

The following material at ¶ 5921.5 et seq. covers rules applicable to taxpayers to whom the investment credit remains available under the above discussion.

PRE-TERMINATION RULES

[¶ 5921.5] **Basic rules.**—The investment credit was repealed, with certain exceptions, by the '69 Tax Reform Act. The discussion in this and the following paragraphs presents applicable rules where the credit may still be used as discussed at ¶ 5921.

The investment credit is a credit against tax equal to a percentage of the investment. Broadly speaking, 7% of "qualified investment" in new, and to a limited extent in used, depreciable property (but not buildings) may be subtracted from tax liability. Thus if tax before credit is \$10,000 and the credit figured as below is \$2,000, the tax payable is \$8,000. Secs. 38; 46, ¶ 5902; 5939.

The credit offsets tax liability dollar-for-dollar up to the first \$25,000 of tax. For the amount of tax above \$25,000, the credit is a 50% offset (25% for taxable years ending on or before 3-9-67—see ¶ 5923), but the amount not usable because of this limitation in the current year may be carried back to the 3 preceding years (but not before 1962) and carried over to the succeeding 5 years (7 years if fifth taxable year following the unused credit year ends after 12-31-66).

Since the Revenue Act of 1964 repealed Sec. 48(g), credit does not reduce basis and thus doesn't limit total depreciation allowance. This applies generally to property put in service *after* December 31, 1963, even though the taxable year began earlier.

As to property put in service before 1964, reduction must still be made. Reg. § 1.48-7(a), (b), ¶ 5975. But it can be written back as of the first taxable year *beginning* after 1963. Reg. § 1.48-7(d). This means future depreciation deductions will be increased. Taxpayer cannot, however, obtain a refund for prior reductions in depreciation because of the basis write-down.

Prior to this change, reduction of basis had to be made even though

the limitation based on tax prevented full current use of the credit. If the carryover period expired without absorbing the whole credit, a deduction equal to the unused credit was allowed to compensate for the over-reduction in basis. If the credit was adjusted under the recapture rule an upward adjustment of basis was made. Since no reduction in basis is required for tax years beginning after 12-31-63, the deduction for the unused credit is no longer available and Sec. 181 was repealed.

Recapture of credit is discussed at ¶ 5927. For special classes of taxpayers and partnerships, see ¶ 5930.

The credit applies to all taxable years ending after December 31, 1961, but only as to qualified investment acquired, constructed, or reconstructed after that date. The use of the credit was temporarily suspended for the period beginning on 10-10-66 and ending on 3-9-67. Generally, there was no investment credit for new or used machinery or equipment (in excess of \$20,000 of investment) acquired by taxpayer during the suspension period or acquired, pursuant to an order placed during such period, before 5-24-67, unless certain exceptions applied. Detailed discussion of suspension rules is at ¶ 5998.

Property qualifies for the credit in the year it is put into service by the taxpayer even though under his depreciation method depreciation does not start until the following year. Reg. § 1.46-3(d)(1), ¶ 5945. But an exception is provided in Reg. § 1.46-3(d)(4)(ii) where the basis of the property does not reflect its full cost. Property held for rent is placed in service in the year possession is transferred to the lessee. Reg. § 1.46-3(d)(3). The investment is not prorated according to the period of use in the initial year; in short, all of the investment is taken into account, if at all, that year even though the property is not put into service until the last day of the taxable year.

Additional references:

Temporary suspension of investment credit	¶ 5998
Décisions and rulings	¶ 5987—5989
Items taken into account in certain corporate acquisitions	¶ 18,501
Period of limitation with respect to investment credit carrybacks	¶ 36,491; 36,597
Effect of investment credit carryback on the computation of interest on tax	¶ 37,016; 37,046
Depreciation guidelines and rules	¶ 15,196
Additional first year depreciation	¶ 16,238

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¶ 5922 Useful-life test and percentage taken into account.—Only property having a useful life of at least 4 years to the taxpayer at the time of acquisition qualifies. If useful life is at least 4 years, the tentative credit is 7% times the basis or cost—to the extent taken into account—of qualified property acquired during the year. The part of the basis or cost taken into account varies with the useful life of the property as follows:

- (1) If useful life is 8 years or more, 100%—that is 7% of basis or cost is allowed.
- (2) If useful life is 6 or 7 years, 66⅔%—that is 4⅔% of basis or cost is allowed.
- (3) If useful life is 4 or 5 years, 33⅓%—that is 2⅓% of basis or cost is allowed. Sec. 46(c)(2), ¶ 5939.
- (4) If useful life is less than 4 years, no credit.

Example:

<i>Asset</i>	<i>Useful life</i>	<i>Cost</i>	<i>Qualified investment</i>
Truck	4	\$12,000	\$ 4,000 (⅓)
Office machine	7	18,000	12,000 (⅔)
Plant equipment	10	20,000	20,000
			\$36,000
			.97
			\$ 2,520
To put it another way:			
<i>Asset</i>	<i>Cost and Percent</i>		<i>Credit</i>
Truck	\$12,000 × 2⅓% =		\$ 220
Office machine	\$18,000 × 4⅔% =		810
Plant equipment	\$20,000 × 7% =		1,490
			\$2,520

For property used mainly in the utility business of most regulated public utilities, the amount taken into account is ⅓ of the above percentages. In other words, 3% for 8-year property; 2% for 6- or 7-year property; and 1% for 4- or 5-year property. Sec. 46(c)(3).

Note that an estimated useful life must be assigned to each separate asset. This is true even if the taxpayer is using a multiple-asset account or is grouping assets into the new Guideline classes of the depreciation reform program, ¶ 15,196, et seq. The useful life to be used is either the guideline class life under Sec. 4, Part II of Rev. Proc. 62-21 at ¶ 15,208.4 or the estimated actual useful life. Reg. § 1.46-3(e)(1), ¶ 5945. See *Triangle Publications, Inc.*, at ¶ 5989(55).

TAX SAVING. Whenever you're in doubt as to the estimation of the useful life of a business asset, you should claim the longest possible life to get the maximum investment credit.

¶ 5923 Limit on credit based on amount of tax.—The credit may not exceed the tax liability. For taxable years ending after 3-9-67 if the tax is more than \$25,000, the credit is \$25,000 plus 50% of tax liability over \$25,000. For taxable years ending on or before 3-9-67, the credit was limited to \$25,000 plus 25% of the tax liability over \$25,000. The limitation is prorated, on a daily basis for tax years spanning 3-9-67. The limitation

must also be reduced (but not below zero) by an amount equal to the credit that would have been earned on suspension period property; the reduction is made only for taxable year in which such property is placed in service. Sec. 46(a)(2); Reg. § 1.46-1(b), ¶ 5943.

Any unused credit may be carried back and over subject to the rules below. "Tax" for this purpose is the tax after credits other than withholding and the investment credit, but does not include the tax on unreasonably accumulated earnings, on personal holding companies or the tax resulting from the recovery of foreign expropriation losses. For tax years ending after 1969, the minimum tax on tax preferences of Sec. 56 also isn't included.

The \$25,000 figure applies on a joint return; on the separate return of a married person the figure is reduced to \$12,500, unless his spouse has no credit. The \$25,000 is apportioned among members of an affiliated group (specially defined) whether or not they file a consolidated return. (For taxable years ending on or after 12-31-70, the amount is apportioned among component members of a controlled group.) The \$25,000 may be apportioned among the members in any manner the common parent may select, if such parent and each member of the group consent. Reg. § 1.46-1(f). Each partner takes the \$25,000 figure into account separately. So do beneficiaries of estates and trusts and stockholders in Subchapter S corporations. ¶ 5930.

Effect of prior tax surcharge on limitation on credit. ¶ 6101.

[[§ 5924] Carryback or carryover of unused credits.—Generally, unused credits may be carried back for 3 years and carried forward for 7 years. However, for taxable years beginning after December 31, 1968, and ending after April 18, 1969, the '69 Tax Reform Act added a further 20% limitation to the use of the carryover as well as an exception to this limitation. See further discussion below.

An otherwise allowable credit that may not be used because of the limitation based on tax is a carryback for 3 years and carryover for 7 years if fifth taxable year following the unused credit year ends after 12-31-66 (for 5 years if such fifth taxable year ends before 1-1-67). Sec. 46(b)(1); Reg. § 1.46-2(a)(1)-(3), ¶ 5944. (There is no carryback to a year ended before January 1, 1962; a carryback to a year beginning in 1961 and ending in 1962 is prorated.) It may be used in the year to which carried to the extent that the limit based on tax in that year exceeds the credit based on investment that year. If there is more than one carry to a particular year, the earliest is applied first.

For carryback to any taxable year ending on or before 12-31-65 with regard to property used predominantly in a U.S. possession, see Reg. § 1.46-2(a)(4).

A taxpayer who has an unused credit for a year which resulted from a net operating loss carryback to that year is permitted to carry the unused credit to the three preceding taxable years. This rule applies to investment credit carrybacks attributable to carryback of net operating losses sustained in taxable years ending after 7-31-67. The unused credit may also be carried forward as is permitted with respect to unused credits generally. P.L. 90-225, 12-27-67. For prior years, the unused credit that resulted from a net operating loss carryback could be carried forward only, not back. See Reg. § 1.46-2(c).

For quick refunds or credits resulting from carrybacks, see ¶ 36,191 et seq.

Carrybacks and carryovers of unused credit must also be reduced by any credit recaptured under Sec. 47. Reg. § 1.47-1(b), ¶ 5955. See also ¶ 5927.

