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Reg. §1.48-9(b)(1) continued

nating in taxable years prior to a particular unused credit year, shall first be applied against the limitation based on amount of tax for such preceding or succeeding taxable year. To the extent the limitation based on amount of tax for the preceding or succeeding year exceeds the sum of the credit earned for such year and other unused credits attributable to years prior to the particular unused credit year, the unused credit from the particular unused credit year shall be added to the amount allowable as a credit under section 38 for such preceding or succeeding year. To the extent that an unused credit cannot be added for a particular preceding or succeeding taxable year because of the limitation contained in this *subparagraph or in subparagraph (2) of this paragraph*, such unused credit shall be available as a carryback or carryover to the next succeeding taxable year to which it may be carried.

(2) Taxable years beginning after December 31, 1968, and ending after April 18, 1969. The total amount of investment credit carrybacks and carryforwards which may be added to the amount allowable as a credit under section 38 for any taxable year beginning after December 31, 1968, and ending after April 18, 1969, shall not exceed 20 percent of the higher of (i) the aggregate of the investment credit carrybacks and carryforwards to the taxable year, or (ii) the aggregate of the investment credit carrybacks and carryforwards to any preceding taxable year that began after December 31, 1968, and ended after April 18, 1969.

(c) Effect of net operating loss carryback from a taxable year ending on or before July 31, 1967. If the effect of a net operating loss carryback from a taxable year ending on or before July 31, 1967, is to create an unused credit (as defined in paragraph (b)(1) of this section), such unused credit shall not be treated as an investment credit carryback. However, the full amount of the unused credit so arising shall be available for use as an investment credit carryover for the 7 taxable years (5 taxable years in a case in which paragraph (a)(3) of this section applies) following the unused credit year. Thus, assume that a calendar-year taxpayer has a credit earned for 1965 of $25,000 and a liability for tax of the same amount. If in 1966 such taxpayer has a net operating loss which he carries back to 1965 thereby fully eliminating his taxable income and liability for tax for 1965, then the $25,000 credit earned (no longer allowable for 1965) becomes an unused credit which, although may not be treated as an investment credit carryback, shall be carried forward to each of the subsequent years to which it may be carried. On the other hand, if his net operating loss arose in 1967 rather than in 1966, then the $25,000 unused credit for 1965 would be an investment credit carryback to each of the 3 taxable years preceding 1965 and an investment credit carryover to each of the subsequent years to which it may be carried.

(d) Taxable years beginning before January 1, 1963, and ending after December 31, 1961. Section 49(b)(4) provides a transition rule relating to the amount of an investment credit carryback which may be added to the amount allowable as a credit under section 38 for a taxable year beginning before January 1, 1963, and ending after December 31, 1961. For purposes of determining the amount of unused credits which may be carried back to such a taxable year and added to the amount allowable as a credit for such year, the limitation based on amount of tax for such year (determined without regard to this paragraph) shall be reduced to an amount which bears the same ratio to such limitation as the number of days in such taxable year after December 31, 1961, bears to the total number of days in such year.

(e) Corporate acquisitions. For the carryover of unused credits in the case of certain corporate acquisitions, see section 381(c)(25).

(f) Periods of less than 12 months. A section 1 part of a year which is considered as a taxable year under section 441(f) and 7701(a)(23) shall be treated as a preceding or a succeeding taxable year for the purpose of determining under section 49(b) the taxable years to which an unused credit may be carried.

(g) Examples. The provisions of paragraphs (a) through (f) of this section may be illustrated by the following examples:

Example (1). Corporation X files its income tax return on the basis of the

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

calendar year. X's credit earned and its limitation based on amount of tax for each of its taxable years 1962 through 1968 are as follows:

	Credit earned	Limitation based on amount of tax
1962	$175,000	$200,000
1963	250,000	160,000
1964	260,000	210,000
1965	210,000	230,000
1966	220,000	230,000
1967	200,000	250,000
1968	270,000	280,000

(1) Corporation X's credit earned for 1962, $175,000, is allowable in full as a credit under section 38 for 1962 since such amount is less than the limitation based on amount of tax for such year, $200,000. Since the limitation based on amount of tax for 1963 is $160,000, only $160,000 of the $250,000 credit earned for such year is allowable under section 38 for a credit for 1963. The unused credit for 1963 of $90,000 ($250,000 less $160,000) is an investment credit carryback to 1959 and an investment credit carryover to 1964 and subsequent years. The portions of the $90,000 unused credit which are to be added to the amount allowable as a credit under section 38 for 1962 and for 1964 and subsequent years are computed as follows:

(i) 1962. The portion of the unused credit for 1963 ($90,000) which is allowable as a credit for 1962 is $25,000. This amount shall be added to the amount allowable as a credit for 1962. The balance of the unused credit for 1963 to be carried to 1964 is $65,000. These amounts are computed as follows:

Carryback to 1962			$90,000
1962 limitation based on tax		$200,000	
Less: Credit earned for 1962	$175,000		
Unused credits attributable to years preceding 1963	0	175,000	
Limit on amount of 1963 unused credit which may be added as a credit for 1962			25,000
Balance of 1963 unused credit to be carried to 1964			$65,000

(ii) 1964. The portion of the balance of the unused credit for 1963 ($65,000) allowable as a credit for 1964 is $10,000. This amount shall be added to the amount allowable as a credit for 1964. The balance of the unused credit for 1963 to be carried to 1965 is $55,000. These amounts are computed as follows:

Carryover to 1964			$65,000
1964 limitation based on tax		$210,000	
Less: Credit earned for 1964	$200,000		
Unused credits attributable to years preceding 1963	0	200,000	
Limit on amount of 1963 unused credit which may be added as a credit for 1964			10,000
Balance of 1963 unused credit to be carried to 1965			$55,000

Reg. § 1.46-2(g) Example (1)(ii) continued:

(iii) 1965. The portion of the balance of the unused credit for 1963 ($55,000) allowable as a credit for 1965 is $20,000. This amount shall be added to the amount allowable as a credit for 1965. The balance of the unused credit for 1963 to be carried to 1966 is $35,000. These amounts are computed as follows:

Carryover to 1965			$55,000
1965 limitation based on tax		$230,000	
Less: Credit earned for 1965	$210,000		
Unused credits attributable to years preceding 1965	0	210,000	
Limit on amount of 1963 unused credit which may be added as a credit for 1965			20,000
Balance of 1963 unused credit to be carried to 1966			$35,000

(iv) 1966. The entire balance of the unused credit for 1963 ($35,000) is allowable as a credit for 1966, since the limitation based on amount of tax for 1966 exceeds the sum of the credit earned for 1966 and unused credits attributable to years prior to 1963 by an amount in excess of $35,000. Since the balance of the unused credit for 1963 has been fully allowed, no portion thereof remains to be carried to 1967 or 1968. This is illustrated as follows:

Carryover to 1966			$35,000
1966 limitation based on tax		$250,000	
Less: Credit earned for 1966	$250,000		
Unused credits attributable to years preceding 1966	0	250,000	
Limit on amount of 1963 unused credit which may be added as a credit for 1966			40,000
Balance of 1963 unused credit to be carried to 1967			$ 0

(2) Since the limitation based on amount of tax for 1967 is $250,000, only $240,000 of the $250,000 credit earned for such year is allowable as a credit for 1967. The unused credit for 1967 of $10,000 (which is from $250,000 of the investment credit carryback to 1964, 1965, and 1966 and an investment credit carryover to 1968 and subsequent years. The portion of the $10,000 unused credit which shall be added to the amount allowable as a credit for such years are computed as follows:

(i) 1968. The portion of the unused credit for 1967 ($10,000) allowable as a credit for 1968 is none. The balance of the unused credit for 1967 to be carried to 1968 is $10,000. These amounts are computed as follows:

Carryback to 1966			$10,000
1968 limitation based on tax		$210,000	
Less: Credit earned for 1968	$200,000		
Unused credits attributable to years preceding 1967 (unused credit from 1966)	10,000	210,000	
Limit on amount of 1967 unused credit which may be added as a credit for 1968			0
Balance of 1967 unused credit to be carried to 1969			$10,000

Reg. §1.46-3(g) Example (1)(ii) continued

(ii) 1967. The portion of the unused credit for 1967 ($40,000) allowable as a credit for 1966 is zero. The balance of the unused credit for 1967 to be carried to 1968 is $40,000. These amounts are computed as follows:

Carryback to 1965			$40,000
1965 limitation based on tax		$280,000	
Less: Credit earned for 1965	$210,000		
Unused credits attributable to years preceding 1967 (unused credit from 1966)	20,000	230,000	
Limit on amount of 1967 unused credit which may be added as a credit for 1965			0
Balance of 1967 unused credit to be carried to 1968			$40,000

(iii) 1968. The portion of the unused credit for 1967 ($40,000) allowable as a credit for 1968 is $5,000. This amount shall be added to the amount allowable as a credit for 1968. The balance of the unused credit for 1967 to be carried to 1969 is $35,000. These amounts are computed as follows:

Carryback to 1968			$40,000
1968 limitation based on tax		$260,000	
Less: Credit earned for 1968	$220,000		
Unused credits attributable to years preceding 1967 (unused credit from 1968)	35,000	255,000	
Limit on amount of 1967 unused credit which may be added as credit for 1968			5,000
Balance of 1967 unused credit to be carried to 1969			$35,000

(iv) 1969. The portion of the balance of the unused credit for 1967 ($35,000) allowable as a credit for 1969 is $10,000. This amount shall be added to the amount allowable as a credit for 1969. The balance of the unused credit for 1967 to be carried to 1970 and subsequent years is $25,000. These amounts are computed as follows:

Carryover to 1969			$35,000
1969 limitation based on tax		$280,000	
Less: Credit earned for 1969	$270,000		
Unused credits attributable to years preceding 1967	0	270,000	
Limit on amount of 1967 unused credit which may be added as a credit for 1969			10,000
Balance of 1967 unused credit to be carried to 1970			$25,000

Example (2). Corporation X files its income tax return on the basis of a fiscal year ending June 30. For the taxable year beginning July 1, 1967, and ending June 30, 1968, X's credit earned is $15,000, and its limitation based on tax is $200,000. The full credit earned ($15,000) is allowable for X's taxable year ending June 30, 1968, as a credit against tax since such amount is less than the limitation

Reg. § 1.46-3(g) Example (2) continued

($250,000). For purposes of determining the amount of an investment credit carryback from any subsequent taxable year which may be added to the amount allowable as a credit for the taxable year ending June 30, 1968, the limitation based on amount of tax for such year shall be reduced from

$200,000 to $90,178 $\left(200{,}000 \times \frac{181}{385}\right)$. Therefore, the total investment credit carrybacks to the taxable year ending June 30, 1968 may not exceed $91,178 ($90,178 less $85,000).

Example (3). A, a calendar year taxpayer, has a total of $500 in investment credit carryovers to 1970, composed of a $150 unused credit from 1968 and a $350 unused credit from 1969. A's limitation based on amount of tax for 1970 is $125. Under paragraph (b)(3) of this section, A limited to the use of only $100 (80 percent of $500) of his unused credits to 1970 and to each subsequent year. Since, in the absence of the 20-percent limitation, A could have used $125 of the carryover from 1968, $25 of such carryover (i.e., the portion that cannot be used in 1970 solely because of the 20-percent limitation) qualifies for the additional 3-year carryover period provided in paragraph (a)(5) of this section.

Example (4). The facts are the same as in example (3) except that A placed in service in 1970 property eligible for the investment credit under one of the rules provided in section 48(b), producing an unused credit of $400 for 1970 that is a carryback to 1969. Under paragraph (b)(3) of this section, the limitation on the use of carryovers and carrybacks to 1969 and each subsequent year is retroactively increased to $160, i.e., 80 percent of $200 (the sum of $500 in carryovers and $300 in carrybacks to 1969). Accordingly, an additional $35 of the carryover from 1968 becomes usable in 1969. Since the remaining $15 of the carryover from 1968 is not usable because of the limitation provided in paragraph (b)(4) of this section, such $15 amount does not qualify for the additional 3-year carryover period provided in paragraph (a)(5) of this section.

(c) *Wholly owned domestic corporations.* An unused credit of a corporation which elects in an unused credit year for which the corporation is not an electing small business corporation (as defined in section 1371(a)) and which is a carryback or carryover to a taxable year for which the corporation is an electing small business corporation shall not be added to the amount allowable as a credit under section 38 to the shareholders of such corporation for any taxable year. However, a taxable year for which the corporation is an electing small business corporation shall be counted as a taxable year for purposes of determining the taxable years to which such unused credit may be carried.

(T.D. 7322, filed 5-7-74; amended by T.D. 8060, filed 10-9-85.)

(d) *Definitions.* (1) With respect to any taxable year, the qualified investment of the taxpayer is the aggregate (expressed in dollars) of (i) the applicable percentage of the basis of each new section 38 property placed in service by the taxpayer during such taxable year, plus (ii) the applicable percentage of the cost of each used section 38 property placed in service by the taxpayer during such taxable year. With respect to any section 38 property, qualified investment means the applicable percentage of the basis (or cost) of such property. Section 38 property placed in service by the taxpayer during the taxable year includes the taxpayer's share of the basis (or cost) of section 38 property placed in service by a partnership in the taxable year of such partnership ending with or within the taxpayer's taxable year. In the case of a shareholder of an electing small business corporation (as defined in section 1371(a)), or a beneficiary of an estate or trust, see [illegible] respectively, for determination of the basis (or cost) of section 38 property placed in service by such corporation, estate, or trust. For the purpose of this section, section 38 property is used section 38 property, see [illegible] and section 38 property only.