For taxable years beginning after December 31, 1968 and ending after April 18, 1969, the above rules still apply, subject to the following changes. The total amount of investment credit carryovers and carrybacks which may be added to amount allowable as a credit for any such taxable year can't exceed 20% of the higher of (a) the aggregate of investment credit carryovers and carrybacks to the taxable year, or (b) the aggregate credit carryovers and carrybacks to any preceding taxable year that began after 12-31-68, and ended after 4-18-69. Sec. 46(b)(5), ¶ 5939; Reg. § 1.46-2(b)(2), ¶ 5944. However, if a taxpayer has unused investment credits which he couldn't carry over *solely* because of the new 20% limitation, then he may carry over these unused credits for an additional 3 years. When these credits are carried over for 3 years because of this new rule, the 20% limitation (as well as the general 50% of tax liability rule) will apply. Sec. 46(b)(6); Reg. § 1.46-2(a)(5). Examples (3) and (4) in Reg. § 1.46-2(g) illustrate these rules.

¶ 5925] Qualified investment in new and used property.—Qualified investment may be in new or used property. Sec. 48(b) and (c), ¶ 5965. New property is that the first use of which commences with the taxpayer, or property constructed or reconstructed by him. Used property, of course, is other property. In both cases, only property acquired after 1961 qualifies. The distinction between new and used property is the same as the now-familiar distinction applied in determining whether property qualifies for accelerated depreciation under the 1954 Code rules.

As to new property, the applicable percentage is applied to taxpayer's basis for the property determined according to the general tax rules on basis, ¶ 31,141 et seq. Installation and freight costs are added to basis for purpose of credit. Reg. § 1.46-3(c), ¶ 5945. Say taxpayer swaps an old machine with an adjusted basis of \$8,000 for a *new*, similar machine and pays \$1,000 cash to boot. The trade-in is tax-free and the basis of the new machine is \$9,000 (basis of old plus boot); and that is the amount taken into account in applying the percentages. (Taxpayer, as explained below, may have to adjust prior credits because of his disposition of the traded-in machine.) Special rule, described below, applies to property replacing property by casualty or theft.

Used property qualifies only if acquired by purchase. "Purchase" does not include acquisitions: (a) from a related person (defined in IRC Sections 267 and 707(b), as modified), (b) by a corporation from an affiliated corporation (specially defined), (c) from a decedent, and (d) of property whose basis is carried over from the person from whom acquired (gifts, for example). Nor does used property qualify if, after acquisition by taxpayer, it is used by the person who used such property before such acqui-

sition, or by a person related to the person who used the property before such acquisition under Sec. 179(d)(2)(A) and (B). Thus property purchased in a sale-leaseback or property purchased by a tenant (who used the property) from his landlord does not qualify. Property is not considered used by the acquirer before acquisition if pre-acquisition use was only casual. Reg. § 1.48-3(a)(2), (3), ¶ 5971. See also decisions at ¶ 5988(8).

As to used property, the applicable percentage is applied to taxpayer's cost. In a tax-free trade-in, cost is limited to boot given. Where the property replaces similar property and the transaction is not tax-free, cost is reduced by the adjusted basis of the property replaced. These rules do not apply, that is, the full "cost" of the replacement property is taken into account, (1) if the disposition of the old property resulted in a recapture of prior credits, or (2) unless you buy or contract to buy the replacement property within 60 days before or after selling the old property. Reg. § 1.48-3(b).

Example (1): Taxpayer swaps a machine with an adjusted basis and value of \$8,000 for a used similar machine, paying \$1,000 cash to boot. Because the swap is tax-free, the amount taken into account in applying the percentages is \$1,000. But if taxpayer has to adjust the credit taken on the acquisition of the traded-in machine, the amount taken into account is \$9,000.

Assume the swap was not tax-free, and that value of the old machine was \$10,000. The amount taken into account in applying the percentages is \$3,000 (\$11,000 "cost" less \$8,000).

Example (2): Taxpayer sells truck 1 on Sept. 19, which he bought in Jan. of the previous year, and which has an adjusted basis of \$1,200. On Dec. 1, he buys truck 2 as a replacement for \$2,000. The full cost of truck 2, \$2,000 may be taken into account in computing qualified investment, since the replacement property was bought more than 60 days after the old property was sold. If truck 2 had been bought on Oct. 15, the cost which may be taken into account is \$800 (\$2,000 less \$1,200).

Circumstances under which Section 38 property is disposed of or otherwise ceases to qualify, thereby giving rise to recapture of credit, are in Reg. § 1.47-2, ¶ 5956. See also ¶ 5927.

Dollar limit on used property.—The total cost of acquisitions of used property in any one year taken into account in applying the percentages may not exceed \$50,000. Sec. 48(c)(2); Reg. § 1.48-3(c)(1). If total acquisitions are more, taxpayer may select the items to be taken into account; presumably he will select the longer-lived. Reg. § 1.48-3(c)(4). The \$50,000 limit applies on a joint return; on the separate return of a married person the limit is \$25,000, unless his spouse acquired no qualifying used property that year. Affiliated corporations (component members of a controlled group, for tax years ending on or after 12-31-70) are limited to one \$50,000 amount. As to partnerships, the \$50,000 limit applies at both the partnership and partner levels; so too, as to estates and trusts and their beneficiaries, and Subchapter S corporations and their stockholders.

Example: Partnership AB pays \$60,000 for used equipment. The partnership may take only \$50,000 into account, of which A's share is \$25,000. In addition, A as a sole proprietor pays \$40,000 for used equipment. While his "investment" is \$65,000, the amount he may take into account is limited to \$50,000. He may select all of the \$25,000 derived through the firm and \$25,000 of his individual investment, or all of his individual investment and \$10,000 of the derived investment.

Effect of casualty or theft.—To figure the qualified investment in prop-

erty replacing property lost by casualty or theft, start with the basis or cost of the new property. Then reduce by whichever of these amounts is the smaller: (1) any insurance or other recovery, (2) the adjusted basis of the lost property. See Sec. 46(c)(4); Reg. § 1.46-3(h), ¶ 5945.

Example: Property is completely destroyed by fire. Its adjusted basis was \$20,000; the insurance recovery is \$25,000. Replacement property is acquired at a cost of \$28,000. The qualified investment is \$8,000, unless taxpayer elects recognition of gain under Sec. 1033(a)(3), in which case the qualified investment will be \$9,000. If the insurance recovery had been \$19,000, the qualified investment would have been \$9,000.

Before making the above reduction, taxpayer must figure whether the recapture rule (see ¶ 5927) disallows more in qualified investment than the casualty rule disallows in basis or cost. If it does, the rules for recapture, as amended by the '69 Tax Reform Act apply.

¶ 59267 What property qualifies.—Eligible property is called "Section 38 property," and the definition of this term is the nub of the credit provision. Sec. 48(a), ¶ 5965. With exceptions stated below, Section 38 property means:

(1) Depreciable tangible *personal* property. This qualifies whether or not used in manufacturing, production, extraction or the furnishing of utility-like services. Reg. § 1.48-1(c), ¶ 5969. Local law definitions are not controlling; items that local law may classify as fixtures may qualify. Examples are outside gasoline pumps, grocery counters, printing presses, and display racks.

(2) Other tangible property, that is real property-like assets (but never a building and its structural components). Reg. § 1.48-1(e). To qualify under this heading the property must (a) be used in manufacturing, production, extraction or the furnishing of utility-like services, or (b) constitute a research or storage facility of an activity under (a). Examples are blast furnaces, oil and gas pipelines, railroad tracks, fences for cattle, silos, and telephone poles. Bank vault doors, record vault doors, night depository facilities, and walk-up and drive-up teller's windows qualify, but not drive-up teller's booths. Among farm improvements qualifying are storage facilities providing only storage space, not working space. See also rulings at ¶ 5987 et seq.

Excluded in all cases as a building and its structural components are the basic structure and such parts as central air conditioning and heating systems, and plumbing, wiring, and lighting fixtures. But the term "structural components" does not include machinery (such as an air conditioning and humidification system) solely required to meet temperature or humidity requirements essential for the operation of other machinery or the processing of materials or foodstuffs. These qualify even though they may incidentally provide for the comfort of the workers or serve, to a minor degree, areas where temperature control is not essential. Reg. § 1.48-1(e)(2).

Elevators and escalators qualify: (1) if construction or reconstruction is completed after June 30, 1963, or (2) acquisition occurred after June 30, 1963. Sec. 48(a)(1)(C); Reg. § 1.48-1(m).

No intangible property qualifies. Thus a patent or copyright is excluded; so too the cost of a leasehold. But improvements made by a tenant (excluding the building and its components) may qualify.

Livestock does not qualify.

To qualify, the property must be subject to depreciation (i.e. have a basis to taxpayer, see ¶ 5989(28)) or amortization and must have a useful life of at least 4 years. If a property is only partly depreciable (part-business, part-pleasure car), only the depreciable part qualifies.

Even though within the above definition, the following do not qualify:

(1) Property used mainly (more than 50%) outside the U.S. But, generally speaking, this exception does not apply to the rolling stock of railroads, aircraft, vessels, and motor vehicles used in international operations, containers used in international transportation, off-shore drilling equipment. Further, this exception does not apply, for taxable years ending after March 9, '67, to aircraft registered by the Administrator of the Federal Aviation Agency which are operated outside the U.S. under a contract with the U.S. Sec. 48(a)(2)(B)(i); Reg. § 1.48-1(g)(2). For special rules on recapture of credit for aircraft leased for use outside the U.S. after April 18, 1969, see ¶ 5927.

Also, for taxable years ending after 12-31-65, property placed in service after this date which is used in a U.S. possession by a U.S. person or by a corporation organized in a possession qualifies, with certain exceptions as provided in Sec. 48(a)(2)(B)(vii); Reg. § 1.48-1(g)(2)(vii).

(2) Property used by a tax-exempt organization other than a cooperative. But if the organization is subject to the tax on unrelated business income, property used in that activity can qualify. For tax years beginning after 1969, if the qualifying property is "debt-financed" (defined in Sec. 514(c), ¶ 21,237), the cost or basis used for the Sec. 46(c) computation is limited to the percentage of cost or basis used under Sec. 514 to fix the organization's gross income from the property in the year placed in service.

(3) Property used by the United States, a state or its political subdivisions, an international organization, or any agency or instrumentality of the foregoing.

(4) Property used mainly to furnish lodging. There are two exceptions to this exception, that is, the following are eligible: (a) Non-lodging commercial facilities available to persons not using the lodging on the same basis as to persons who do. (Example: Restaurant equipment in an apartment hotel.) (b) Property used by a transient motel or hotel in furnishing lodging. Reg. § 1.48-1(h).

Note that the above rules are stated in terms of use of the property. This means that neither the owner nor the person who rents out property for the proscribed use can count it for credit.

See also rulings and cases at ¶ 5987 et seq.

¶ 5927 Recapture of credit.—The '69 Tax Reform Act continued the recapture rules discussed below with 2 exceptions: there is no recapture for any Sec. 38 property which is stolen or destroyed by casualty after April 18, 1969, and recapture is limited in the case of property replaced after April 18, 1969, if certain statutory conditions are met. For discussion, see (2), below.

A tax adjustment may be necessary if property is disposed of before the end of its estimated useful life or ceases to be section 38 property. Sec. 47, ¶ 5953; Reg. § 1.47-1, ¶ 5955. Disposition includes any kind of disposition (e.g., sale, tax-free or taxable exchange, gift, involuntary conversion), with the exceptions listed below. It also includes a sale by a partner of his interest in the firm, or by a stockholder of his stock in a Subchapter S corporation. Property may cease to be Section 38 property because, for

example, it is switched to foreign use. See below for further details as to disposition or cessation.

The tax for the *current* year is increased by the amount that the credit or carryover would have been decreased had the original credit been computed on the period of actual use instead of estimated use.

Example: You buy machinery for \$20,000; useful life is 10 years. Your credit, \$2,100. You sell the machinery in the fifth year. That means you would have actually been entitled to a credit for only $\frac{1}{2}$ of the cost based on a 5-year useful life. **Result:** Your credit is \$700 rather than \$2,100; thus your tax for the year of sale is increased by \$1,400.

Note that, in effect, recapture denies credit as to \$20,000 of the cost. For the importance of this concept, see "Effect of casualty or theft", ¶ 5925.

If the property were disposed of after 8 years, no adjustment would be required. However, since the property must be used at least 4 years to be entitled to any credit, the entire credit is subject to recapture if actual useful life to taxpayer is less than 4 years.

A somewhat similar adjustment is made if nonpublic utility property becomes public utility property. But no adjustment in the reverse situation.

As stated, the adjustment is made in the year of disposition or cessation. Thus prior returns are not reopened and no interest is charged.

In general, taxpayer must maintain records from which he can establish, with respect to each item of section 38 property, the following: (a) Date the property is disposed of or otherwise ceases to be section 38 property, (b) estimated useful life which was assigned to the property, (c) month and taxable year in which property was placed in service, and (d) basis or cost, actually or reasonably determined, of property. Reg. § 1.47(e). Failure to maintain such records will result in recapture in the manner indicated in the examples in Reg. § 1.47-1(e)(1)(iii). For treatment of "mass assets," see Reg. § 1.47-1(e)(2), (4) and standard mortality dispersion table, ¶ 5989(75), usable in lieu of tables based on taxpayer's actual experience for computing qualified investment.

Disposition: For recapture of credit purposes, a "disposition" of section 38 property covers many common situations in addition to sales. For example, it may include gifts, trade-ins, corporate distributions in liquidations or as in-kind property dividends, contributions of property to a corporation (including Subchapter S corporations) or to certain partnerships, sale by a corporation in a "tax-free" Sec. 337 liquidation, certain involuntary conversions, sales of stock by a Subchapter S shareholder, sale by a partner of an interest in a partnership, or sale by a beneficiary of an interest in an estate or trust. "Disposition" also includes a sale in a sale-and-leaseback transaction, except as limited by Reg. § 1.47-3(g), and a transfer upon the foreclosure of a security interest, but the term doesn't include a mere transfer of title to a creditor upon creation of a security interest. Retirement of property is also a disposition. Reg. § 1.47-2(a)(1), (d), ¶ 5956.

If taxpayer disposes of section 38 property in same year he put it into service, he generally doesn't claim any credit for year of purchase. However, this is not always the rule. See for example, death transfers and tax-free transfers, below.

Cessation: Recapture of credit also applies when equipment ceases to be section 38 property. Reg. § 1.47-2(a)(2). Examples are where a business asset is switched to personal use in whole or in part or to foreign use, or where the percentage of use of asset between personal and business changes after year the credit was originally taken. Reg. § 1.47-2(e). There is a special rule for aircraft leased for temporary use outside the U.S. See below.

Leased property: For recapture purposes, the mere leasing of section

38 property by a lessor who took its basis into account in computing his qualified investment for the credit year isn't a disposition. But, where a lease is treated as a sale for income tax purposes the transaction is considered a disposition. Leased property ceases to be section 38 property to the lessor if, in any taxable year after credit year, it wouldn't qualify as such in hands of lessor, lessee or any sublessee. Reg. § 1.47-2(b)(1). Rules on whether disposition or cessation has occurred where lessor elects to treat lessee as purchaser are in Reg. § 1.47-2(b)(2).

Special rule for aircraft leased for temporary use outside the U.S.—Sec. 47(a)(6), ¶ 5953, added by P.L. 91-676, 1-12-71, permits leasing of an aircraft for use abroad for up to 4 years without recapture of a previously allowed investment credit. The new rule, which is effective for taxable years ending after April 18, 1969, as to aircraft used outside the U.S. after that date, applies to any aircraft which was new property eligible for the credit in the year in which it was placed in service. Such aircraft may be leased to a foreign carrier under a "qualifying lease".

A qualifying lease is a lease executed after April 18, 1969, from a U.S. air carrier that qualifies under Federal law and complies with the rules of the Civil Aeronautics Board.

If the aircraft is used abroad more than in the U.S., then foreign use is taken into account only to the extent of the aircraft's use in the U.S. But if foreign use is less than use in the U.S. (i.e., less than half of the actual useful life), then the actual useful life is used.

Example. A jet airplane was first placed in service on March 1, 1969. It qualified for the credit at that time. It was used in the U.S. through August 31, 1970. The carrier leased it as of that date to a foreign carrier under a qualified lease for use abroad through August 31, 1973. At the end of the lease, the carrier plans to sell the aircraft to the foreign carrier.

The entire credit claimed on the plane is subject to recapture. The carrier has used the plane only 3 years—1½ years in the U.S. and 1½ years abroad. Only half the foreign use time is taken into account since the plane had been used in the U.S. for only 1½ years.

Exceptions to recapture of credit: A taxpayer is not subject to the recapture provisions in certain types of transactions. Reg. § 1.47-3, ¶ 5957. These exceptions are:

(1) *Death transfers.*—There's no recapture when equipment is transferred because of the death of an individual taxpayer. Instead, the property is treated as if it had actually been held for the entire useful life estimated by the deceased to figure the credit.

Example: Sole proprietor bought \$20,000 worth of equipment in '64 and took \$1,400 credit on it. He died in '67 and the equipment passed to his son. *Result:* None of the credit has to be paid back. Further, the son can sell the equipment right away without running the risk of recapture.

Recapture doesn't apply to the death transfer of a partner's interest or of the stock of a Subchapter S shareholder. Nor does it apply on transfer of a deceased's interest to the surviving owner in a joint tenancy. However, it does apply to a gift by a taxpayer prior to his death even though the value of the gift is included in his estate (as a gift in contemplation of death, for example).

If, under Reg. § 1.48-4, the lessor of new section 38 property made a valid election to treat lessee as having purchased the property for purposes of

the credit, there is no recapture if, by reason of lessee's death, there is a termination of the lease and transfer of leased property to lessor, or there is an assignment of lease and transfer of leased property to another person. See Reg. § 1.47-3(b), ¶ 5957.

(2) *Replacement of property.*—(a) *Property destroyed by casualty:* For section 38 property destroyed by casualty or stolen after April 18, 1969, there is no recapture, whether or not the property is replaced. Sec. 47(a)(4), ¶ 5953; Reg. § 1.47-3(c)(1), ¶ 5957.

The following rules apply to property affected by casualty or theft before April 19, 1969. Generally, the recapture provisions aren't applicable to property disposed of or otherwise ceases to be section 38 property due to its destruction or damage by a casualty, or by theft if it is replaced by section 38 property. Reg. § 1.47-3(c)(2).

To determine whether or not the recapture rules apply, taxpayer proceeds as follows:

(a) He applies the recapture rule to determine how much "qualified investment" would normally be disallowed.

(b) When he buys section 38 equipment to replace the destroyed property, he starts with the basis of the newly acquired property. Then, he reduces this amount by the *lesser* of: (i) the insurance proceeds (or other recovery); or (ii) the adjusted basis of the destroyed property, to determine how much basis reduction there would be.