Reg. § 1.46-3(a) continued

(2) The basis (or cost) of section 38 property placed in service during a taxable year shall not be taken into account in determining qualified investment for such year if such property is disposed of or otherwise ceases to be section 38 property during such year, except where [1]§ 1.47-3 applies. Thus, if individual A places in service during a taxable year section 38 property and later in the same year sells such property, the basis (or cost) of such property shall not be taken into account in determining A's qualified investment. On the other hand, if A places in service section 38 property during a taxable year and dies later in the same year, the basis (or cost) of such property would be taken into account in computing qualified investment. Similarly, if section 38 property is destroyed by fire in the same year in which it is placed in service and *[paragraph (h) of this*

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[1]footnote ¶ 5015] Matter in *italics* added by TD 6991, which struck out:
(1) "section 47(b) or 48(c)(1)"
(2) "section 48(c)(4)"

Reg. § 1.46-3(a)(2) continued

section applies to reduce the basis (or cost) of replacement property, the basis (or cost) of the destroyed property would be taken into account in computing qualified investment. *In order to determine whether section 38 property is disposed of or otherwise ceases to be section 38 property see § 1.47-2.*

(2) Qualified investment is reduced in the case of property which is "public utility property" (see paragraph (h) of this section), and in the case of property of 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 organization described in section 1381(a) (see § 1.46-4).

(b) *Applicable percentage.* The applicable percentage to be applied to the basis (or cost) of property is 33⅓ percent if the estimated useful life of the property is 4 years or more but less than 6 years; 66⅔ percent if the estimated useful life is 6 years or more but less than 8 years; or 100 percent if the estimated useful life is 8 years or more. The provisions of this paragraph may be illustrated by the following example:

Example. Corporation X acquires and places in service during 1963 the following new and used section 38 properties:

Property	Estimated useful life	Basis (or cost)
A (new)	5 years	$ 60,000
B (new)	10 years	90,000
C (new)	6 years	150,000
D (used)	4 years	30,000

Corporation X's qualified investment for 1963 is $220,000 determined in the following manner:

Property	Basis (or cost)	Applicable percentage	Qualified investment
A	$ 60,000	× 33⅓%	$ 20,000
B	90,000	× 100%	90,000
C	150,000	× 66⅔%	100,000
D	30,000	× 33⅓%	10,000
Total			$220,000

(c) *Basis or cost.* (1) The basis of any new section 38 property shall be determined in accordance with the general rules for determining the basis of property. Thus, the basis of property would generally be its cost (see section 1012), unreduced by the adjustment to basis provided by section 48(g)(1) with respect to property placed in service before January 1, 1971, and any other adjustment to basis, such as that for depreciation, and would include all items properly included by the taxpayer in the depreciable basis of the property, such as installation and freight costs. However, for purposes of determining qualified investment, the basis of new section 38 property constructed, reconstructed, or created by the taxpayer shall not include any depreciation sustained with respect to any other property used in the construction, reconstruction, or creation of such new section 38 property. (See paragraph (b)(4) of § 1.48-1.) If new section 38 property is acquired in exchange for cash and other property in a transaction described in section 1031 in which no gain or loss is recognized, the basis of the newly acquired property for purposes of determining qualified investment would be equal to the adjusted basis of the other property plus the cash paid. See § 1.48-4 for the basis of property to a lessee where the lessor has elected to treat such lessee as a purchaser.

(2) The cost of any used section 38 property shall be determined in accordance with paragraph (b) of § 1.48-3. However, the aggregate cost of used section 38

Reg. § 1.46-3(e)(2) continued

property which may be taken into account in any taxable year in computing qualified investment cannot exceed $50,000 (see paragraph (c) of § 1.48-3).

(3) For reduction in the basis (or cost) of certain property which replaces other property which was destroyed or damaged by fire, storm, shipwreck, or other casualty, or which was stolen, see *paragraph (h) of this section.*

(d) Placed in service. (1) For purposes of the credit allowed by section 38, property shall be considered placed in service in the earlier of the following taxable years:

(i) The taxable year in which, under the taxpayer's depreciation practice, the period for depreciation with respect to such property begins; or

(ii) The taxable year in which the property is placed in a condition or state of readiness and availability for a specifically assigned function, whether in a trade or business, in the production of income, in a tax-exempt activity, or in a personal activity.

Thus, if property meets the conditions of subdivision (ii) of this subparagraph in a taxable year, it shall be considered placed in service in such year notwithstanding that the period for depreciation with respect to such property begins in a succeeding taxable year because, for example, under the taxpayer's depreciation practice such property is accounted for in a multiple asset account and depreciation is computed under an "averaging convention" (see § 1.167 (a)-10), or depreciation with respect to such property is computed under the completed contract method, the unit of production method, or the retirement method.

(2) In the case of property acquired by a taxpayer for use in his trade or business (or in the production of income), the following are examples of cases where property shall be considered in a condition or state of readiness and availability for a specifically assigned function:

(i) Parts are acquired and set aside during the taxable year for use as replacements for a particular machine (or machines) in order to avoid operational time loss.

(ii) Operational farm equipment is acquired during the taxable year and it is not practicable to use such equipment for its specifically assigned function in the taxpayer's business of farming until the following year.

(iii) Equipment is acquired for a specifically assigned function and is operational but is undergoing testing to eliminate any defects.

However, fruit-bearing trees and vines shall not be considered in a condition or state of readiness and availability for a specifically assigned function until they have reached an income-producing stage. Moreover, materials and parts acquired to be used in the construction of an item of equipment shall not be considered in a condition or state of readiness and availability for a specifically assigned function.

(3) Notwithstanding subparagraph (1) of this paragraph, property with respect to which an election is made under § 1.48-1 to treat the lessee as having purchased such property shall be considered placed in service by the lessor in the taxable year in which possession is transferred to such lessee.

(4) (i) The credit allowed by section 38 with respect to any property shall be allowed only for the first taxable year in which such property is placed in service by the taxpayer. The determination of whether property is section 38 property in the hands of the taxpayer shall be made with respect to such first taxable year. Thus, if a taxpayer places property in service in a taxable year and such property does not qualify as section 38 property (or only a portion of such property qualifies as section 38 property) in such year, no credit (or a credit only as to the portion which qualifies in such year) shall be allowed to the taxpayer with respect to such property notwithstanding that such property (or a greater portion of such property)

Reg. § 1.46-3(d)(4)(i) continued

qualifies as section 38 property in a subsequent taxable year. For example, if a taxpayer places property in service in 1970 and uses the property entirely for personal purposes in such year, but in 1971 begins using the property in a trade or business, no credit is allowable to the taxpayer under section 38 with respect to such property. See § 1.48-1 for the definition of section 38 property.

(ii). Notwithstanding subdivision (i) of this subparagraph, if, for the first taxable year in which property is placed in service by the taxpayer, the property qualifies as section 38 property but the basis of the property does not reflect its full cost for the reason that the total amount to be paid or incurred by the taxpayer for the property is indeterminate, a credit shall be allowed to the taxpayer for such first taxable year with respect to so much of the cost as is reflected in the basis of the property as of the close of such year, and an additional credit shall be allowed to the taxpayer for any subsequent taxable year with respect to the additional cost paid or incurred during such year and reflected in the basis of the property as of the close of such year. The estimated useful life used in computing each additional credit with respect to the property shall be the same as the estimated useful life used in computing the credit for the first taxable year in which the property was placed in service by the taxpayer. Assume, for example, that in 1968 X Corporation, a utility company which makes its return on the basis of a calendar year, enters into an agreement with Y Corporation, a builder, to construct certain utility facilities for a housing development built by Y. Assume further that part of the funds for the construction of the utility facilities is advanced by Y under a contract providing that X will repay the advances over a 10-year period in accordance with an agreed formula, after which no further amounts will be repayable by X even though the full amount advanced by Y has not been repaid. Assuming that the utility facilities are placed in service in 1968 and qualify as section 38 property, X is allowed a credit for 1968 with respect to the basis in the utility facilities at the close of 1968. For each succeeding taxable year X is allowed an additional credit with respect to the increase in the basis of the utility facilities resulting from the repayments to Y during such year.

(e) Estimated useful life—(1) In general. With respect to assets placed in service by the taxpayer during any taxable year, for the purpose of computing qualified investment the estimated useful lives assigned to all assets which fall within a particular guideline class (within the meaning of Revenue Procedure 62-21) may be determined, at the taxpayer's option, under either subparagraph (2) or (3) of this paragraph. Thus, the taxpayer may assign estimated useful lives to all the assets falling in one guideline class in accordance with subparagraph (2) of this paragraph, and may assign estimated useful lives to all the assets falling within another guideline class in accordance with subparagraph (3) of this paragraph. See subparagraphs (4) and (5) of this paragraph for determination of estimated useful lives of assets not subject to subparagraph (2) or (3) of this paragraph.

(2) Class life system. The taxpayer may assign to each asset falling within a guideline class, which is placed in service during the taxable year, the class life of the taxpayer for the guideline class for such year as determined under Section 4, Part II of Revenue Procedure 62-21. The preceding sentence may be applied to the assets falling within a guideline class irrespective of whether the taxpayer uses single asset accounts or multiple asset accounts in computing depreciation with respect to such assets and irrespective of whether the taxpayer chooses to have his depreciation allowance with respect to such assets examined under the rules provided in Revenue Procedure 62-21.

(3) Individual useful life system. (i) The taxpayer may assign an individual estimated useful life to each asset falling within a guideline class which is placed

Reg. § 1.46-3(e)(3)(i) continued

in service during the taxable year. With respect to the assets falling within the guideline class which are placed in single asset accounts for purposes of computing depreciation, the estimated useful life used for each asset for that purpose shall be used in determining qualified investment. With respect to the assets falling within the guideline class which are placed in multiple asset accounts (including a guideline class account described in Revenue Procedure 83-35) for which a group, classified, or composite rate is used in computing depreciation (or in single asset accounts for which an average life rate is used), the determination of estimated useful life for each asset in the account shall be made individually on the best estimate obtainable on the basis of all the facts and circumstances. The individual estimated useful lives used for all the assets placed in a multiple asset account, when viewed together, must be consistent with the group, classified, or composite life used for the account for purposes of computing depreciation.

(ii) In determining the individual estimated useful lives of assets similar in kind contained in a multiple asset account (or in single asset accounts for which an average life rate is used), the taxpayer may (a) assign to each of such assets the average useful life of such assets used for purposes of computing depreciation, or (b) assign separate lives to such assets based on the estimated range of years taken into consideration in establishing the average useful life. Thus, for example, if a taxpayer places 9 similar trucks in an average estimated useful life of 7 years, based on an estimated range of 6 to 8 years (3 trucks with a useful life of 6 years, 3 trucks with a useful life of 7 years, and 3 trucks with a useful life of 8 years), in a multiple asset account for which a group rate is used in computing depreciation, he may either assign a useful life of 6 years to 3 of the trucks, 7 years to 3 of the trucks, and 8 years to 3 of the trucks, or he may assign the average useful life of the trucks (7 years) to each of the 9 trucks. Similarly, if a taxpayer places 90 similar telephone poles in an average useful life of 23 years, based on an estimated range of 5 to 30 years (9 with a useful life of less than 4 years, 8 with a useful life of 4 to 6 years, 4 with a useful life of 6 to 8 years, and 91 with a useful life of more than 8 years), in a multiple asset account for which a group rate is used in computing depreciation, he may either assign useful lives corresponding to the estimated range of years of the poles (i.e., a useful life of less than 4 years to 9 of the poles, etc.), or he may assign the average useful life of the poles (23 years) to each of the poles.

(iii) In the case of "mass assets" (as defined in paragraph (b)(2) of § 2.48-1) for which the taxpayer is permitted to use an appropriate mortality disposition table (including a standard mortality disposition table) under paragraph (c)(1) of 31.167-1 (Estimated useful lives with regard to guidelines (c)(3)(ii) thereof), the taxpayer may use such table for purposes of individually estimated useful lives by applying, under subdivision (ii)(b) of this subparagraph, separate lives to such assets based on the estimated range of years taken into consideration in establishing the average useful life. If a taxpayer uses a standard mortality disposition table for any taxable year, such table must be used for all subsequent taxable years unless the taxpayer obtains the consent of the Commissioner to change.

(iv) For purposes of subdivision (ii) of this subparagraph, assets (other than "mass assets") shall not be considered as "similar in kind" in respect of other assets unless all such assets are substantially of the same value, and shall meet section 38 property be considered as "similar in kind" to nonsection 38 property.

(f) Useful life of property subject to recapture. In the case of property with respect to which recapture in full of depreciation is attributable, the term

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[1] Continued on next page.
(2) "mass"
(3) "the mass"
(4) "multiple."

Reg. § 1.48-9(c)(1) continued

over which amortization deductions are taken shall be considered as the estimated useful life of such property.

(5) *Useful life of property subject to certain methods of depreciation.* If a taxpayer is using a method of depreciation, such as the unit of production or retirement method, which does not measure the useful life of the property in terms of years, he must estimate such useful life in years in order to compute his qualified investment.

(6) *Record requirements.* The taxpayer shall maintain sufficient records to determine whether section 47 (relating to certain dispositions, etc., of section 38 property) applies with respect to any asset.