If the recapture rule results in a greater disallowance of qualified investment than the reduction rule disallows in basis, then recapture comes into play and there's no basis reduction. But, if the reduction rule results in a greater (or equal) disallowance, then the basis reduction governs and there's no recapture. Reg. § 1.46-3(h).

For purposes of the basis reduction rule, property is considered "replacement property" only if the new property is put into service by the due date (including extensions) for filing the year of casualty return. Reg. § 1.46-3(h)(1). Thus, if taxpayer replaces later, he doesn't have to go through the basis reduction rule above, but there might be recapture.

(b) *Certain property replaced after April 18, 1969:* If property eligible for the investment credit is disposed of and, within 6 months of the disposition, is replaced by similar property which would have qualified for the credit had it not been repealed by section 49, then the amount of recapture on the disposition of the old property is in effect reduced by the amount of credit which would have been available to the property which replaced it. Hence, the amount of recapture can be reduced to zero, but not below it. Sec. 47(a)(5); Reg. § 1.47-3(h)(1). Under certain conditions, property disposed of may be replaced with property leased from another. Reg. § 1.47-3(h)(2).

(3) *Reselection of used property:* There's a \$50,000 limit on the cost of used section 38 property taxpayer can take into account in figuring his credit for any one year. Any excess cost can't be carried over. In fact, it's usually wasted. But if the cost of used property exceeded \$50,000 and the property actually selected is disposed of before the end of its useful life, recapture of credit can be avoided by reselecting excess used property for the earlier year to take its place. Reg. § 1.47-3(d).

To bypass recapture by reselection of excess used property, taxpayer must attach to his tax return a statement giving his name, address and taxpayer account number. This statement must also indicate as to both the originally selected used property, and the newly selected used property, the month and year placed in service, cost and estimated useful life. Reg. § 1.47-3(d)(3).

(4) *Corporate tax-free transfers under Sec. 381(a)*: Recapture isn't required if the transfer of section 38 property is from one corporation to another in a tax-free reorganization or liquidation if the acquiring corporation succeeds to the tax attributes of the transferor corporation under Sec. 381(a), ¶ 18,502. This includes the carryover-basis liquidation of an 80% subsidiary under Sec. 334(b)(1), ¶ 17,680. The acquiring corporation will stand in the shoes of the transferor corporation as to carryovers of unused credits and potential adjustments because of early dispositions or cessations. Reg. § 1.47-3(e).

(5) *Mere change in the form of conducting business*: Recapture isn't required because of a mere change in the form of conducting the trade or business if (1) section 38 property remains in the same business; (2) taxpayer retains a "substantial interest" in the business; (3) substantially all the property, (whether or not section 38) is transferred in the change of form; and (4) basis of section 38 property is carried over (in whole or in part). Reg. § 1.47-3(f)(1). Thus, no adjustment is required if a sole proprietor transfers section 38 property to a partnership in exchange for an interest or to a corporation for stock. In these cases, however, the acquirer by making early disposition of the property causes recomputation of transferor's credit. Similarly, a recomputation could be required on sale of transferor's interest or his failure to retain a substantial interest in the firm. Reg. § 1.47-3(f)(5).

Taxpayer is considered to have retained a substantial interest only if, after the change, his interest is (1) substantial in relation to the total interest of all the owners; or (2) is equal to or greater than his interest prior to the change. Thus, where a 5% partner retains at least a 5% interest after incorporation, he's considered to have retained a substantial interest in the business. Reg. § 1.47-3(f)(2).

(6) *Sale-and-leaseback transactions*: Recapture isn't required where section 38 property is disposed of and as part of the same transaction is leased back to the vendor, even though gain or loss is recognized to the vendor-lessee and the property ceases to be subject to depreciation in his hands. See Reg. § 1.47-3(g).

As to special taxpayers and partnerships, see (i) below.

If, as a result of an early disposition in a taxable year beginning before January 1, 1964, of property placed in service before that date, the tax is increased under Sec. 47(a)(1) or (2), or an adjustment in an unused credit carryover or carryback is made under Sec. 47(a)(3), the basis of the property is increased. Reg. § 1.48-7(c), ¶ 5975.

Procedure for reporting credit recapture.—Individuals, estates, trusts, or corporations should compute the amount of recapture on Form 4255, Tax from Recomputing a Prior Year Investment Credit. This form, which should be attached to the tax return, is to be used if the maximum amount of credit allowable has been allowed at the time of the disposition of the Sec. 38 property, and if the credit is recaptured either in full or in part. If there is an unused investment credit attributable to the disposed asset, the taxpayer, instead of using Form 4255, should compute the recapture tax on a separate schedule which should be attached to the return.

¶ 5928 *Public utility property.*—In the case of utilities eligible for the 7% credit such as transportation companies, no U.S. regulatory agency may require a rate reduction ("flow through") because of taxes saved by the credit. In the case of utilities subject to the 3% credit, a U.S. agency may reduce the rate, but only by spreading the tax saving over the useful life

of the asset. This change is not a Code amendment. Section 203(e) of the Revenue Act of 1964, Amending Acts, IRC Vol. See also Reg. § 1.46-3(g), ¶ 5945.

¶ 5929] Lessees treated as purchasers.—Under Sec. 48(d), a lessor may elect to treat his lessee as the purchaser (acquirer) of qualified property. Reg. § 1.48-4, ¶ 5972.

The election applies only to property acquired new, or constructed, by lessor. It does not apply to used property (including property used by lessor), or to reconstructed property. Reg. § 1.48-4(a)(2).

The lessor who makes this election waives the credit for himself; the lessee gets the credit for the year he puts the property into service and uses lessor's life for purposes of computing depreciation, regardless of the lease term. Reg. § 1.48-4(d). A lessee can pass through his credit to a sublessee if both he (lessee) and the original lessor properly elect. Reg. § 1.48-4(e).

For leases executed on or after February 26, 1964, for credit purposes, the lessee's basis is deemed to be the property's fair market value, except as to leases between affiliated corporations where the lessee takes the lessor's basis. (For tax years ending on or after 12-31-70, the lessee takes the lessor's basis when there is a lease between component members of a controlled group.) For leases executed before February 26, 1964, credit is computed on fair market value when lessor is the manufacturer; as to others the computation is on lessor's basis.

Elections may be made on a property-by-property basis, or for any tax year (of lessee) lessor may elect to treat lessee as having purchased all property of which lessee gets possession during such year. The election must be made in the manner specified in Reg. § 1.48-4(f) and (g) on or before due date (including extensions) of lessee's return for lessee's taxable year during which possession of the property is transferred to lessee.

For property placed in service before 1-1-64, lessee's rent deduction had to be reduced to reflect the credit. Total rent deduction (and other deductions under Sec. 162, ¶ 11,005, for amounts paid under the lease) was reduced by the amount of "credit earned" on leased property. "Credit earned" is 7% of qualified investment. For property placed in service after 1963, no reduction in lessee's rent deductions is necessary to reflect the credit.

Rules on the adjustment of the rental deductions are in Reg. § 1.48-4(k) and (m). (Reg. § 1.48-4(l) superseded Temp. Reg. § 16.2-1(f)(3)). Examples are at Reg. § 1.48-4(i).

If lessor of property placed in service before January 1, 1964 treats lessee as having purchased such property for purposes of the Sec. 38 credit, and if lessee actually buys the property prior to the expiration of its useful life, the basis of the property is increased. Reg. § 1.48-7(e), ¶ 5975.

Reg. § 1.48-4 superseded Temp. Reg. § 16.2-1 adopted by TD 6619, 1962-2 CB 397, TD 6731, 1964-1 CB 11.

¶ 5930] Special classes of taxpayers and partnerships.—Sec. 593 organizations: In determining qualified investment and in applying the \$25,000 limitation based on tax, Sec. 593 organizations (that is, mutual savings banks, cooperative banks, and domestic building and loan associations), regulated investment companies, real estate investment trusts and Sec. 1381(a) cooperatives take into account only a pro rata share. For Sec. 593 organizations, the pro rata share is 50%. Reg. § 1.46-4, ¶ 5945. For the others, it is the amount proportionate to the income not passed through to stockholders, members or patrons. Reg. § 1.46-4(b),(c).

Estates and trusts: For estates, trusts, and their beneficiaries, the quali-

fied investment is apportioned in accordance with the income taxable to each. Sec. 48(f); Reg. § 1.48-6(a)(1), ¶ 5974. The investment apportioned to a beneficiary is treated by him as if he made it. Reg. § 1.48-6(a)(3). The \$25,000 limitation based on tax is not affected at the beneficiary level, but at the trust level is reduced to the percentage of income taxable to the trust. Reg. § 1.48-6(c). If an estate or trust disposes of section 38 property (or if such property otherwise ceases to qualify in the hands of the estate or trust), the recapture of credit rules would apply to the estate or trust, and to each beneficiary treated as a taxpayer with respect to such property. See Reg. § 1.47-5, ¶ 5959.

Subchapter S corporations: Qualified investment made by a Subchapter S corporation is deemed made ratably by the persons who are stockholders on the last day of its taxable year, and is treated by them as if they had made the investment directly. Sec. 48(e); Reg. § 1.48-5(a), ¶ 5973. Recapture rules affecting stockholders of a Subchapter S corporation are in Reg. § 1.47-4, ¶ 5958. For a discussion of these rules, see ¶ 33,373(1)(d).

For proceedings relating to consents of minority shareholders required by Reg. § 1.47-4, see *Rev. Rul. 70-458*, ¶ 5989(40).