(i) *Partnerships—(1) In general.* In the case of a partnership, each partner shall take into account separately, for his taxable year with or within which the partnership taxable year ends, his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property placed in service by the partnership during such partnership taxable year. Each partner shall be treated as the taxpayer with respect to his share of the basis of partnership new section 38 property and his share of the cost of partnership used section 38 property. The estimated useful life to each partner of such property shall be deemed to be the estimated useful life of the property in the hands of the partnership. Partnership section 38 property shall not, by reason of each partner taking his share of the basis or cost into account, lose its character as either new section 38 property or used section 38 property, as the case may be.

(2) *Determination of partner's share.* (i) Each partner's share of the basis (or cost) of any section 38 property shall be determined in accordance with the ratio in which the partners divide the general profits of the partnership (that is, the taxable income of the partnership as described in section 702(a)(9)) *regardless of whether the partnership has a profit or a loss for the taxable year during which the section 38 property is placed in service.* However, if the ratio in which the partners divide the general profits of the partnership changes during the taxable year of the partnership, the ratio effective for the date on which the property is placed in service shall apply.

(ii) Notwithstanding subdivision (i) of this subparagraph, if all related items of income, gain, loss, and deduction with respect to any item of partnership section 38 property are specially allocated in the same manner and if such special allocation is recognized under section 704(a) and (b) and paragraph (b) of § 1.704-1, then each partner's share of the basis of such item of new section 38 property or the cost of such item of used section 38 property shall be determined by reference to such special allocation without regard to the date on which the property is placed in service.

(iii) Notwithstanding subdivision (i) and (ii) of this subparagraph, if with respect to a partnership taxable year the conditions set forth in (a) through (c) of this subdivision are satisfied with respect to a partner, then such partner shall not take into account the basis (or cost) of any section 38 property placed in service by the partnership during such taxable year. The conditions referred to in the preceding sentence are:

(a) Such partner's interest in the general profits of the partnership during the taxable year is 5 percent or less;

(b) Under the partnership agreement, such partner will not, for a period during the taxable year or within 3 years after the end of such year; and

(c) The partnership agreement provides that the basis (or cost) of section 38 property placed in service by the partnership during the taxable year shall not be taken into account by a partner described in (a) and (b) of this subdivision.

Reg. § 1.46-3(f)(2)(iii) continued

Any basis (or cost) of section 38 property which is not taken into account by a partner because of the provisions of this subdivision shall be taken into account by the other partners in accordance with subdivision (i) of this subparagraph.

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

Example (1). Partnership ABCD acquires and places in service on January 1, 1962, an item of new section 38 property, and acquires and places in service on September 1, 1962, another item of new section 38 property. The ABCD partnership and each of its partners reports income on the basis of the calendar year. Partners A, B, C, and D share partnership profits equally. Each partner's share of the basis of each new partnership section 38 property is 25 percent.

Example (2). Assume the same facts as in example (1) and the following additional facts: A dies on June 30, 1962, and B purchases A's interest as of such date. Each partner's share of the profits from January 1 to June 30 is 25 percent. From July 1 to December 31, B's share of the profits is 50 percent, and C and D's share of the profits is 25 percent each. For A's last taxable year (January 1 to June 30, 1962), A shall take into account 25 percent of the basis of the section 38 property placed in service on January 1. B shall take into account 25 percent of the basis of the section 38 property placed in service on January 1 and 50 percent of the basis of the section 38 property placed in service on September 1. C and D shall each take into account 25 percent of the basis of each new section 38 property placed in service by the partnership in 1962.

Example (3). Partnership XYZ is engaged in the business of renting soda fountain equipment and icemakers to restaurants. The partnership makes no elections under § 1.48-4 to treat its lessees as having purchased such property. Under the terms of the partnership agreement, the income, gain or loss on disposition, depreciation, and other deductions attributable to the icemakers are specially allocated 70 percent to partner X and 30 percent to partner Y. In all other respects X and Y share profits and losses equally. If the special allocation with respect to the icemakers is recognized under section 704(a) and (b) and paragraph (b) of § 1.704-1, the basis (or cost) of the icemakers which qualify as partnership section 38 property shall be taken into account 70 percent by X and 30 percent by Y. The basis (or cost) of partnership section 38 property not subject to the special allocation shall be taken into account equally by X and Y.

Example (4). Assume the same facts as in example (3) and the following additional facts: During November 1962, the partnership, which reports its income on the basis of a fiscal year ending May 31, acquires and places in service two items which qualify as new section 38 property, an icemaker and a soda fountain. The icemaker has an estimated useful life of 8 years to the partnership and a basis of $1,000. The soda fountain has an estimated useful life of 6 years to the partnership and a basis of $300. Partner X also owns and operates a business as a sole proprietorship and reports income on the calendar year basis. During 1962, X acquires and places in service in his sole proprietorship a machine which qualifies as new section 38 property. This machine has an estimated useful life of 4 years and a basis of $200. X owns no interest in any other partnerships, electing small business corporations, estates, or trusts. His total qualified investment for 1962 is $1,000, computed as follows:

Property	Estimated useful life	Basis	X's share of basis	Applicable percentage	Qualified investment
Partnership XYZ					
Icemaker	8	$1,000	$700	100%	$ 700
Soda Fountain	6	300	300	66⅔%	200
Sole Proprietorship					
Machine	4	200	——	50%	100
Total					$1,000

[1] For [illegible], see p. 61,111

Reg. § 1.46-3 continued

(g) **Public utility property.** (1) In the case of section 38 property which is public utility property, the amount of the qualified investment with respect to such property shall be 3/7 of the amount otherwise determined under this section with respect to such property.

(2) The term "public utility property" means property used predominantly in the trade or business of the furnishing or sale of—

(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(c)(5) of the Communications Act of 1934, as amended; 47 U.S.C., sec. 222(c)(5)),

if the rates for such furnishing or sale, as the case may be, have been established or approved by a State (including the District of Columbia) 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. The term "established or approved" includes the filing of a schedule of rates with any body named in the preceding sentence which has the power to approve such rates, even though such body has taken no action on the filed schedule. For purposes of this paragraph, any activity described in subdivision (i), (ii), (iii), or (iv) of this subparagraph, which is regulated in a manner described in this subparagraph, shall be referred to as a "public utility activity." If property is used by a taxpayer both in a public utility activity and in another activity, the characterization of such property shall be based on the predominant use of such property during the taxable year in which it is placed in service.

(3) Public utility property includes property which is leased to others by a taxpayer whose the leasing of such property is part of the lessor's public utility activity. Thus, such leased property is public utility property even though the lessee uses such property in an activity which is not a public utility activity, and whether or not the lessor of such property 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. Property leased by a lessor, where the leasing is not part of a public utility activity, to a lessee who uses such property predominantly in a public utility activity is public utility property for purposes of computing the lessor's or lessee's qualified investment with respect to such property.

(4) (i) With respect to property of a taxpayer engaged in both the production or transmission of gas and the local distribution of gas, section 38 property shall be considered as used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system if expenditures for such property are chargeable to any of the following accounts under either the uniform system of accounts prescribed for natural gas companies (class A and class B) by the Federal Power Commission, effective January 1, 1961, or the uniform system of accounts for class A and B gas utilities adopted in 1962 by the National Association of Railroad and Utility Commissioners (or would be chargeable to any of the following accounts if the taxpayer used either of such systems):

(a) Accounts 360 through 365, inclusive (Local Storage Plant), or

(b) Accounts 367 through 387, inclusive (Distribution Plant).

(ii) If expenditures for section 38 property are chargeable (or would be chargeable) to any of the following accounts under either of the systems named in subdivision (i) of this subparagraph, the determination of whether or not such property is used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system shall be made under all the facts and circum-

Reg. § 1.48-3(g)(4)(ii) continued

statutes relating to the actual use of such property in the year such property is placed in service:

(a) Accounts 304 through 320, inclusive (Manufactured Gas Production Plant), or

(b) Accounts 391 through 399, inclusive (General Plant).

For example, if an office machine is used 85 percent of the time for billing customers of the taxpayer's local distribution system in the year in which it is placed in service, such office machine shall be considered as used predominantly in the trade or business of the furnishing or sale of gas through a local distribution system.

(h) Certain replacement property.

(1) (i) If section 38 property is placed in service by the taxpayer to replace property (whether or not section 38 property) similar or related in service or use which was destroyed or damaged by fire, storm, shipwreck, or other casualty, or stolen, then for purposes of paragraph (a) of this section the basis (or cost) of the replacement section 38 property otherwise determined under paragraph (c) of this section shall be reduced by an amount equal to the lesser of—

(a) The amount of money, or the fair market value of other property, received as compensation, by insurance or otherwise, for the property which was destroyed, damaged, or stolen, or

(b) The adjusted basis of such destroyed, damaged, or stolen property (immediately before such destruction, damage, or theft).

(ii) For purposes of subdivision (i) of this subparagraph—

(a) Section 38 property placed in service after the due date (including extensions of time thereof) for filing the taxpayer's income tax return for the taxable year in which the other property was destroyed, damaged, or stolen shall not be considered as replacement section 38 property, and

(b) If the property which is destroyed, damaged, or stolen is leased property, no other leased property shall be considered as replacement property with respect to the property destroyed, damaged, or stolen, in any case in which the lessor makes or made an election under section 48 (d) (relating to election with respect to certain leased property) with respect to either the property destroyed, damaged, or stolen, the other leased property, or both.

(2) Subparagraph (1) of this paragraph shall not apply to replacement property if the reduction, under such subparagraph (1), in the basis (or cost) of such replacement property is less than the excess of—

(i) The qualified investment with respect to the destroyed, damaged, or stolen property, over

(ii) The recomputed qualified investment with respect to such property (determined under the principles of paragraph (a) of § 1.47-1).

(3) This paragraph may be illustrated by the following example:

Example (1). (i) A acquired and placed in service on January 1, 1963, machine No. 1, which qualified as section 38 property, with a basis of $60,000 and an estimated useful life of 6 years. The amount of qualified investment with respect to such machine was $20,000. On January 2, 1966, machine No. 1 is completely destroyed by fire. On January 1, 1968, the adjusted basis of such machine in A's hands is $30,000. On November 1, 1968, A receives $35,000 in insurance proceeds as compensation for the destroyed machine, and on December 15, 1968, A acquires and places in service machine No. 2, which qualifies as section 38 property, with a basis of $40,000 and an estimated useful life of 6 years to replace machine No. 1.

Reg. § 1.46-3(h)(3) Example (1) continued

(3) Under subparagraph (1) of this paragraph, the $41,000 basis of machine No. 2 is reduced, for purposes of paragraph (a) of this section, by $23,000 (that is, the $23,000 insurance proceeds since such amount is less than the $24,750 adjusted basis of machine No. 1 immediately before it was destroyed) to $18,000 since such reduction (that is, $23,000) is greater than the $20,000 reduction in qualified investment which would be made if paragraph (a) of § 1.47-1 were to apply to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

Example (2). (i) The facts are the same as in example (1) except that on November 1, 1963, A receives only $10,000 in insurance proceeds as compensation for the destroyed machine.

(ii) The $41,000 basis of machine No. 2 is not reduced, for purposes of paragraph (a) of this section, under this paragraph since the $10,000 reduction which would have been made under this paragraph had it applied (that is, the $10,000 insurance proceeds since such amount is less than the $24,500 adjusted basis of machine No. 1 immediately before it was destroyed) is less than the $20,000 reduction in qualified investment which is made since paragraph (a) of § 1.47-1 applies to machine No. 1 ($20,000 qualified investment less zero recomputed qualified investment).

(----- T.D. 6946, Reg. § 1.46-1 (TD 6731, filed 5-7-64; amended by TD 6958, filed 6-20-68.) Limitations with respect to cost in persons.

(a) Mutual savings institutions. In the case of an organization to which section 596 applies (that is, a mutual savings bank, a cooperative bank, or a domestic building and loan association)--

(1) The qualified investment with respect to each section 38 property shall be 50 percent of the amount otherwise determined under § 1.46-3, and

(2) The $25,000 amount specified in section 46(a)(2)[1], relating to limitation based on amount of tax, shall be reduced by 50 percent of such amount.

For example, if a domestic building and loan association places in service on January 1, 1968, new section 38 property with a basis of $60,000 and an estimated useful life of 6 years, its qualified investment for 1968 with respect to such property computed under § 1.46-3 is $20,000 (66⅔ percent or $30,000). However, under this paragraph such amount is reduced to $10,000 (50 percent of $20,000). If an organization to which section 596 applies is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2)[1] shall be reduced in accordance with the provisions of paragraph (f) of § 1.46-1 before such amount is further reduced under this paragraph.

(b) Regulated investment companies and real estate investment trusts. (1) In the case of a regulated investment company or a real estate investment trust subject to taxation under subchapter M, chapter 1 of the Code--

(i) The qualified investment with respect to each section 38 property otherwise determined under § 1.46-3, and

(ii) The $25,000 amount specified in section 46(a)(2)[1], relating to limitation based on amount of tax,

shall be reduced to such person's ratable share of each such amount. If a regulated investment company or a real estate investment trust is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2)[1] shall be reduced in accordance with the provisions of paragraph (f) of § 1.46-1 before such amount is further reduced under this paragraph.

(2) A person's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which--

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[1] Amended § 46(a)(2), TD 6731, struck out:
(i) "(3) and (5)"

Reg. § 1.46-4(b)(2) continued

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the amount of the deduction for dividends paid taken into account under section [illegible](D) in computing investment company taxable income, or under section 857(b)(2)(C) in computing real estate investment trust taxable income, as the case may be.