Partnerships: The percentage of basis of partnership property (or cost, if used property) assigned to each partner is the percentage used (at the time the property was placed in service) in determining his share of partnership profits—unless the partnership has a special allocation rule covering income, gain, loss, and deduction items related to such property. However, a partnership agreement may provide that basis (or cost) of section 38 property shall not be taken into account by a partner whose interest in the

general profits of the partnership during the taxable year is 5% or less, and who under the agreement will retire from the partnership during the taxable year or within 8 years after end of taxable year. Any basis or cost not taken into account by such partner is taken into account by other partners. Reg. § 1.46-3(f)(2), ¶ 5945.

If a partnership prematurely disposes of partnership section 38 property (or if such property otherwise ceases to qualify in the hands of the partnership), the recapture of credit rules would apply to the partners who originally received the benefit of the credit. An adjustment will also be necessary if before the close of the estimated useful life of such property, a partner's proportionate interest in the general profits of the partnership (or in the particular item of property) is reduced below a specified percentage. This reduction may be caused by a sale of his interest, by change in the partnership agreement, or by the admission of a new partner. See Reg. § 1.47-6, ¶ 5960.

¶ 5931 How to claim the credit.—An individual, estate, trust, or corporation claiming the investment credit must attach Form 3468 (as revised) to its return. Estates and trusts which apportion the investment between the estate or trust and the beneficiaries should in addition to the form attach a statement showing the allocation of the investment among the beneficiaries. Partnerships and Subchapter S corporations are not required to file Form 3468 because the credit is claimed by the partner or shareholder. But they must attach a statement to their returns showing the allocation of investment to the partners or shareholders by amount, type and life of property. See Instructions, Form 3468. For special classes of taxpayers, see ¶ 5930.

For procedure of reporting recapture income, see ¶ 5927.

¶ 5930 CODE SEC. 46. AMOUNT OF CREDIT.

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(a) Determination of Amount.—

(1) General rule.—The amount of the credit allowed by section 38 for the taxable year shall be equal to 7 percent of the qualified investment (as defined in subsection (c)).

(2) Limitation based on amount of tax.—Notwithstanding paragraph (1), the credit allowed by section 38 for the taxable year shall not exceed—

(A) so much of the liability for tax for the taxable year as does not exceed \$25,000, plus

(B) for taxable years ending on or before the last day of the suspension period (as defined in section 48(j)), 25 percent of so much of the liability for tax for the taxable year as exceeds \$25,000, or

(C) for taxable years ending after the last day of such suspension period 50 percent of so much of the liability for tax for the taxable year as exceeds \$25,000.

In applying subparagraph (C) to a taxable year beginning on or before the last day of such suspension period and ending after the last day of such suspension period, the percent referred to in such subparagraph shall be the sum of 25 percent plus the percent which bears the same ratio to 25 percent as the number of days in such year after the last day of the suspension period bears to the total number of days in such year. The amount otherwise determined under this paragraph shall be reduced (but not below zero) by the credit which would have been allowable under paragraph (1) for such taxable year with respect to suspension period property but for the application of section 48(h)(1).

(3) Liability for tax.—For purposes of paragraph (2), the liability for tax for the taxable year shall be the tax imposed by this chapter for such year, reduced by the sum of the credits allowable under—

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- (A) section 33 (relating to foreign tax credit),
 (B) section 26 (relating to partially tax-exempt interest), and
 (C) section 37 (relating to retirement income).

For purposes of this paragraph, any tax imposed for the taxable year by section 56 (relating to minimum tax for tax preferences), section 581 (relating to accumulated earnings tax), section 541 (relating to personal holding company tax), or section 1213 (relating to tax on certain capital gains of subchapter S corporations), and any additional tax imposed for the taxable year by section 1351(d)(1) (relating to recoveries of foreign expropriation losses), shall not be considered tax imposed by this chapter for such year.

(4) Married individuals.—In the case of a husband or wife who files a separate return, the amount specified under subparagraphs (A) and (B) of paragraph (2) shall be \$12,500 in lieu of \$25,000. This paragraph shall not apply if the spouse of the taxpayer has no qualified investment for, and no unused credit carryback or carryover to, the taxable year of such spouse which ends within or with the taxpayer's taxable year.

(5) Controlled groups.—In the case of a controlled group, the \$25,000 amount specified under paragraph (2) shall be reduced for each component member of such group by apportioning \$25,000 among the component members of such group in such manner as the Secretary or his delegate shall by regulations prescribe. For purposes of the preceding sentence, the term "controlled group" has the meaning assigned to such term by section 1563(a).

(b) Carryback and Carryover of Unused Credits.—

(1) Allowance of credit.—If the amount of the credit determined under subsection (a)(1) for any taxable year exceeds the limitation provided by subsection (a)(2) for such taxable year (hereinafter in this subsection referred to as "unused credit year"), such excess shall be—

(A) an investment credit carryback to each of the 3 taxable years preceding the unused credit year, and

(B) an investment credit carryover to each of the 7 taxable years following the unused credit year,

and shall be added to the amount allowable as a credit by section 33 for such years, except that such excess may be a carryback only to a taxable year ending after December 31, 1961. The entire amount of the unused credit for an unused credit year shall be carried to the earliest of the 10 taxable years to which (by reason of subparagraphs (A) and (B)) such credit may be carried, and then to each of the other 9 taxable years to the extent that, because of the limitation contained in paragraph (2), such unused credit may not be added for a prior taxable year to which such unused credit may be carried.

(2) Limitation.—The amount of the unused credit which may be added under paragraph (1) for any preceding or succeeding taxable year shall not exceed the amount by which the limitation provided by subsection (a)(2) for such taxable year exceeds the sum of—

(A) the credit allowable under subsection (a)(1) for such taxable year, and

[Footnote 5220] Matter in *italics* in Sec. 46(a)(3) added by section 501(b)(4), Tax Reform Act of 1969.

Effective date (Sec. 501(c), Tax Reform Act of 1969).—Applies to tax years ending after 1969.

Matter in *italics* in Sec. 46(a)(5), added by section 401(e)(1), Tax Reform Act of 1969, which struck out:

- (1) "affiliated"
 (2) "an affiliated"
 (3) "subparagraphs (A) and (B) of"
 (4) "the"

(5) "section 1504(c), except that all corporations shall be treated as includible corporations (without any exclusion under section 1504(b))"

Effective date (Sec. 401(b)(3), Tax Reform Act of 1969).—Applies to tax years ending on or after December 31, 1973.

Matter in *italics* in Sec. 46(b) added by section 703(b), Tax Reform Act of 1969.

Effective date (Code Sec. 46(b)(5), (6)).—Applies to tax years beginning after 1969 and ending after April 15, 1969 as provided in Code Secs. 46(b)(5) and (6).

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(B) the amounts which, by reason of this subsection, are added to the amount allowable for such taxable year and attributable to taxable years preceding the unused credit year.

(3) [Struck out by section 2(a), P.L. 90-225, 12-27-67]

(4) **Taxable year beginning before January 1, 1962.**—For purposes of determining the amount of an investment credit carryback that may be added under paragraph (1) for a taxable year beginning before January 1, 1962, and ending after December 31, 1961, the amount of the limitation provided by subsection (a) (2) is the amount which bears the same ratio to such limitation as the number of days in such year after December 31, 1961, bears to the total number of days in such year.

(5) **Taxable Years Beginning After December 31, 1968, and Ending After April 18, 1969.**—The amount which may be added under this subsection for any taxable year beginning after December 31, 1968, and ending after April 18, 1969, shall not exceed 20 percent of the higher of—

(A) the aggregate of the investment credit carrybacks and investment credit carryovers to the taxable year, or

(B) the highest amount computed under subparagraph (A) for any preceding taxable year which began after December 31, 1968, and ended after April 18, 1969.

(6) **Additional 3-Year Carryover Period in Certain Cases.**—Any portion of an investment credit carryback or carryover to any taxable year beginning after December 31, 1968, and ending after April 18, 1969, which—

(A) may be added under this subsection under the limitation provided by paragraph (2), and

(B) may not be added under the limitation provided by paragraph (5), shall be an investment credit carryover to each of the 3 taxable years following the last taxable year for which such portion may be added under paragraph (1), and shall (subject to the provisions of paragraphs (1), (2), and (5)) be added to the amount allowable as a credit by section 38 for such years.

(c) **Qualified Investment.**—

(1) **In general.**—For purposes of this subpart, the term "qualified investment" means, with respect to any taxable year, the aggregate of—

(A) the applicable percentage of the basis of each new section 38 property (as defined in section 48(b)) placed in service by the taxpayer during such taxable year, plus

(B) the applicable percentage of the cost of each used section 38 property (as defined in section 48(c)(1)) placed in service by the taxpayer during such taxable year.

(2) **Applicable percentage.**—For purposes of paragraph (1), the applicable percentage for any property shall be determined under the following table:

If the useful life is—	The applicable percentage is—
4 years or more but less than 6 years	33 $\frac{1}{3}$
6 years or more but less than 8 years	66 $\frac{2}{3}$
8 years or more	100

For purpose of this paragraph, the useful life of any property shall be determined as of the time property is placed in service by the taxpayer.

(3) **Public utility property.**—

(A) In the case of section 38 property which is public utility property, the amount of the qualified investment shall be $\frac{3}{7}$ of the amount determined under paragraph (1).

(B) For purposes of subparagraph (A), the term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of—

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- (i) electrical energy, water, or sewage disposal services,
- (ii) gas through a local distribution system,
- (iii) telephone service, or
- (iv) telegraph service by means of domestic telegraph operations (as defined in section 222(a)(5) of the Communications Act of 1934, as amended; 47 U.S.C., sec. 222(a)(5)).

If the rates for such furnishing or sale, as the case may be, have been established or approved by a State or political subdivision thereof, by an agency or instrumentality of the United States, or by a public service or public utility commission or other similar body of any State or political subdivision thereof.

(4) **Certain replacement property.**—For purposes of paragraph (1), if section 38 property is placed in service by the taxpayer to replace property which was—

- (A) destroyed or damaged by fire, storm, shipwreck, or other casualty, or
- (B) stolen,

the basis of such section 38 property (in the case of new section 38 property), or the cost of such section 38 property (in the case of used section 38 property), which (but for this paragraph) would be taken into account under paragraph (1) shall be reduced by an amount equal to the amount received by the taxpayer as compensation, by insurance or otherwise, for the property so destroyed, damaged, or stolen, or to the adjusted basis of such property, whichever is the lesser. No reduction in basis or cost shall be made under the preceding sentence in any case in which the reduction in qualified investment attributable to the substitution required by section 47(a)(1) with respect to the property so destroyed, damaged, or stolen (determined without regard to section 47(a)(4)) is greater than the reduction described in the preceding sentence.

(d) **Limitations with Respect to Certain Persons.**—

(1) **In general.**—In the case of—

- (A) an organization to which section 593 applies,
 - (B) a regulated investment company or a real estate investment trust subject to taxation under subchapter M (sec. 851 and following), and
 - (C) a cooperative organization described in section 1381(a),
- the qualified investment and the \$25,000 amount specified under subparagraphs (A) and (B) of subsection (a)(2) shall equal such person's ratable share of such items.

(2) **Ratable share.**—For purposes of paragraph (1), the ratable share of any person for any taxable year of the items described therein shall be—

- (A) in the case of an organization referred to in paragraph (1) (A), 50 percent thereof,
- (B) in the case of a regulated investment company or a real estate investment trust, the ratio (i) the numerator of which is its taxable income and (ii) the denominator of which is its taxable income computed without regard to the deduction for dividends paid provided by section 852(b)(2)(D) or 857(b)(2)(C), as the case may be, and
- (C) in the case of a cooperative organization, the ratio (i) the numerator of which is its taxable income and (ii) the denominator of which is its taxable income increased by amounts to which section 1382(b) or (c) applies and similar amounts the tax treatment of which is determined without regard to subchapter T (sec. 1331 and following).

For purposes of subparagraph (B) of the preceding sentence, the term "taxable income" means in the case of a regulated investment company its investment company taxable income (within the meaning of section 852(b)(2)), and in the case of a real estate investment trust its real estate investment trust taxable income (within the meaning of section 857(b)(2)).

Reg. 1.5943-1 Regulation.—The regulation below does not reflect the changes made by P.L. 89-384, 4-8-66, and the '69 Tax Reform Act in Sec. 46(a), explained at ¶ 5923.

Reg. § 1.46-1 (TD 6731, filed 5-7-64; TD 6931, filed 10-9-67; amended by TD 6953, filed 6-20-68.) Determination of amount.

Reg. § 1.46-1 continued

(a) *In general.* Except as otherwise provided in this section and in § 1.46-2, the amount of the credit allowed by section 38 for the taxable year is equal to 7 percent of the taxpayer's qualified investment for such year (as determined under § 1.46-3). The amount equal to 7 percent of qualified investment shall be referred to in this section and §§ 1.46-2 through 1.48-7 as the "credit earned".

(b) *Limitation based on amount of tax.—(1) In general.* Notwithstanding the amount of the credit earned for the taxable year, *under section 46(a)(2)* the credit allowed by section 38 for the taxable year is limited to—

¹(i) If the liability for tax (as defined in paragraph (c) of this section) is \$25,000 or less, the liability for tax; or

²(ii) If the liability for tax is more than \$25,000, then

(a) For a taxable year ending on or before March 9, 1967, the first \$25,000 of the liability for tax plus 25 percent of the liability for tax in excess of \$25,000³, and

(b) For a taxable year ending after March 9, 1967 the first \$25,000 of the liability for tax plus 50 percent of the liability for tax in excess of \$25,000.

However, such \$25,000 amount may be reduced in the case of certain married individuals filing separate returns (see paragraph (e) of this section); corporations which are members of an affiliated group (see paragraph (f) of this section); trusts and estates (see paragraph (c) of § 1.48-6); and organizations to which section 593 applies, regulated investment companies or real estate investment trusts subject to taxation under subchapter M, chapter 1 of the Code, and cooperative organizations described in section 1381(a) (see § 1.46-4). The excess of the credit earned for the taxable year over the limitation described in this paragraph for such taxable year is an unused credit which may be carried back or forward to other taxable years in accordance with § 1.46-2.

(2) *Transitional rule.* In applying subparagraph (1)(ii)(b) of this paragraph to a taxable year beginning on or before March 9, 1967, and ending after such date, the percent referred to in such subparagraph shall be the sum of 25 percent and a portion of 25 percent. The portion shall be determined by multiplying 25 percent by a fraction, the numerator of which is the number of days in such taxable year after March 9, 1967, and the denominator of which is the total number of days in such year. For example: Assume that corporation X has a taxable

[Footnote 1 5943] Matter in italics added by TD 6958, which struck out:

- (1) "(1)"
- (2) "(2)"²
- (3) ""

Reg. § 1.46-1(b)(2) continued

year beginning January 1, 1967, and ending December 31, 1967. For such year, the percent referred to in subparagraph (1)(ii)(b) is 45.342 percent, that is, 25 percent plus 20.342 percent (25 percent multiplied by 297/265).

(3) *Adjustment for suspension period property.* Under section 46 (a)(2), the amount of the limitation based on amount of tax otherwise determined under such section is reduced (but not below zero) by an amount equal to the credit which would have been earned for the taxable year with respect to suspension period property (as defined in section 48(h)(2)) but for the application of section 43(b)(1). The reduction described in the preceding sentence shall be made only for the taxable year in which such suspension period property is placed in service (within the meaning of paragraph (d) of § 1.46-3).

(c) *Liability for tax.* For the purpose of computing the limitation based on amount of tax, section 46(a)(3) defines the liability for tax as the income tax imposed for the taxable year by chapter 1 (including the 2-percent tax on consolidated taxable income imposed with respect to taxable years beginning before January 1, 1964, and the 6-percent additional tax imposed by section 1562(b) with respect to taxable years ending after December 31, 1963), reduced by the sum of the credits allowable under—

- (1) Section 33 (relating to taxes of foreign countries and possessions of United States),
- (2) Section 34 (relating to dividends received by individuals before January 1, 1965),
- (3) Section 35 (relating to partially tax-exempt interest received by individuals), and
- (4) Section 37 (relating to retirement income).

For purposes of this paragraph, the tax imposed by section 531 (relating to imposition of accumulated earnings tax) or by section 541 (relating to imposition of personal holding company tax) shall not be considered tax imposed by chapter 1. Thus, the liability for tax and the credit allowed by section 38 for the taxable year are determined before computing any tax imposed by section 531 or 541. In addition, any increase in tax resulting from the application of section 47 (relating to certain dispositions, etc., of section 38 property) shall not be treated as tax imposed by chapter 1 for purposes of computing the liability for tax. See section 47(c).

(d) *Examples.* The application of paragraphs (a), (b), and (c) of this section may be illustrated by the following *examples*:

Example (7) X Corporation's qualified investment for its taxable year ending December 31, 1963, is \$2,050,000. X's credit earned for the taxable year is \$143,500 (7 percent of \$2,050,000). X's income tax for such year, computed without regard to credits against tax or tax imposed by section 531 or 541, is \$190,000. Such amount includes \$5,000 resulting from the application of section 47. X is allowed under section 33 a foreign tax credit of \$50,000. X's liability for tax is computed as follows:

<i>Liability for tax</i>	
Income tax (including increase in tax under section 47, but before credits and section 531 or 541 tax)	\$190,000
Less: Increase in tax resulting from application of section 47 ..	\$ 5,000
Foreign tax credit	50,000
	55,000
Liability for tax	\$135,000

[Footnote § 5913 continued]
(4) "Example"

Reg. § 1.46-1(d) Example (1) Continued

Under section 46(a)(2), X's limitation based on amount of tax for the taxable year is \$52,500 (\$25,000 plus 25 percent of \$110,000). X Corporation's credit allowed by section 38 for the taxable year therefore is \$52,500. X has an unused credit for the year of \$91,000 (\$143,000 less \$52,000) which it may carry back or over to other taxable years in accordance with § 1.46-2.

Example (2). Assume the same facts as in example (1), except that X Corporation's taxable year is the fiscal year ending June 30, 1968. X's credit allowed by section 38 for such taxable year is limited to \$30,000 (\$25,000 plus 50 percent of \$110,000), and its unused credit for such year is \$63,500 (\$143,500 less \$30,000).

Example (3). Assume the same facts as in example (2). Assume further that X Corporation places in service on July 1, 1967, a machine which is suspension period property, and that the credit earned by X with respect to the machine for the taxable year would have been \$5,000 but for the provisions of section 48(h)(1). Under section 46(a)(2) the limitation otherwise determined (\$30,000) is reduced by the \$5,000 credit that X would have earned with respect to the machine but for section 48(h)(1). Thus, the credit allowed X Corporation for the taxable year is \$75,000, and X's unused credit for such year is \$68,500 (\$143,500 less \$75,000).