For purposes of the preceding sentence, 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)). For purposes of this paragraph only, in computing taxable income for a taxable year beginning before January 1, [illegible], a regulated investment company or a real estate investment trust may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under § 1.48-7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Corporation X, a regulated investment company subject to taxation under section 852 of the Code which makes its return on the basis of the calendar year, placed in service on January [illegible], section 38 property with a basis of $30,000 and an estimated useful life of [illegible] years. Corporation X's investment company taxable income under section 852(b)(2) is [illegible],000 after taking into account a deduction for dividends paid of [illegible],000.

(ii) Under this paragraph, corporation X's qualified investment for the taxable year [illegible] with respect to such property is [illegible], computed as follows: (a) $30,000 (qualified investment under § 1.46-3), multiplied by (b) $10,000 (taxable income), divided by (c) $100,000 (taxable income plus the deduction for dividends paid). For 1964, the $25,000 amount specified in section 46(a)(2) is reduced to $2,500.

(c) *Cooperatives.* (1) In the case of a cooperative organization described in section 1381(a)—

(i) The qualified investment with respect to each section 38 property otherwise determined under § 1.46-3, and

(ii) The $25,000 amount specified in section 46(a)(2), relating to limitation based on amount of tax,

shall be reduced to such cooperative's ratable share of each such amount. If a cooperative organization described in section 1381(a) is a member of an affiliated group (as defined in section 46(a)(5)), the $25,000 amount specified in section 46(a)(2) shall be reduced in accordance with the provisions of paragraph (f) of § 1.46-1 before such amount is further reduced under this paragraph.

(2) A cooperative's ratable share of the amount described in subparagraph (1)(i) and the amount described in subparagraph (1)(ii) of this paragraph shall be the ratio which—

(i) Taxable income for the taxable year, bears to

(ii) Taxable income for the taxable year plus the sum of (a) the amount of the deductions allowed under section [illegible], (b) the amount of the deductions allowed under section 1382(c), and (c) amounts similar to the amounts described in (a) and (b) of this subdivision the tax treatment of which is determined without regard to subchapter T, chapter 1 of the Code and the regulations thereunder. Amounts similar to deductions allowed under section 1382(b) or (c) are, for example, in the case of a taxable year of a cooperative organization beginning before January 1, [illegible], [illegible] deducted and may [illegible] which are [illegible] 1382(b)(1). In the case of a taxable year of a cooperative organization beginning after December [illegible], such amounts are [illegible] and [illegible] section 1382(b) or (c) because they are paid with respect to [illegible] before 1963. For purposes of this paragraph only, in computing taxable income for a

Reg. § 1.46-1(c)(3)(ii) continued

taxable year beginning before January 1, 1964, a cooperative may compute depreciation deductions with respect to section 38 property placed in service before January 1, 1964, without regard to the reduction in basis of such property required under § 1.48-7.

(3) This paragraph may be illustrated by the following example:

Example. (i) Cooperative X, an organization described in section 1381(a) which makes its return on the basis of the calendar year, places in service on January 2, 1964, section 38 property with a basis of $30,000 and an estimated useful life of 6 years. Cooperative X's taxable income is $30,000 after taking into account deductions of $20,000 allowed under section 1382(b), deductions of $5,000 allowed under section 1382(c), and deductions of $10,000 allowed under section 382(b)(3)(B).

(ii) Under this paragraph, cooperative X's qualified investment for the taxable year 1964 with respect to such property is $3,625, computed as follows: (a) $22,000 (qualified investment under § 1.46-3), multiplied by (b) $10,000 (taxable income), divided by (c) $106,000 (taxable income plus the sum of the deductions allowed under sections 1382(b), 1382(c), and 382(b)(3)(B)). For 1964, the $25,000 amount specified in section 46(c)(2)[1] is reduced to $2,500.

[illegible] SEC. 47. CERTAIN [illegible] PROPERTY. [illegible] OF SECTION 38 PROPERTY.

(a) General rule.—Under regulations prescribed by the Secretary or his delegate—

(1) Early disposition, etc.—If during any taxable year any property is disposed of, or ceases to be section 38 property with respect to the taxpayer, before the close of the useful life used in taking into account in computing the credit under section 38, then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from redetermining, in determining qualified investment, for such useful life the period beginning with the time such property was placed in service by the taxpayer and ending with the time such property ceased to be section 38 property.

(2) Property becomes public utility property.—If during any taxable year any property taken into account in determining qualified investment becomes public utility property (within the meaning of section 46(c)(3)(B)), then the tax under this chapter for such taxable year shall be increased by an amount equal to the aggregate decrease in the credits allowed under section 38 for all prior taxable years which would have resulted solely from treating such property, for purposes of determining qualified investment, as public utility property (after giving due regard to the period before such change in use). If the application of this paragraph to any property is followed by the application of paragraph (1) to such property, proper adjustments shall be made in the application of such paragraph (1).

(3) Carryovers and carrybacks affected.—In the case of any credit described in paragraph (1) or any change in the credit in paragraph (2), the carryovers and carrybacks under section 39(b) shall be adjusted by reason of such cessation (or change in use).

(4) Property exchanged or involuntarily converted.—An increase in tax under paragraph (1) and no adjustment shall be made under paragraph (2) in any case in which—

(A) any property is disposed of, or ceases to be section 38 property with respect to the taxpayer, pursuant to the destruction or damage by fire, storm, shipwreck, or other casualty, or by reason of the theft,

(B) [illegible] to replace the property described in subparagraph (A), and

(C) the reduction in basis or cost of such section 38 property described in the first sentence of section 48(a)(4) is equal to or greater than the reduction in qualified investment which (but for this paragraph) would be made by reason of the substitution required by paragraph (2) with respect to the property described in subparagraph (A).

Subparagraphs (B) and (C) shall not apply with respect to any casualty or theft occurring after April 18, 1969.

(5) Credit in property replaced after April 18, 1969.—In any case in which—

(A) section 38 property is disposed of, and

(B) property which would be section 38 property but for section 49 is placed in service by the taxpayer to replace the property disposed of,

the increase under paragraph (1) and the adjustment under paragraph (3) shall not be greater than the increase or adjustment which would result if the qualified investment of the property described in subparagraph (B) (determined as if such property were section 38 property) were substituted for the qualified investment of the property disposed of (as determined under paragraph (1)). Except in the case of a disposition by reason of a casualty or theft occurring before April 19, 1969, the preceding sentence shall apply only if the section 38 property disposed of is replaced within 6 months after date of such disposition.

(6) *Aircraft used outside the United States after April 18, 1969.*—

(A) General rule.—Any aircraft which is section 38 property for the taxable year in which it was placed in service and which is used outside the United States under a qualifying lease or lease shall be treated as not consisting of section 38 property for the period of such use. Until such aircraft has been used for a period or periods totaling 1 year in total. For purposes of the preceding sentence, the registration of such aircraft under the laws of a foreign country shall be treated as use outside the United States.

(B) Computation of credit if aircraft disposed of.—If an aircraft described in subparagraph (A) is disposed of or ceases to be section 38 property, the increase under paragraph (1) and the adjustment under paragraph (3) shall not be greater than the increase or adjustment which would result if the qualified investment of such aircraft were based upon a useful life equal to the lesser of (i) the period of the life of such aircraft with respect to the taxpayer, or (ii) twice the number of full calendar months during which such aircraft was [illegible] by the United States, or owned by a United States person, or registered by the Civil Aeronautics Board and was used in the United States, or owned by and used by a person described in section 7701(a)(30)(A) of this title, or used partly in the United States and partly outside the United States by a person described in section 7701(a)(30)(B) of this title, before January 1, 1971 [illegible] without regard to this paragraph).

(C) Qualified lease defined.—For purposes of subparagraph (A), the term "qualified lease" means a lease [illegible] for which an election is in effect under section 761 of the Tariff Schedules Act of 1962 (76 Stat. 1138) [illegible] the provisions of the Tariff Schedules Act of 1962, as amended by the Civil Aeronautics Board Overseas Authority [illegible] if such lease was executed after April 18, 1969.

(b) Section Not to Apply in Certain Cases.—Subsection (a) shall not apply to—

(1) [illegible]

(2) [illegible]

For purposes of [illegible] by section 1 of this Act, [illegible]

[illegible] 83 Stat. [illegible].

[illegible] 83 Stat. 90-91, 26 U.S.C. [illegible] applies to taxable years ending after [illegible].

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in the form of conducting the trade or business so long as the property is retained in such trade or business as section 38 property and the taxpayer retains a substantial interest in such trade or business.

(c) Special Rule.--Any increase in tax under subsection (a) shall not be treated as tax imposed by this chapter for purposes of determining the amount of any credit allowable under subpart A.

¶ 5397T. Committee Report (P.L. 91-616, 1-12-71).—Application of investment credit recapture rule to leased aircraft.

[House General Explanation]

In general, the bill provides that a new airplane which qualified for the investment credit under the rules of present law for the year it was placed in service may be used outside the United States without a recapture of the credit for up to half of the period taken into account in determining the amount of the credit allowed with respect to the airplane. This provision only applies, however, if the airplane is used outside the United States under a lease from a U.S. air carrier which is made after April 15, 1969 (in general, the date of the repeal of the investment credit) and which complies with the provisions of the Federal Aviation Act of 1958 or the Civil Aeronautics Board's rules and regulations under that Act.

In addition to the maximum period which may be taken into account in computing the amount of an investment credit is 8 years, the bill provides that there is in all cases to be a recapture of the investment credit if an airplane is used outside the United States under the type of lease described above (to be registered under the laws of a foreign country) for more than 4 years. The amount of the credit to be recaptured in this event is to be determined under the rules described below.

As indicated above, the basic effect of your committee's bill in this area is that an airplane may not be used outside the United States for more than half the period taken into account in determining for recapture purposes the amount of the investment credit allowed with respect to the airplane. Accordingly, the bill provides that if an airplane which is used outside the United States in the manner described above is disposed of or otherwise ceases to qualify for investment credit property before the end of the period taken into account in determining the amount of the credit, a portion of the investment credit is to be recaptured to be determined in the manner provided below. In computing the period of time the aircraft is considered to have been actually used by the taxpayer, the calendar months during any part of which it was used outside the United States under the type of lease described above may be taken into account only to the extent of the number of calendar months during all the days of which the plane was used in the United States (or was operated to and from the United States or under contract with the United States). The plane also must have been registered with the Federal Aviation Agency during these months. However, the bill provides that an aircraft (after it is placed in service) for any calendar month in a taxable year ending before 1971 is to be treated as used in the United States if the plane was qualified investment credit property under present law for that year).

The application of the recapture rule provided by the bill may be illustrated by the following example. Assume an airplane was placed in service by a U.S. air carrier in the middle of a taxable year and was used for the remaining 6 months of that taxable year and the entire following taxable year solely in the United States. Assume further that the airplane was then leased (under a lease of the type described above) for use outside the United States for a period of 3 years and was, in fact, used in that manner for the 3-year period. Assume further that at the end of the 3-year period the plane was sold by the U.S. air carrier. Although the air carrier has actually had the plane for a period of 4½ years, it is considered under the bill to have used the plane for a period of only 3 years. This results from the fact that only 1½ of the 3 years the plane was used outside the United States may be taken into account since the plane had been used in the United States for only 1½ years. Accordingly, upon the sale of the plane, there would be a recapture of the entire investment credit previously allowed with respect to it since no credit is allowed with respect to property used less than 4 years.

The amendment made by this bill is to apply to taxable years ending after April 15, 1969.

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C.B. 2d 595.] The Regulation below doesn't reflect the changes made by P.L. 91-676, 1-12-71, in Sec. 47(a), explained at ¶ 7027 and in the Committee Report ¶ 5621.

Reg. §1.47-3 (T.D. 6981, filed 10-6-67.) Recomputation of credit allowed by section 38.

(a) General rule.--(1) In general.--(i) If during the taxable year any section 38 property the basis (or cost) of which was taken into account, under paragraph (a) of §1.46-3, in computing the taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property or becomes public utility property (as defined in paragraph (g) of §1.46-3) with respect to the taxpayer, before the close of the estimated useful life (as determined under subparagraph (3)(i) of this paragraph) which was taken into account in computing such qualified investment, then the credit earned for the credit year (as defined in subdivision (ii)(c) of this subparagraph) shall be recomputed under the principles of paragraph (a) of §1.46-3 and paragraph (a) of §1.47-2 substituting, in lieu of the estimated useful life of the property that was taken into account originally in computing qualified investment, the actual useful life of the property as determined in the subparagraph (3)(ii) of this paragraph. There shall also be recomputed under the principles of §§1.46-1 and 1.47-2 the credit allowed for the credit year and for any other taxable year affected by reason of the reduction in credit earned for the credit year, giving effect to such reduction in the computation of carrybacks or carryforwards of unused credits. If the recomputation described in the preceding sentence results in the aggregate in a decrease (taking into account such recomputations under this paragraph in respect of prior taxable years) as defined in subdivision (ii)(b) of this subparagraph (ii) in the credits allowed for the credit year and for any other taxable year affected by the reduction in credit earned for the credit year, then the income for the succeeding taxable year shall be increased by the amount of such decrease in credits allowed. For treatment of such increase in tax, see paragraph (b) of this section. For rules relating to "disposition" and "cessation", see §1.47-4. For rules relating to certain exceptions to the application of this section, see §1.47-3. For special rules in the case of a cooperative organization corporation (as defined in section 1381(a)), an estate or trust, or a partnership, see respectively, §§1.47-4, 1.47-5, or 1.47-6.