Example (4). Assume the same facts as in example (3), except that the credit earned by X Corporation with respect to the machine would have been \$90,000 but for the provisions of section 48(h)(1). X's credit allowed for the taxable year is zero, since the limitation otherwise determined (\$30,000) is reduced (but not below zero) by the \$90,000 credit that X would have earned with respect to the machine. Therefore, X's unused credit for such year is \$143,500.

(e) Married individuals. If a separate return is filed by a husband or wife, the limitation based on amount of tax under paragraph (b) of this section shall be computed by substituting a \$12,500 amount for the \$25,000 amount in applying paragraph (b) (1) ^a of this section. However, this reduction of the \$25,000 amount to \$12,500 applies only if the taxpayer's spouse is entitled to a credit under section 38 for the taxable year of such spouse which ends with, or within, the taxpayer's taxable year. The taxpayer's spouse is entitled to a credit under section 38 either because of investment made in qualified property for such taxable year of the spouse (whether directly made by such spouse or whether apportioned to such spouse, for example, from an electing small business corporation, as defined in section 1371(b)), or because of an investment credit carryback or carryover to such taxable year. The determination of whether an individual is married shall be made under the principles of section 143 and the regulations thereunder.

(f) Apportionment of \$25,000 amount among members of an affiliated group—
(1) In general. In determining the limitation based on amount of tax under

[Footnote § 5943 continued]

(5) "X's credit allowed by section 38 for the taxable year is \$52,500 (\$25,000 plus 25 percent of \$110,000). X has an unused credit for the taxable year of \$91,000 (\$143,500 less \$52,500) which it may carry back or over to other taxable years in accordance with § 1.46-2."

(6) "and (2)"

(7) "Section 46(a)(5) provides that in the case of an affiliated group (as defined in subparagraph (5) of this paragraph), the \$25,000 amount specified in section 46(a)(2) shall be reduced for each member of the group by apportioning \$25,000 among the members of the group. Except as otherwise provided in this paragraph, the \$25,000 amount shall be apportioned among those corporations which are members of the affiliated group on the last day of the taxable year of the common parent. For the taxable year of each such member ending with, or within which falls, the last day of the taxable year of the common parent, the credit allowed by section 38 cannot exceed—

(i) So much of its liability for tax for such taxable year as does not exceed its share of the \$25,000 amount apportioned to it under the rules prescribed in this paragraph, plus

(ii) 25 percent of so much of its liability for tax for such taxable year as exceeds its share of the \$25,000 amount so apportioned to it."

Reg. § 1.46-1(f) (1) continued

section 46(a)(2) in the case of an affiliated group (as defined in subparagraph (5) of this paragraph), the \$25,000 amount specified in such section shall be reduced for each member of the group by apportioning \$25,000 among the members of the group. The apportionment of the \$25,000 amount shall be made for the taxable year of each such member ending with, or within which falls, the last day of the taxable year of the common parent and, except as otherwise provided in this paragraph, shall be made among those corporations which are members of the affiliated group on such last day.

(2) Manner of apportionment. (i) In the case of corporations which are members of an affiliated group on the last day of the taxable year of the common parent, the \$25,000 amount may be apportioned among such members (for the taxable year of each such member ending with, or within which falls, the last day of the taxable year of the common parent) in any manner the common parent may select, provided that the common parent, and each such member of the group less than 100 percent of the stock of which is owned in the aggregate by other members of the group on such last day, consent to the apportionment plan. However, no portion of the \$25,000 amount shall be apportioned to a taxable year ending before January 1, 1962. The consent of each member for which a consent is required to the apportionment plan shall be in the form of a statement signed by the member consenting to the plan. The statement shall set forth the name, address, and taxpayer account number of each member of the affiliated group on such last day (including those members in which other members own 100 percent of the stock) and of any corporation to which any portion of such group's \$25,000 amount is apportionable under subparagraph (3) of this paragraph; the identity of the common parent; the last day of the common parent's taxable year; and the amount apportioned to each corporation. The consents may be incorporated in one statement. The statement (or statements) shall be attached to the timely filed income tax return of the common parent and shall be irrevocable after the due date of such return (including extensions of time). However, if the due date (including extensions of time) of the return of a common parent is before July 15, 1964, the required statement (or statements) shall be considered timely filed if filed on or before July 15, 1964, with the district director with whom the common parent files its return. Each member of the affiliated group on the last day of the taxable year of the common parent shall keep as a part of its records a copy of the consent of the common parent (or a copy of the statement containing all the required consents).

(ii) An apportionment plan adopted by an affiliated group with respect to a particular taxable year of the common parent shall be valid only for the taxable year of each member of the group which ends with, or within which falls, the last day of such taxable year of the common parent. Thus, an affiliated group must file a separate consent to an apportionment plan with respect to each taxable year of the common parent as to which an apportionment plan is desired.

(iii) If an apportionment plan is not timely selected, the \$25,000 amount specified in section 46(a)(2) shall be reduced for each member of the affiliated group, for its taxable year ending with, or within which falls, the last day of the common parent's taxable year, to an amount equal to (a) \$25,000 divided by (b) the number of corporations in such group as of the close of such last day. If the taxable year of the common parent or any other member of such group ends before January 1, 1962, any such parent or member shall not be considered a member of the group for any such taxable year in determining the number of corporations referred to in (b) of the preceding sentence.

(iv) If a member of the affiliated group (including the common parent) makes its income tax return on the basis of a 52-53-week taxable year, the principles of section 441(f)(2)(A)(ii) and paragraph (b)(1) of § 1.441-2 apply in determining the last day of such a taxable year.

Reg. § 1.46-1(f) continued

(3) Short taxable year. (i) If (a) the return of a corporation is for a short period ending after December 31, 1961, (b) such corporation is a member of an affiliated group as of the last day of such period, and (c) the last day of the common parent's taxable year does not end with or within such short period, then the \$25,000 amount shall be reduced for such corporation to an amount equal to \$25,000 divided by the number of corporations in such group as of the close of such corporation's short period. In such case, the total amount that may be apportioned under subparagraph (2) of this paragraph (either equally or according to a plan) among the members of an affiliated group which have the same common parent as the corporation with the short period shall be \$25,000 less the amount apportioned to such corporation for its short period ending in the taxable year of the common parent of the affiliated group. If the common parent of the corporation with the short period is not affiliated with any other corporation at the end of such parent's taxable year within which the short period ends, the \$25,000 amount shall be reduced for the parent by the amount apportioned to such corporation for its short period.

(ii) In lieu of the apportionment provided for in subdivision (i) of this subparagraph, a corporation (with a short period) may waive its right to receive the part of the \$25,000 amount apportionable to it by specifically so indicating on a statement meeting the requirements of subdivision (iii) of this subparagraph. In such case, no amount shall be considered apportioned to such corporation.

(iii) The corporation with the short period shall attach a statement to its timely filed income tax return (including extensions of time). However, if the due date of the return (including extensions of time) is before July 15, 1964, the statement may be filed on or before such date with the district director with whom the return has been filed. The statement shall indicate the name, address, and taxpayer account number of each member of the affiliated group as of the close of the short period; the identity of the common parent and the last day of the common parent's taxable year; and the amount apportioned to itself or, if appropriate, a waiver of the amount apportionable to it. A copy of the statement shall be furnished to the common parent.

(4) Two or more common parents. If a corporation during its taxable year is a member of two or more affiliated groups as of the last day of the taxable year of the common parent of each such group, such corporation shall be considered to be a member of only the affiliated group whose common parent's taxable year ends earliest in such corporation's taxable year.

(5) Definition of affiliated group. For purposes of this paragraph, an affiliated group means one described in section 1504(a), except that all corporations shall be treated as includible corporations, without any exclusion under section 1504(b). Thus, a foreign corporation or a corporation exempt from taxation under section 501 may be a member of an affiliated group for purposes of this paragraph even though under section 1504(b) neither corporation would be an includible corporation.

(6) Affiliated group filing a consolidated return. *In the case of an affiliated group whose members join in filing a consolidated return for a taxable year, see § 1.1502-3(a)(8). If some members of an affiliated group join in filing a consolidated return and other members of such group do not join (such as a corporation exempt from taxation under section 501), then, unless a consent is timely filed apportioning the \$25,000 amount among the group filing the consolidated return and*

[Footnote § 5943 continued]

(8) "The limitation based on amount of tax for an affiliated group all of whose members join in the filing of a consolidated return shall be so much of the consolidated liability for tax as does not exceed \$25,000, plus 25 percent of the consolidated liability for tax in excess of \$25,000. If, however, there are other members of the affiliated group which do not join in the filing of the consolidated return"

(9) "and a consent is not"

Reg. § 1.46-1(f)(6) continued

the other members of the affiliated group, each member of the affiliated group (including each member which joins in filing the consolidated return) shall be treated as a separate corporation for purposes of equally apportioning the \$25,000 amount under subparagraph (2)(iii) of this paragraph. In such case, the limitation based on amount of tax for the group filing the consolidated return shall be computed by substituting for the \$25,000 amount the total of the amounts apportioned to each corporation which joins in filing the consolidated return. If the group filing the consolidated return and the other members of the affiliated group adopt an apportionment plan, the group filing the consolidated return shall be treated as a single member for the purpose of applying subparagraph (2)(i) of this paragraph. Thus, for example, only one consent, executed by the common parent, to the apportionment ^{plans} is required for the group filing the consolidated return. If any member of the affiliated group which joins in the filing of the consolidated return is an organization to which section 593 applies or a cooperative organization described in section 1381(a), see paragraph ^{(a)(3)(ii)} of § 1.1502-8.

(7) Nonresident foreign corporation. (i) No part of the \$25,000 amount shall be apportioned under this paragraph to a foreign corporation not engaged in trade or business within the United States (hereinafter referred to in this subparagraph as a "nonresident foreign corporation"), nor shall such corporation be considered as a member for purposes of determining the number of corporations which divide equally the \$25,000 amount under subparagraph (2)(iii) of this paragraph. Furthermore, the consent of such corporation to an apportionment plan is not required.

(ii) A nonresident foreign corporation which is a common parent of an affiliated group shall be considered to have a taxable year ending December 31.

(iii) If a nonresident foreign corporation is a common parent of an affiliated group, the statement (or statements) containing the consents of members of the group, required by subparagraph (2)(i) of this paragraph, shall be considered timely filed if filed with the Director, International Operations Division, Internal Revenue Service, Washington, D.C. 20225, on or before the 75th day after the end of its taxable year (as determined under subdivision (ii) of this subparagraph) or July 15, 1964, whichever is later.

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

Example (1). P, a domestic corporation, files an income tax return for its taxable year ending January 31, 1962. On such date P owns all the outstanding stock of S, also a domestic corporation. S files a separate income tax return on the basis of a fiscal year ending June 30. The membership of the affiliated group is ascertained as of the close of January 31, 1962, the last day of the taxable year of the common parent, P. On that day the affiliated group consists of P and S. P consents to an apportionment plan in which the \$25,000 amount is apportioned entirely to S for its taxable year ending June 30, 1962 (S's taxable year within which the last day of the taxable year of the common parent, January 31, 1962, falls). Such consent is timely filed. For purposes of computing the credit under section 38, S's limitation based on amount of tax for its taxable year ending June 30, 1962, is so much of S's liability for tax as does not exceed \$25,000, plus 25 percent of S's liability for tax in excess of \$25,000. P's limitation for its taxable year ending January 31, 1962, is equal to 25 percent of P's liability for tax. On the other hand, if an apportionment plan is not timely filed, P's limitation would be so much of P's liability for tax as does not exceed \$12,500 plus 25 percent of P's liability for tax in excess of \$12,500, and S's limitation would be computed similarly.

[Footnote 75913 continued]

(ic) "plan"

(ii) "(a)(2)(ii) of § 1.1502-51"

Reg. § 1.16-1(f) (8) continued

Example (2) Assume the same facts as in example (1), except that P's taxable year ends ¹²March 31, 1968 (on which date it owns all the outstanding stock of S¹³) and that S's taxable year ends June 30, 1968. The limitation based on amount of tax for such taxable years is computed, using 50 percent rather than 25 percent.

Example (3) F, a domestic corporation exempt from taxation under section 501, files a return for its taxable year ending December 31, 1963, on which date it owns all the stock of P, a domestic corporation. P files a consolidated return as a common parent for its fiscal year ending June 30, 1964, with its two wholly owned domestic subsidiaries, S and A. The membership of the affiliated group is ascertained as of the close of December 31, 1963, the last day of the taxable year of the common parent, F, and accordingly consists of F, P, S, and A. No consent to an apportionment plan is filed. Therefore, each member is apportioned \$6,250 of the \$25,000 amount (\$25,000 divided ¹⁴equally among the four members). The limitation based on amount of tax for the affiliated group filing a consolidated return (P, S, and A) for the year ending June 30, 1964 (the consolidated taxable year within which December 31, 1963, falls)¹⁵ is computed by using \$18,750 instead of the \$25,000 amount. The \$18,750 is arrived at by adding together the \$6,250 amounts apportioned to F, S, and A.¹⁶ If, however, F files a timely consent, it may apportion the entire \$25,000 amount to the group filing the consolidated return (P, S, and A).

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Example ¹⁸(4) P, a domestic corporation filing income tax returns on a calendar-year basis, owns all the stock of S, T, and U, all domestic corporations. S, T, and U file separate returns on a calendar-year basis. On June 30, 1963, S is liquidated, and therefore has a short taxable year beginning January 1, 1963, and ending June 30, 1963. S does not waive its right to its equal portion of the \$25,000 amount. For such short taxable year, the \$25,000 amount shall be reduced for S to \$6,250 (\$25,000 divided by 4, the number of corporations in the affiliated group at the close of S's short taxable year). The total amount apportionable to the members of the affiliated group of which P is the common parent for their taxable years ending December 31, 1963, is \$18,750 (\$25,000 minus the \$6,250 apportioned to S for its short taxable year ending June 30, 1963). The \$18,750 amount may be apportioned according to an apportionment plan or, if a plan is not timely filed, will be apportioned equally among P, T, and U.

Q-7 [5944] Reg. § 1.13-2 (TD 6731, filed 5-7-64; amended by TD 6931, filed 10-9-67; TD 6958, filed 6-20-68; TD 7126, filed 6-9-71.) Carryback and carryover of unused credit.

(a) Allowance of unused credit as carryback or carryover.—(1) In general. Section 46(b)(1) provides for carrybacks and carryovers of any unused credit. An unused credit is the excess of the credit earned for the taxable year (as defined

[Footnote 5943 continued]

(12) "December 31, 1961"

(13) "No portion of the \$25,000 amount is apportioned to P since its taxable year ends before January 1, 1962. Accordingly, S is apportioned the entire \$25,000 amount for its taxable year ending June 30, 1962."

(14) "by"

(15) ""

(16) "If the consolidated liability for tax of P, S, and A is \$27,750 for the taxable year ending June 30, 1964, then the credit allowed by section 38 for such group or such taxable year cannot exceed \$21,000 (\$18,750 plus 25 percent of \$9,000)."

(17) "Example (4). Assume the same facts as in example (2), except that a consent by F is filed with the timely filed return of F apportioning the entire \$25,000 amount to the group filing a consolidated tax return (P, S, and A). The credit allowed by section 38 for such group for its taxable year ending June 30, 1964, cannot exceed \$25,625.00 (\$25,000 plus 25 percent of \$2,750)."

(18) "(5)"

Reg. § 1.46-2(a)(1) continued

in paragraph (a) of § 1.46-1 over the limitation based on amount of tax for such taxable year (as determined under paragraph (b) of § 1.46-1). Subject to the ¹limitations contained in paragraph (b) of this section, an unused credit shall be added to the amount allowable as a credit under section 38 for the years to which the unused credit can be carried. The year with respect to which an unused credit arises shall be referred to in this section as the "unused credit year."

(2) Taxable years to which unused credit may be carried. Except as provided in subparagraphs (3) ¹, (4), and (5) of this paragraph, an unused credit shall be an investment credit carryback to each of the 3 taxable years preceding the unused credit year and an investment credit carryover to each of the 7 taxable years (or 10 taxable years in cases to which subparagraph (5) of this paragraph applies) succeeding the unused credit year, except that an unused credit shall be a carryback only to taxable years ending after December 31, 1961. An unused credit must be carried first to the earliest of the 10 (or 13) taxable years to which it may be carried, and then to each of the other 9 (or 13) taxable years (in order of time) to the extent that the unused credit may not be added (because of the ¹limitations contained in paragraph (b) of this section) to the amount allowable as a credit under section 38 for a prior taxable year.

(3) Fifth taxable year following unused credit year ending on or before December 31, 1966. If the fifth taxable year following the unused credit year ends on or before December 31, 1966, then the unused credit shall be an investment credit carryover to each of the 5 taxable years succeeding such unused credit year.

(4) Property used predominantly in a possession of the United States. The amount of any investment credit carryback to any taxable year ending on or before December 31, 1965, shall be determined without regard to section 43(a)(2)(B)(vii), relating to property used predominantly in a possession of the United States. See paragraph (g)(2)(vii) of § 1.48-1. For example: Assume that corporation X, a calendar year taxpayer, places in service during 1965 property described in section 43(a)(2)(B)(vii); that X's unused credit for 1968 is \$10,000; and that, but for the application of section 43(a)(2)(b)(vii), X's unused credit for 1968 would have been \$7,000. X's investment credit carryback from 1968 to 1965 is limited to \$7,000, and X's 1968 carryback to 1966 is \$3,000 plus any portion of the \$7,000 carried back to 1965 which was not allowed as a credit for such year.

(5) Additional 3-year carryover period in certain cases. Any portion of an investment credit carryback or carryover to any taxable year beginning after December 31, 1968, and ending after April 15, 1969, which may be added to the amount allowable as a credit for such taxable year under the limitation provided in subparagraph (1) of paragraph (b) of this section but may not be added solely because of the limitation provided in subparagraph (2) of such paragraph shall be an investment credit carryover to each of the 10 taxable years succeeding the unused credit year.

(b) ¹Limitations on allowance of unused credit—(1) In general. The amount of the unused credit from any particular unused credit year which may be added to the amount allowable as a credit under section 38 for any of the ²preceding or ⁴succeeding taxable years to which such credit may be carried shall not exceed the amount by which the limitation based on amount of tax for such preceding or succeeding taxable year exceeds the sum of ⁶(i) the credit earned for such preceding or succeeding year, and ⁶(ii) other unused credits carried to such preceding or succeeding year which are attributable to unused credit years prior to the particular unused credit year. Thus, in determining the amount, if any, of an unused credit from a particular unused credit year which shall be added to the amount allowable as a credit for any preceding or succeeding taxable year, the credit earned for such preceding or succeeding taxable year, plus any unused credits origi-

[Footnote § 5944] Matter in *italics* added by TD 7126, which struck out:

(1) "limitation"	(4) "7"
(2) "and"	(5) "(1)"
(3) "3"	(6) "(2)"