(ii) For purposes of this section and §§1.47-2 through 1.47-6--

(a) The term "credit year" means the taxable year in which section 38 property was taken into account in computing a taxpayer's qualified investment.

(b) The term "recapture year" means the taxable year in which section 38 property the basis (or cost) of which was taken into account in computing a taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property or becomes public utility property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing such qualified investment.

(c) The term "recapture recomputation" means a recomputation made under this paragraph.

(2) Rules for applying subparagraph. For purposes of subparagraph (1) of this paragraph--

(i) In determining whether section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer's qualified investment, the term [illegible] shall not include the shortest life of the useful life categories within which the [illegible] property [illegible] by reason of [illegible] paragraph [illegible] the period by which [illegible] is longer than the [illegible] property [illegible] not be considered [illegible] property is held [illegible] disposed of before the close of the [illegible] property is sold [illegible]

Reg. § 1.47-1(a)(2)(i) *continued*

years (that is, the shortest life of the 6 years or more but less than 8 years useful life category) after the date on which it was placed in service. Likewise, section 38 property with an estimated useful life of 10 years which is placed in service on January 1, 1962, shall not be treated as having been disposed of before the close of its estimated useful life if such property is sold at any time after January 1, 1970 (that is, 8 years or more after the date on which it was placed in service).

(ii) In determining the recomputed qualified investment with respect to property which is disposed of or otherwise ceases to be section 38 property the term "actual useful life" means, except as otherwise provided in this section and §§ 1.47-2 through 1.47-6, the period beginning with the date on which the property was placed in service by the taxpayer and ending with the date of such disposition or cessation. See paragraph (e) of this section.

(b) *Increase in income tax and reduction of investment credit carryover*—(1) *Increase in tax.* Except as provided in subparagraph (2) of this paragraph, any increase in income tax under this section shall be treated as income tax imposed on the taxpayer by chapter 1 of the Code for the recapture year notwithstanding that without regard to such increase the taxpayer has no income tax liability, has a net operating loss for such taxable year, or no income tax return was otherwise required for such taxable year.

(2) *Special rule.* Any increase in income tax under this section shall not be treated as income tax imposed on the taxpayer by chapter 1 of the Code for purposes of determining the amount of the credits allowable to such taxpayer under—

(i) Section 33 (relating to taxes of foreign countries and possessions of United States),

(ii) Section 34 (relating to dividends received by individuals before January 1, 1965),

(iii) Section 35 (relating to partially tax-exempt interest received by individuals),

(iv) Section 37 (relating to retirement income), and

(v) Section 38 (relating to investment in certain depreciable property).

(3) *Reduction in credit allowed as a result of a net operating loss carryback.* (i) If a net operating loss carryback from the recapture year or from any taxable year subsequent to the recapture year reduces the amount allowed as a credit under section 38 for any taxable year up to and including the recapture year, then there shall be a new recapture determination under paragraph (a) of this section for each recapture year affected, taking into account the reduced amount of credit allowed after application of the net operating loss carryback.

(ii) Subdivision (i) of this subparagraph may be illustrated by the following example:

Example (1). (a) X Corporation, which makes its returns on the basis of a calendar year, acquired and placed in service on January 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 (7 percent of $10,000) was allowed under section 38 as a credit against its liability for tax of $700. In 1963 and 1964, X Corporation had no liability for tax and placed in service no section 38 property. On January 5, 1965, such item of section 38 property was sold to Y Corporation. Since the actual useful life of such item was only one year, there was a recapture determination under paragraph (a) of this section. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1962 was increased by the total decrease in the credit earned for the taxable year 1962 (i.e., by the $700 credit, $350 minus zero recomputed credit earned).

Reg. § 1.47-1(b)(d)(3) Example (1) continued

(b) For the taxable year 1961, X Corporation has a net operating loss which is carried back to the taxable year 1957 and reduces its liability for tax, as defined in paragraph (e) of § 1.46-3, for each taxable year to $350. As a result of such net operating loss carryback, X Corporation's credit allowed under section 38 for the taxable year 1957 is limited to $700 and the excess of $300 ($750 credit earned minus $200 limitation based on amount of tax) is an investment credit carryover to the taxable year 1958.

(c) For 1960, there is a recapture determination under subdivision (i) of this subparagraph for the 1957 recapture year. The $500 increase in the income tax imposed on X Corporation for the taxable year 1957 is redetermined to be $200 (that is, the $200 credit allowed after taking into account the 1957 net operating loss minus zero credit which would have been allowed taking into account the 1957 recapture determination). In addition, X Corporation's $300 investment credit carryover to the taxable year 1958 is reduced by $300 ($750 minus $450) to zero and X Corporation is entitled to no credit on account of the tax paid as a result of the 1960 determination.

Example (2). (a) X Corporation, which reports its income on the basis of a calendar year, acquired and placed in service on January 3, 1958, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such item was $6,000. For the taxable year 1958, X Corporation's tax (prior to 47 percent of $10,000 was allowed under section 38 as a credit against its liability for tax of $700. In 1959 and in 1960, Corporation had no liability for tax and placed in service no section 38 property. On January 2, 1962, one item of section 38 property is sold to Y Corporation. For the taxable year 1962, X Corporation has a net operating loss which is carried back to the taxable year 19[illegible] Corporation's liability for tax, as defined in paragraph (e) of [illegible] taxable year to $100.

(b) As a result of such net operating loss carryback, X Corporation's credit allowed under section 38 for the taxable year 1958 is limited to $100 and the excess of $600 ($700 credit earned minus $100 limitation based on amount of tax) is an investment credit carryover to the [illegible] year 1959.

(c) Since the actual useful life of the item of section 38 property sold to Y Corporation was only 2 years, there is a recapture determination under paragraph (a) of this section. X Corporation's $600 investment credit carryover to 1959 is reduced by $600 to zero. The increase in tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1959 is increased by the $600 reduction in credit allowed by section 38 (a). If [illegible]

(d) *Statement of recomputation.* The taxpayer shall attach to his income tax return for the recapture year a statement showing in detail the computation of the increase in tax imposed on such taxpayer by chapter 1 of the Code and the reduction in any investment credit.

(e) *Miscellaneous and Code of Regulations no. 1.*—(1) *General rule.* For purposes of this section and §§ 1.47-2 through 1.47-3, in determining the actual useful life of section 38 property—

(i) Such property shall be treated as placed in service on the first day of the month in which such property is placed in service. The month in which property is placed in service shall be determined under the principles of paragraph (b) of § 1.46-3.

(ii) If [illegible] with respect to the property—

(a) [illegible] a sale, [illegible] such property or [illegible] he has [illegible]

(b) [illegible] (for example, [illegible] such property is [illegible]

Reg. § 1.47-3(c)(1)(ii)(b) continued

furnishing of lodging during such taxable year, such occasion shall be treated as having occurred on the first day of such taxable year.

(3) Special rule. Notwithstanding subparagraph (1) of this paragraph, if a taxpayer uses an averaging convention (see § 1.167(a)-10) in computing depreciation with respect to section 38 property, then, for purposes of this section and §§ 1.47-2 through 1.47-6, he may use the assumed dates of additions and retirements in determining the actual useful life of such property provided such assumed dates are used consistently for purposes of subpart B of part IV of subchapter A of chapter 1 of the Code with respect to all section 38 property for which such convention is used for purposes of depreciation. This subparagraph shall not apply in any case where from all the facts and circumstances it appears that the use of such assumed dates results in a substantial distortion of the investment credit allowed by section 38. Thus, for example, if the taxpayer computes depreciation under a convention under which the average of the beginning and ending balances of the asset account for the taxable year are taken into account, he may use July 1 as the assumed date of all additions and retirements to such account. Similarly, if the taxpayer computes depreciation under a convention under which the average of the beginning and ending balances of the asset account for each month is taken into account, he may use the date determined by reference to the weighted average of the monthly averages as the assumed date of all additions and retirements to such account.

(4) Example. This paragraph may be illustrated by the following example:

Example. Assume that section 38 property is placed in service (within the meaning of paragraph (d) of § 1.46-3) on December 2, 1970 (thus, the asset is treated as being placed in 1971) and under the taxpayer's depreciation practice the period for depreciation with respect to such property begins on January 1, 1971.

Reg. § 1.47-1(c)(1)(i) *Example continued*

and that the property is actually retired on December 2, 1970. Under the general rule of subparagraph (1) of this paragraph, the property is treated as placed in service on December 1, 1965, and as ceasing to be section 38 property with respect to the taxpayer on December 2, 1970, even though under the taxpayer's depreciation practice the period for depreciation with respect to such property begins on January 1, 1966, and terminates on January 1, 1971. However, under the special rule of subparagraph (2) of this paragraph the taxpayer may determine the actual useful life of the property by reference to the assumed dates of January 1, 1966, and January 1, 1971.

(d) *Examples.* Paragraphs (a) through (c) of this section may be illustrated by the following examples:

Example (1). (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on January 1, 1962, three items of section 38 property each with a basis of $12,000 and an estimated useful life of 15 years. The amount of qualified investment with respect to each such asset was $10,000. For the taxable year 1962, X Corporation's credit earned of $3,000 was allowed under section 38 as a credit against its liability for tax of $4,000. On December 2, 1965, one of the items of section 38 property is sold to Y Corporation.

(ii) The actual useful life of the item of property which is sold on December 2, 1965, is three years and eleven months. The recomputed qualified investment with respect to such item of property is zero ($10,000 basis multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,000 (7 percent of $10,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $200 decrease in its credit earned for the taxable year 1962 (that is, $2,800 original credit earned minus $1,000 recomputed credit earned).

Example (2). (i) The facts are the same as in example (1) and in addition on December 1, 1965, X sold all of section 38 property placed in service in the taxable year 1962 to Y Corporation.

(ii) The actual useful life of the item of property which is sold on December 2, 1965, is four years and eleven months. The recomputed qualified investment with respect to such item of property is $1,000 ($10,000 basis multiplied by 33⅓ percent applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,280 (7 percent of $18,000). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by $560 (that is, $1,400 [$2,800 original credit earned minus $1,400 recomputed credit earned] reduced by $840 [the decrease in tax for 1962]).

Example (3). (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 46(a)(3) is only $1,500. Therefore, for such taxable year X Corporation's credit allowed under section 38 is limited to $1,500 and the excess of $1,000 ($2,500 credit earned minus $1,500 credit allowed on account of the limitation in section 46(a)(3)) is allowed for 1963. For the taxable year 1963, $400 is allowed for 1964, and $600 is carried to the taxable year 1965.

(ii) The actual useful life of the item of property which is sold on December 2, 1965, is three years and eleven months. The recomputed qualified investment with respect to such item of property is zero ($10,000 basis multiplied by zero applicable percentage) and X Corporation's recomputed credit earned for the taxable year 1962 is $1,400 (7 percent of $20,000). The credit earned by X Corporation for 1962 has been taken into account in the amount of the $1,000 original credit allowed for 1962 and the $400 additional credit allowed for 1963, so that only $200 remains to be allowed from 1962. The credit allowed for 1963 and 1964 totaled $1,000, so that $400 remains to be allowed from 1962. The $600 carried from 1962 to 1965 has been offset by the $600 decrease in tax for 1965 [the $1,400 original credit allowed for the

Reg. § 1.47-3 (d) Example (3) (ii) continued

taxable year 1963 is reduced by $500 to zero. The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1963 is increased by $25 (that is, the aggregate reduction in the credits allowed by section 38 for 1962, 1963, and 1964).

Example (4). (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on November 1, 1962, an item of section 38 property with a basis of $12,000 and an estimated useful life of 10 years. The amount of qualified investment with respect to such property was $12,000. For the taxable year 1962, X Corporation's credit earned of $600 was allowed under section 38 as a credit against its liability for tax of $600. For each of the taxable years 1963 and 1964 X Corporation's liability for tax was zero and its credit earned was $400; therefore, for each of such years its unused credit was $400. For the taxable year 1965 its liability for tax was $900 and its credit earned was zero; therefore, $200 of the $400 unused credit from 1963 was allowed as credit for 1965 and $200 ($200 from 1963 and $400 from 1964) is an investment credit carryover to 1966. On February 2, 1966, such item of [illegible] 38 property is sold to X Corporation.

(ii) The actual useful life of such item of property is three years and three months. The recomputed qualified investment with respect to such property is zero ($12,000 basis multiplied by zero) and X Corporation's recomputed credit earned for the taxable year 1962 is zero. If such zero recomputed credit earned had been taken into account in place of the $600 original credit earned, the entire $400 unused credit from 1963 (including the $200 portion which was originally allowed as a credit for 1965) and the $400 unused credit from 1964 would have been allowed as investment credit carrybacks against X Corporation's liability for tax of $740 for 1961. (See § 1.47-3 for rules relating to the carryback of unused credits.)

(iii) Therefore, the $800 carryover from 1963 and 1964 to 1966 is eliminated and the income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1965 is increased by the $240 aggregate reduction in the credits allowed by section 38 for the taxable years 1962 and 1963. (That is, $1,040 credits allowed minus $800 which would have been allowed).

Example 5. (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on November 1, 1962, an item of section 38 property with a basis of $10,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such item was $10,000. For the taxable year 1962, X Corporation's credit earned of $700 was allowed as a credit against its liability for tax. For each of the taxable years 1963, 1964, and 1965 X had no taxable income. On July 5, 1966, the item of section 38 property is sold to Y Corporation. For the taxable year 1966 X Corporation has a net operating loss of $8,000.

(ii) The actual useful life of the item of property is three years and eight months. The recomputed qualified investment with respect to such item of property is zero and X Corporation's recomputed credit earned for the taxable year 1962 is zero. [illegible] $8,000 net operating loss for the taxable year 1966, the income tax imposed by chapter 1 of the Code on X Corporation for such year is $700 (that is, the carryback to 1962 is allowed for the full 5 years).

(c) *Recordkeeping requirements.*—(1) *General rule.*—(i) *Record requirements.* In general, the taxpayer must maintain records from which he can establish, with respect to each item of section 38 property, the following items:

(a) The date the property is acquired or otherwise ceases to be section 38 property;

(b) The estimated useful life which was assigned to the property under paragraph (c) of § 1.47-3;

(c) The month and the taxable year in which the property was placed in service; and

[illegible] Reg. § 1.47-3 [illegible] Revenue Ruling 65-56, 1965-1 C.B. 61, [illegible]

Reg. § 1.47-1(c)(1)(i) continued

(d) The basis (or cost), actually or reasonably determined, of the property.

(ii) Recapture determination. For purposes of determining whether section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of its estimated useful life, and for purposes of determining recomputed qualified investment, the taxpayer must establish from his records the facts required by subdivision (i) of this subparagraph.

(iii) Examples. If the taxpayer fails to maintain records from which he can establish the facts required by subdivision (i) of this subparagraph, then this section shall be applied to the taxpayer in the manner indicated in the following examples:

Example (1). Corporation X, organized on January 1, 1961, files its income tax return on the basis of a calendar year. During the years 1962 and 1965, X places in service several items of machinery to which it assigns estimated useful lives of 8 years. X places the items of machinery in a composite account for purposes of computing depreciation. When X's 1968 return is being audited, X is unable to establish whether the items placed in service in 1962 and 1965 were still on hand at the end of 1968. Therefore, for purposes of paragraph (a) of this section, X is treated as having disposed of, in 1968, all of the items of machinery placed in service in 1962 and 1965.

Example (2). Corporation Y, organized on January 1, 1960, files its income tax return on the basis of a calendar year. During each of the years 1960 through 1965, Y places in service 4 items of machinery to each of which it assigns an estimated useful life of 8 years for depreciation purposes (and for purposes of computing qualified investment for relevant years). Y places the items of machinery in a composite account for purposes of computing depreciation (and for purposes of computing qualified investment for relevant years). When Y's 1968 return is being audited, Y can establish that it disposed during 1968 only 2 items of this machinery. However, Y cannot establish the date on which these 2 items were placed in service, nor can Y establish that the items placed in service in 1963 or 1964 are still on hand as of the end of 1968. No previous recapture has taken place with respect to any of the items placed in service in 1960 or 1962. Assuming that paragraph (c)(2) and (3) of this section is not applicable, Y is treated, for purposes of paragraph (a) of this section, as having disposed of, in 1968, the 4 items placed in service in 1964, the most recent year before 1968 in which such property was placed in service, and 2 items from 1965, the next most recent year.

Example (3). The facts are the same as in example (2) except that, when Y's 1968 return is being audited, Y can establish from its records that all 4 items placed in service in 1963 are still on hand and that only 3 items were retired in 1968. For purposes of paragraph (a) of this section, Y is treated as having disposed of, in 1968, the 3 remaining items of machinery placed in service in 1963, and one of the items placed in service in 1965.

(c) *Alternative methods.* (1) If, in the case of mass assets (as defined in subparagraph (4) of this paragraph), it is impracticable for the taxpayer to maintain records from which he can establish with respect to each item of section 38 property the data required by subparagraph (1) of this paragraph, and if he adopts other reasonable recordkeeping practices, consistent with good accounting and engineering practices and not in conflict with his prior recordkeeping practices, then he may substitute [illegible] approach to mortality dispersion table. An [illegible] mortality dispersion table must be based on an acceptable sampling of the taxpayer's actual experience under acceptable statistical or engineering methods. In lieu of such mortality dispersion table, the taxpayer may use [illegible] prescribed by the Commissioner. If the taxpayer [illegible] mortality dispersion table for any [illegible]

Reg. § 1.47-1(c)(2)(i) continued

years, it must be used for all subsequent taxable years unless the taxpayer obtains the consent of the Commissioner to change. If assets are placed in a multiple asset account and if the depreciation rate for such account is based on the maximum expected life of the longest lived asset in such account, in applying a mortality dispersion table (including a standard mortality dispersion table) the average expected useful life of the assets in such account must be used.

(f) Subdivision (i) of this subparagraph shall not apply with respect to assets placed in service in taxable years ending on or after June 30, 1967, unless the estimated useful lives which are assigned to such assets for purposes of determining qualified investment—

(a) Were separate lives based on the estimated range of years taken into account in establishing the average useful life of assets similar in kind under paragraph (c) (2) (ii) (a) of § 1.46-3, and

(b) Were determined by use of a mortality dispersion table (including a standard mortality dispersion table),

(ii) Any estimated mortality dispersion table prescribed by the Commissioner shall be based on average useful life categories and with respect to each category shall contain 5 columns, the first 4 of which shall state the percentage of property assumed to have a useful life of—

Column (1): Less than 4 years,

Column (2): 4 years or more but less than 8 years,

Column (3): 8 years or more but less than 12 years,

and

Column (4): 12 years or more.

The 5th column shall state the [illegible] qualified investment for a percentage and shall be used in connection with [illegible] to be made under § 1.46-3(c)(2)(ii)(a)(iii).

(iv) Where for the taxable year [illegible] table is used for a taxable year under subdivision (ii) of this [illegible] and such table was used in determining [illegible] shall (for purposes of section 47, this section, and §§ 1.47-2 through 1.47-6) be deemed to have been disposed of on the day before the expiration of the 4-year period beginning on the date on which it was considered as placed in service under § 1.47-4(a), and [illegible] column (2) of the table shall be deemed to have been disposed of on the day before the expiration of the 8-year period beginning on the date on which it was considered as placed in service; and the percentage of property shown in column (3) shall be deemed to have been disposed of on the day before the expiration of the 12-year period beginning on the date on which it was considered placed in service. In applying this subdivision for purposes of recomputing qualified investment, the proper average useful life category shall be used [illegible] such property was used in determining qualified investment.

(v) In lieu of the [illegible] (iv) of this subparagraph for purposes of recomputing qualified investment [illegible] taxable years (a) ending before [illegible] to paragraph (c)(2)(ii)(a) of § 1.46-3 applied to such subdivision (iv) would otherwise apply with respect to any such asset, recompute qualified investment on the basis of the estimated useful life (a) as the proper total qualified investment based on the percentage shown in column (4) of the table and (b) the total qualified investment [illegible] of which by the taxpayer in the year in which the property was placed in service.

Reg. § 1.47-1(c)(2)(v) Example continued

taxpayer's 1967 return is being audited he is unable to establish that any of the mass assets placed in service in 1963 were still on hand at the end of 1967. The taxpayer elects to use the standard mortality dispersion table prescribed by the Commissioner to determine the amount of recapture with respect to these mass assets. Assume that the table prescribed by the Commissioner shows with respect to mass assets with an average useful life of 6 years the following:

Percent of property assumed to have a useful life of—				
Less than 4 years	4 years or more, but less than 6 years	6 years or more, but less than 8 years	8 years or more	Total qualified investment (Percent)
(1)	(2)	(3)	(4)	(5)
15.87	31.13	37.13	15.87	50.00

(a) Under these circumstances 15.87 percent of the mass assets placed in service in 1963 are deemed to have been disposed of during 1967. With respect to these assets, the amount of qualified investment for 1963 was $10,580 ($15,870 × ⅔) and the amount of credit earned was $740.6 (7% of $10,580), whereas the recomputed qualified investment is zero and the recomputed credit earned in zero. Thus, the tax imposed by chapter 1 of the Code for 1967 is increased by $740.60.

(b) No recapture determination is required for 1968 since no assets are deemed to have been disposed of in that year. During 1969, 31.13 percent of the mass assets placed in service in 1963 are deemed to have been disposed of. With respect to these assets, the amount of qualified investment for 1963 was $21,753.34 ($32,130 × ⅔) and the amount of credit earned was $1,522.73 (7% of $21,753.34), whereas the recomputed qualified investment is $11,576.07 ($31,130 × ⅓) and the recomputed credit earned is $795.37 (7% of $11,576.07). Thus, the tax imposed by chapter 1 of the Code for 1969 is increased by $795.36 ($1,522.73 minus $795.37).

(c) If the taxpayer chooses to recompute qualified investment by using the method provided in subdivision (v) of this subparagraph, the increase in tax for 1967 (the first recapture year) would be $2,367.67, i.e., the original credit earned, $4,657.67, minus the recomputed credit earned, $2,290 (50%, the percentage shown in column (5), of $100,000 multiplied by 7%). As long as the same average useful life category reflects the taxpayer's experience for subsequent years, no recapture determination will be required for any future year, except as provided by subparagraph (3)(iv) of this paragraph.

(3) Special rules. (i) Taxpayers who properly determine estimated useful lives under § 1.48-2 (e)(3)(ii)(b) or (iii) may treat such assets as having been disposed of or having ceased to be section 38 assets in order of the estimated useful lives that were assigned to such assets. Thus, the asset that is first disposed of or first ceases to be section 38 property may be treated as the asset to which there was assigned the shortest estimated useful life, the next asset disposed of or ceasing to be section 38 property may be treated as the asset to which there was assigned the second shortest life, etc.

(ii) In the case of taxpayers who use the rule of subdivision (i) of this subparagraph with respect to mass assets for which the estimated useful life was determined under § 1.48-2(e)(2)(iii), if the dispersion shown by the mortality dispersion table effective for a taxable year subsequent to the credit year is the same as the dispersion shown by the mortality table that was effective for the credit year (for example, if the same average useful life on the standard mortality dispersion table reflects the taxpayer's experience for both such years), no recapture determination is required for such subsequent taxable year.

(iii) Notwithstanding subdivision (i) of this subparagraph, taxpayers who, for

Reg. § 1.47-3(c)(3)(iii) continued

purposes of determining qualified investment, does not use a mortality dispersion table with respect to certain section 38 assets similar in kind but who consistently assign under paragraph (c)(3)(i)(b) of § 1.48-2 to such assets separate lives based on the estimated range of years taken into consideration in establishing the average useful life of such assets, may select the order in which such assets shall be considered as having been disposed of, regardless of the taxable years in which such assets were placed in service. If a taxpayer uses the method provided in this subdivision to determine that any asset is considered as having been disposed of, then, in addition to complying with the record requirements of subparagraph (1)(i) of this paragraph, such taxpayer must maintain records from which he can establish to the satisfaction of the district director that such asset has not previously been considered as having been disposed of. In addition, if, for any taxable year, a taxpayer uses the method provided in this subdivision for any asset, he must use for such year and for each subsequent taxable year (unless he obtains the district director's consent to change) with respect to all assets similar in kind to such asset—

(a) The method of determining estimated useful lives described in paragraph (c)(3)(ii)(b) of § 1.48-2, and

(b) The method he has selected under this subdivision for determining the order in which such assets are considered as having been disposed of.

A request by a taxpayer to obtain the district director's consent to change a system or method described in this subdivision with respect to assets similar in kind must be submitted to the district director on or before the last day of the taxable year with respect to which the change is sought.

(iv) Notwithstanding subdivisions (i), (ii), and (iii) of this subparagraph, there shall be taken into account separately any increase in the amount of section 38 property of substantial value for which the estimated useful life was determined under § 1.48-2(c)(3)(ii)(b) or (iii). See section 167(m) and the regulations thereunder, and paragraph (b) of § 1.167(a)-5.

(5) *Definition of "mass asset".* For purposes of this paragraph and paragraph (c)(3)(iii) of § 1.48-2, the term "mass asset" means a single group of individual items of property (i) not necessarily homogeneous, (ii) each of which is minor in value relative to the total value of such mass or group, (iii) numerous in quantity, (iv) usually accounted for only on a total dollar or quantity basis, and (v) with respect to which separate identification is impracticable. The term includes portable tools and electric tools, jigs, dies, railroad ties, overhead conductors, underground conductors, textile spindles, and minor items of office, plant, and store furniture and fixtures; and returnable containers and other items which are considered ordinary assets for purposes of computing the allowance for depreciation.

(6) *Example.* This paragraph may be illustrated by the following example:

Example. (i) Taxpayer A uses numerous small returnable containers in his business. It is impracticable for A to keep individual detailed records with respect to such containers which are more than [illegible]. In 1970, A places in service 10 million containers purchased for $1 million, and correctly determines that each of such containers has a useful life of 5 years. Each container is, in effect, a multiple asset account to which is assigned a 5-year recovery period for purposes of computing depreciation. A has conducted an appropriate mortality study which shows that the containers have the following estimated useful lives:

Percent of containers	Useful life
30%	3 years
20	4
20	5
20	6
10	7

[illegible] Rev. Rul. [illegible]

Reg. § 1.47-1(c)(2)(i) Example (1) continued

A assigns separate lives to each asset based on the estimated range of years taken into account in establishing the average useful life of such containers. The qualified investment with respect to such containers in 1969 computed as follows:

Useful life	Basis	Applicable percentage	Qualified investment
4	$200,000	33-1/3	$ 66,666
5	400,000	33-1/3	133,333
6	200,000	66-2/3	133,333
7	100,000	66-2/3	66,666
			$400,000

A's credit earned for 1969 of $33,000 (7 percent times $400,000) is allowed as a credit under section 38 against A's liability for tax of $9 million. (For purposes of this example the computations of investment credit and recapture with respect to containers placed in service in years other than 1969 are omitted.) The mortality studies effective for 1968 and 1967 show that the mean of the containers plan 7 in service in 1969 was retired

(ii) A's mortality study effective with respect to 1970 shows that the containers are being retired as follows:

Percent of assets	Useful life
20	3 years
20	4
20	5
20	6
20	7

Thus, the 1968 study shows that the 4 million containers placed in service in 1966 were retired in 1970. Under the rule of subparagraph (2)(i) of this paragraph, the 2 million containers are treated as consisting of the 1 million containers to which was assigned a 4-year useful life, 1 million with assigned useful life which was assigned a 5-year useful life. Taking into account only the first 20 percent of the containers placed in service in 1966 and retired after less than 5 years, A's recomputed qualified investment for 1969 is $200,000 and his recomputed credit earned is $14,000. A's income tax for 1970 is increased by $1,867 ($28,000 original credit, original minus $26,133 recomputed credit earned).

(iii) The mortality study effective for 1970 shows the same results as the mortality study effective for 1967. That is, that 2 million containers were retired in 1970 (an actual life of 4 years). Under the rule of subparagraph (2)(i) of this paragraph, each 1 million portion is treated as having been assigned useful lives as follows: 2 million as having been assigned a 3-year useful life, 2 million as having been assigned a useful life of 4 years, and 1 million as having been assigned a useful life of 5 years. Taking into account only the first 20 percent of the containers placed in service in 1966 and retired after less than 5 years, A's recomputed qualified investment for 1969 is $200,000 and his recomputed credit earned is $14,000. A's income tax for 1970 is increased by $1,867 ($28,000 original credit, original minus $26,133 recomputed credit earned).

(3) [illegible]

Reg. § 1.47-1 (f) (1) continued

ceiling qualified investment with respect to section 38 property which becomes public utility property (as defined in paragraph (g) of § 1.46-3)—

(i) If such property becomes public utility property less than 4 years from the date on which it was placed in service, then such property shall be treated as public utility property for its entire useful life.

(ii) If such property becomes public utility property 4 years or more but less than 6 years from the date on which it was placed in service, then such property shall be treated as section 38 property which is not public utility property for the first 4 years of its estimated useful life and as public utility property for the remaining period of its estimated useful life.

(iii) If such property becomes public utility property 6 years or more but less than 8 years from the date on which it was placed in service, then such property shall be treated as section 38 property which is not public utility property for the first 6 years of its estimated useful life and as public utility property for the remaining period of its estimated useful life.

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) X Corporation, which makes its returns on the basis of the calendar year, acquired and placed in service on January 1, 1968, an item of section 38 property with a basis of $12,000 and an estimated useful life of 8 years. The amount of qualified investment with respect to such property was $12,000. For the taxable year 1968, X Corporation's credit earned was $840 (7 percent of $12,000) and for such taxable year X Corporation was allowed under section 38 a credit of $840 against its liability for tax. During the taxable year 1971 such property becomes public utility property (as defined in paragraph (g) of § 1.46-3) with respect to X Corporation.

(ii) Such item of section 38 property is treated as section 38 property which is not public utility property for the first four years of its eight years estimated useful life and is treated as public utility property for the remaining four years. The recomputed qualified investment with respect to such item of section 38 property is $7,200, computed as follows:

$12,000 basis × 3⅓ percent applicable percentage	$4,000
$12,000 basis × ⅔ × 66⅔ percent applicable percentage	3,200
Total recomputed qualified investment	7,200

X Corporation's recomputed credit earned for the taxable year 1968 is $630 (7 percent of $7,200). The income tax [illegible] by chapter 1 of the Code on X Corporation for the taxable year 1971 is increased by the $630 decrease in its credit earned for the taxable year 1968 (which is $210 additional credit earned and not the $840 recomputed credit earned).

Example (2). (i) The facts are the same as in example (1) and in addition the item of section 38 property which became public utility property in 1971 is sold by X Corporation on January 2, 1972.

(ii) The useful life of such item of property is six years. For the first four years of its eight year estimated useful life such item is treated as section 38 property which is not public utility property and for the remaining two years is treated as public utility property. The recomputed qualified investment with respect to such item of property is $7,200, computed as follows:

$12,000 basis × 3⅓ percent applicable percentage	$4,000
$12,000 basis × ⅔ × 66⅔ percent applicable percentage	3,200
Total recomputed qualified investment	7,200

[illegible] Reg. § 1.47-1

Reg. § 1.47-1(c)(2) Example (2)(ii) continued

X Corporation's recomputed credit earned for the taxable year 1972 is $600 (7 percent of $8,571). The income tax imposed by chapter 1 of the Code on X Corporation for the taxable year 1972 is increased by $120 (that is, $840 ($240 original credit earned minus $600 recomputed credit earned) minus $720 increase in tax for 1967).

[¶ 5956] The Regulation below doesn't reflect the changes made by P.L. 91-675, 1-12-71, in Sec. 47(c), explained at ¶ 5027; and in the Committee Report at 5954.

Reg. § 1.47-2 (TD 6931, filed 10-4-67). "Disposition" and "cessation".

(a) *General rule*—(1) "Disposition". For purposes of this section and § 1.47-1 and §§ 1.47-3 through 1.47-6, the term "disposition" includes a sale in a sale-and-leaseback transaction, a transfer upon the foreclosure of a security interest and a gift, but such term does not include a mere transfer of title to a creditor upon creation of a security interest. See paragraph (g) of § 1.47-3 for treatment of certain sale-and-leaseback transactions.

(2) "Cessation". (i) A determination of whether section 38 property ceases to be section 38 property with respect to the taxpayer must be made for each taxable year subsequent to the credit year. That is, in each such taxable year the taxpayer must determine, as if such property were placed in service in such taxable year, whether such property would qualify as section 38 property (within the meaning of § 1.48-1) in the hands of the taxpayer for such taxable year.

(ii) Section 38 property does not cease to be section 38 property with respect to the taxpayer in any taxable year subsequent to the credit year merely because under the taxpayer's depreciation practice no deduction for depreciation with respect to such property is allowable to the taxpayer for the taxable year, provided that the property is held by the taxpayer for use in the production of income and that, while held for such use, the property with respect to the taxpayer

(iii) [illegible] by the following examples:

Example (1). A, an individual who [illegible] on the basis of the calendar year, on January 1, 1968, acquired and placed in service in the trade or business or [illegible] section 38 property with a useful life of eight years. On January 1, 1970, A removed the item of section 38 property from use in the trade or business by converting such item to personal use. Therefore, no deduction for depreciation with respect to such item of property is allowable to A for the taxable year 1970. On January 1, 1970, such item of property ceases to be section 38 property with respect to A.

Example (2). On January 1, 1968, A placed in service an item of section 38 property with a basis of $20,000 and an estimated useful life of 4 years. A depreciates such item, which has a [illegible] of $2,000 (after taking into account section 167 (f)), on the double declining balance method at a rate of 50 percent (that is, twice the [illegible] rate of 25 percent). For purposes of computing A's allowable deductions for depreciation of $5,000 for 1968, $3,750 for 1969, and $500 for 1970, A is not allowed a deduction for depreciation for 1970 although he continues to use such item in his trade or business. Such item does not cease to be section 38 property with respect to A in 1970.

(c) [illegible] (1) [illegible] of paragraph [illegible] of § 1.47-3, generally, the [illegible] of section 38 property [illegible] the credit year shall be [illegible] in which [illegible] considered to be [illegible] to be [illegible] to be used [illegible]

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Reg. § 1.47-3(f)(1) continued

property with respect to the lessor if, in any taxable year subsequent to the credit year, such property would not qualify as section 38 property (as defined in § 1.48-2) in the hands of the lessor, the lessee, or any sublessee. Thus, if, in a taxable year subsequent to the credit year, a lessee uses the property predominantly outside the United States, such property shall be considered to have ceased to be section 38 property with respect to the lessee.

(3) Where lessor elects to treat lessee as purchaser. For purposes of paragraph (a) of § 1.47-1, if, under § 1.48-4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, the following rules apply in determining whether such property is disposed of, or otherwise ceases to be section 38 property with respect to the lessee:

(i) Generally, a mere disposition by the lessor of property subject to a lease shall not be considered to be a disposition by the lessee.

(ii) If the lessee makes a disposition of property subject to a lease to a person who may not, under § 1.48-4, make a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38 (such as a person described in paragraph (c)(2) of § 1.48-4), such property shall be considered to have ceased to be section 38 property with respect to the lessee on the date of such disposition.

(iii) If a lease is terminated and the property is transferred by the lessee to the lessor or to any other person, such termination shall be considered to be a disposition by the lessee.

(iv) If the lessee actually purchases such property in the credit year or in a taxable year subsequent to the credit year, such purchase shall not be considered to be a disposition.

(v) The property ceases to be section 38 property with respect to the lessee if in any taxable year subsequent to the credit year such property would not qualify as section 38 property (as defined in § 1.48-1) in the hands of the lessee, the lessor, or any sublessee. Thus, for example, if, in a taxable year subsequent to the credit year, a sublessee uses the property predominantly outside the United States, the property ceases to be section 38 property with respect to the lessee.

(g) Reduction in basis of section 38 property.—(1) General rule. If, in the credit year or in any taxable year subsequent to the credit year, the basis (or cost) of section 38 property is reduced, for example, as a result of a refund of part of the cost of the property, then such section 38 property shall be treated as having ceased to be section 38 property with respect to the taxpayer to the extent of the amount of such reduction in basis (or cost) on the date the actual which results in such reduction in basis (or cost) is received or accrued, except that for purposes of § 1.47-1(c) the actual useful life of the property treated as having ceased to be section 38 property shall be considered to be less than 3 years.

(2) Example. Subparagraph (1) of this paragraph may be illustrated by the following example:

Example. (i) On January 1, 1962, A, a cash basis taxpayer, acquired from X Cooperative an item of section 38 property with a basis of $100 and an estimated useful life of 10 years which he placed in service on such date. The amount of qualified investment with respect to such asset was $100. For the taxable year 1962 A was allowed under section 38 a credit of 7 against his liability for tax. On June 1, 1966, A received a $10 patronage dividend from X Cooperative with respect to such item. Under paragraph (c)(2)(v) of § 1.48-5, the basis of the asset in A's hands is reduced by $10.

(ii) Under subparagraph (1) of this paragraph, on June 1, 1966, the basis of section 38 property is treated as having ceased to be section 38 property with respect to A to the extent of $10 of the original $100 basis.

Reg. § 1.47-2 continued

(d) *Retirements.* A retirement of section 38 property, including a normal retirement (as defined in paragraph (b) of § 1.167(a)-3, and the determination of normal and abnormal retirements), whether from a single asset account or a multiple asset account, and an abandonment, are dispositions for purposes of paragraph (a) of § 1.47-1.

(e) *Conversion of section 38 property to personal use.* (1) If, for any taxable year subsequent to the credit year—

(i) A deduction for depreciation is allowable to the taxpayer with respect to only a part of section 38 property because such property is partially devoted to personal use, and

(ii) The part of the property (expressed as a percentage of its total basis (or cost)) with respect to which a deduction for depreciation is allowable for such taxable year is less than the part of the property with respect to which a deduction for depreciation was allowable in the credit year, then such property shall be considered as having ceased to be section 38 property with respect to the taxpayer to such extent. In addition, property ceases to be section 38 property with respect to the taxpayer to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to listed property) or the corresponding provision of prior law.

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) A, a calendar-year taxpayer, acquired and placed in service on January 1, 1971, for use solely in his business, [illegible] of section 38 property. [illegible] of the property was used by A 60 percent of the time in his business and 40 percent of the time for personal purposes. Since the property was used only 30 percent of the time for personal purposes, [illegible] allowable to A for 1971 with respect to the basis of the property. In the taxable year 1972 [illegible] allowable to A with respect to 70 percent of the basis of the property. In the taxable year 1973 [illegible] is allowable to A only with respect to 40 percent of the basis of the property.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1973, the automobile ceases to be section 38 property with respect to A to the extent of 30 percent (60 percent minus 30 percent).

Example (2). (i) The facts are the same as in example (1). In addition, for the taxable year 1972 a deduction for depreciation is allowable to A only with respect to 60 percent of the basis of the property.

(ii) Under subparagraph (1) of this paragraph, on January 1, 1973, the automobile ceases to be section 38 property with respect to A to the extent of 10 percent (70 percent minus 60 percent) of the basis of the property.

[illegible] The Regulations below [illegible] the changes made by T.D. 6991, 1969-2 C.B. 59, [illegible] Sec. 47(c), as amended by P.L. 91-172, and to the Committee Reports [illegible].

[illegible] (T.D. 6991, 1969-2 C.B. 59, as amended by T.D. 7193, 1972-2 C.B. 7.) See also [illegible] 1.47-1.

(f) *Transfers.* Notwithstanding the provisions of § 1.47-1, relating to "the [illegible] (e) of [illegible] paragraph (b) [illegible] to [illegible] paragraph (b) [illegible] to [illegible] section 47(b) [illegible]

(f) "[illegible]

Reg. § 1.47-3(a) continued

applies), paragraph (f) (relating to mere change in form of conducting a trade or business), paragraph (g) (relating to sale-and-leaseback transactions), or paragraph (h) (relating to certain progress expenditures) of this section applies with respect to such disposition or cessation.

(b) *Transfers by reason of death*—(1) *General rule.* Notwithstanding the provisions of § 1.47-2, relating to "disposition" and "cessation", paragraph (a) of § 1.47-2 shall not apply to a transfer of section 38 property by reason of the death of the taxpayer. Thus, for example, with respect to section 38 property held in joint tenancy, paragraph (a) of § 1.47-1 shall not apply to the transfer of the deceased taxpayer's interest to the surviving joint tenant. If, under § 1.48-4, the lessor of new section 38 property made a valid election to treat the lessee as having purchased such property for purposes of the credit allowed by section 38, paragraph (a) of § 1.47-1 does not apply if, by reason of the death of the lessee, there is a termination of the lease and transfer of the leased property to the lessor, or there is an assignment of the lease and transfer of the leased property to another person. Moreover, paragraph (a) of § 1.47-1 does not apply to the transfer of a partner's interest in a partnership, a beneficiary's interest in an estate or trust, or shares of stock of a shareholder of an electing small business corporation (as defined in section 1371(b)) by reason of the death of such partner, beneficiary, or shareholder. Paragraph (a) of § 1.47-1 applies to a gift by a taxpayer prior to his death even if the value of such gift is included in his gross estate for estate tax purposes (such as a gift in contemplation of death under section 2035). The effect of this subparagraph is that any section 38 property held by a taxpayer at the time of his death is deemed to have been held by him for its entire estimated useful life.

(2) *Examples.* Subparagraph (1) of this paragraph may be illustrated by the following examples:

Example (1). (i) *A*, an individual, acquired and placed in service on January 1, 1970, an item of section 38 property with a basis of $1,000 and with estimated useful life of eight years. On April 30, 1972, *A* died and, as a result of *A*'s death, his interest in such item of section 38 property was transferred to a testamentary trust pursuant to *A*'s will, and on February 1, 1977, the trust is terminated and the item of section 38 property is transferred to the beneficiaries of the trust.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the transfer, as a result of *A*'s death, of his interest in such item of section 38 property to the testamentary trust. Moreover, paragraph (a) of § 1.47-1 does not apply to the February 1, 1977, transfer of such item of section 38 property by the trust to its beneficiaries.

Example (2). (i) *X* Corporation, an electing small business corporation (as defined in section 1371(b)) which files returns on the basis of a calendar year, acquired and placed in service during 1972 an item of section 38 property. On December 31, 1976, *X* Corporation had 10 shares of stock outstanding which were owned as follows: *A* owned eight shares and *B* owned two shares. On December 31, 1982, 40 percent of the basis of the item of section 38 property was apportioned to *A* and 60 percent to *B*. On June 1, 1983, *A* died, and, as a result of *A*'s death, his eight shares of stock in *X* Corporation are transferred to his wife. On July 10, 1983, *X* Corporation sold the item of section 38 property to *X* Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the transfer, as a result of *A*'s death, of the stock in *X* Corporation to his wife. However, with respect to the July 10, 1983, sale paragraph (a) of § 1.47-1 applies only to the 60 percent of the basis of the item of section 38 property which was apportioned to *B*.

(c) *Effective date.* [illegible] (1) [illegible] after April 18, 1969. Notwithstanding [illegible] of § 1.47-3, nothing in paragraph [illegible] section,

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[illegible]
(2) [illegible]

Reg. § 1.47-3(c)(1) continued

paragraph (a) of § 1.47-1 shall not apply to property which, after April 18, 1969, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck or other casualty, or by reason of its theft.

(2) Disposition before April 19, 1969. (i) In the case of property which, before April 19, 1969, is disposed of or otherwise ceases to be section 38 property with respect to the taxpayer on account of its destruction or damage by fire, storm, shipwreck or other casualty, or by reason of its theft, paragraph (c) of § 1.47-1 shall apply only to the extent provided in subdivisions (ii) and (iii) of this subparagraph.

(ii) Paragraph (c) of § 1.47-1 shall not apply if—

(a) Section 38 property is placed in service by the taxpayer to replace (within the meaning of paragraph (b) of § 1.48-3) the destroyed, damaged, or stolen property, and

(b) The basis (or cost) of the section 38 property which is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property is reduced under paragraph (a) of § 1.48-3.

(iii) If property which would be section 38 property but for section 49 is placed in service by the taxpayer to replace the destroyed, damaged, or stolen property, then the provisions of paragraph (b) of this section (other than the requirement that the replacement be placed within 6 months after the disposition) shall apply.

(c) Examples. The provisions of subparagraph (2)(ii) of this paragraph may be illustrated by the following examples:

Example (1). (i) A acquired and placed in service on July 1, 1969, a [illegible] No. 1 which qualified as section 38 property with a basis of $20,000 and an estimated useful life of [illegible] years. The amount of the investment credit with respect to such machine was properly [illegible] for the taxable year 1969 and such amount of $1,000 was allowed as a credit against [illegible] for such year. On July 1, 1970, A acquired and placed in service machine No. 2. On January 1, 1971, machine No. 1 was completely destroyed by fire. On January 7, 1971, A purchased and placed in service machine No. 3. A's basis in machine No. 3 was $25,000. A received $15,000 in compensation for the destroyed machine, and on February 27, 1971, A acquired and placed in service machine No. 4. A's basis in machine No. 4 was $10,000. A received $5,000 in compensation for the destroyed machine, and on February 27, 1971, A acquired and placed in service machine No. 5. A's basis in machine No. 5 was $20,000. A properly, with [illegible] and an estimated useful life of [illegible] years, placed machine No. 1.

(ii) Under subparagraph (1) of this paragraph, paragraph (c) of § 1.47-1 does not apply with respect to machine No. 1 because machine No. 3 was acquired and placed in service by A in order to replace machine No. 1 and [illegible] machine No. 1. Accordingly, for purposes of paragraph (b) of § 1.48-3, machine No. 3 is treated as [illegible] machine No. 1. Under paragraph (a) of § 1.48-3, for purposes of paragraph (b) of § 1.48-3, the basis of machine No. 3 is reduced by $20,000. Under paragraph (b) of § 1.48-3, the basis of machine No. 3 is reduced by $5,000, the amount of the investment credit with respect to machine No. 1 which was recaptured by reason of the destruction of machine No. 1.

Example (2). (i) The facts are the same as in example (1) except that A received only $10,000 in insurance proceeds as compensation for the destroyed machine.

(ii) Although machine No. 3 is treated as a replacement for machine No. 1, subparagraph (2) of this paragraph does not apply with respect to machine No. 1 since the basis of machine No. 3 is not reduced by reason of § 1.48-3. Paragraph (a) of § 1.47-1 applies with respect to the January 1, 1970, disposition of machine No. 1. The actual useful life of machine No. 1 is one year. A's recomputed [illegible]

Example (3)
(i) "(2)"
(ii) "(2)"
(iii) "(2)"
(a) "(2)"
(b) "(2)"
(i) [illegible]

Par. [illegible] § 1.47-3

Reg. § 1.47-3(e)(2) Example (2)(ii) continued

multiplied by such applicable percentage) that A's recomputed credit carried for the taxable year 1962 is zero. The income tax imposed by chapter 1 of the Code on A for the taxable year 1962 is increased by $1,200.

(d) *Recalculation of used section 38 property*—(1) *In general.* If—

(i) Used section 38 property (as defined in § 1.48-2) the cost of which was taken into account in computing the taxpayer's qualified investment is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing such qualified investment, and

(ii) For the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, the sum of (a) the cost of used section 38 property placed in service by the taxpayer, and (b) the cost of used section 38 property apportioned to such taxpayer exceeded $50,000, then such taxpayer may treat the cost of any used section 38 property (regardless of its estimated useful life) which was not originally selected, under paragraph (c)(4) of § 1.46-3, to be taken into account in computing qualified investment for such taxable year (or previously modified under this subparagraph) as having been selected (in accordance with the principles of paragraph (c)(4)(ii) of § 1.46-3) in place of the cost of the used section 38 property described in subdivision (i) of this subparagraph. Hereinafter such recalculated property is referred to as "newly selected used section 38 property". For purposes of this subparagraph, the cost of used section 38 property apportioned to a taxpayer means the sum of the cost of used section 38 property apportioned to him by a trust, estate, or electing small business corporation (as defined in section 1.51(c)), 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 taxpayer's taxable year. In the case of a taxpayer to whom paragraph (c)(2) of § 1.46-3 applied for the taxable year in which the property described in subdivision (i) of this subparagraph was placed in service, $ 25,000 shall be substituted for the $50,000 amount referred to in subdivision (ii)(b) of this subparagraph, and in the case of a member of an affiliated group (as defined in subparagraph (6) of § 1.48-3 (e)) the amount apportioned to such member under paragraph (c) of § 1.46-3 shall be substituted for such $50,000 amount.

(2) *Application of paragraph (e) of § 1.47-1.* (i) If a taxpayer treats, under subparagraph (1) of this paragraph, the cost of any used section 38 property which was not originally selected or taken into account in place of the cost of used section 38 property described in subparagraph (1)(i) of this paragraph, then, notwithstanding the provisions of § 1.47-2 (relating to "disposition" and "cessation"), paragraph (e) of § 1.47-1 shall apply to the taxpayer described in subparagraph (1)(i) of this paragraph only with respect to the recapture of the cost of the newly selected used section 38 property.

(ii) If the cost of property described in subparagraph (1)(i) of this paragraph exceeds the cost of the newly selected used section 38 property, then the property described in subparagraph (1)(i) of this paragraph shall cease to be section 38 property with respect to the taxpayer to the extent of such excess.

(iii) If the newly selected used section 38 property is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life of the property described in subparagraph (1)(i) of this paragraph, then, for the purpose of applying paragraph (e) of § 1.47-1 with respect to such newly selected used section 38 property, [illegible] shall be treated as the cost of such property. The subparagraph [illegible] with respect to the cost of section 38 property which is newly selected [illegible]

Reg. § 1.47-3(d)(2)(ii) continued

section 38 property. See paragraph (c) of § 1.47-5, relating to date placed in service and date of disposition or cessation.

(3) *Information requirement.* (i) If in any taxable year this paragraph applies to a taxpayer, such taxpayer shall attach to his income tax return for such taxable year a statement containing the information required by subdivision (ii) of this subparagraph.

(ii) The statement referred to in subdivision (i) of this subparagraph shall contain the following information:

(a) The taxpayer's name, address and taxpayer account number; and

(b) With respect to the original selected used section 38 property and the newly selected used section 38 property, the month and year placed in service, cost, and estimated useful life.

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

Example (1). (i) X Corporation purchased and placed in service on January 1, 1962, machines No. 1 and No. 2, which qualified as used section 38 property, each with a cost of $50,000 and an estimated useful life of eight years. The applicable cost of used section 38 property taken into account by X Corporation in computing its qualified investment for the taxable year 1962 could not exceed $20,000; therefore, under paragraph (c) (1) of § 1.47-3, X elected to take the $20,000 cost of machine No. 1 to be taken into account in computing its qualified investment for the taxable year 1962. The qualified investment with respect to machine No. 1 was $10,000. For the taxable year 1962 X's credit amount of $4,000 was allowed under section 38

Reg. § 1.47-3(f)(4) Example (1) continued

on a credit against its liability for tax. On January 2, 1955, X Corporation sells machine No. 1 to Y Corporation.

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the $60,000 cost of machine No. 2 as having been elected to be taken into account in computing its qualified investment for the taxable year 1957 in place of the $30,000 cost of machine No. 1. Therefore, under subparagraph (2) (i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 2, 1955, disposition of machine No. 2.

Example (3). (i) The facts are the same as in example (1) and in addition X Corporation, on December 2, 1958, sells machine No. 2 to Y Corporation.

(ii) Under subparagraph (2) (ii) of this paragraph, paragraph (a) of § 1.47-1 applies with respect to the December 2, 1958, disposition of machine No. 2. The actual useful life of machine No. 2 is four years and eleven months (that is, the period beginning on January 1, 1955, and ending on December 2, 1958). The recomputed qualified investment with respect to machine No. 2 is $24,000 ($60,000 cost multiplied by 40% (percent applicable to recovery) and Y Corporation's recomputed credit allowed for the taxable year 1957 is $2,400. The credit so allowed is increased by chapter 1 of the Code on X Corporation's tax for the taxable year 1958 is increased by the $2,000 decrease in its credit allowed by the 1957 taxable year 1958 (that is, $3,500 original credit earned minus $1,500 recomputed credit allowed).

Example (4). (i) [illegible] (2) except that machine No. 2 had a cost of [illegible].

(ii) Under subparagraph (1) of this paragraph, X Corporation treats the $60,000 cost of machine No. 2 as having been elected to be taken into account in computing its qualified investment for the taxable year 1957 in place of the $30,000 cost of machine No. 1. However, under subparagraph (2) (ii) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 2, 1955, disposition of machine No. 1 in the amount of $15,000 ($30,000 cost of machine No. 1 [illegible] actual useful life of such machine No. 1 is three years (that is, the period beginning on January 1, 1955, and ending on January 2, 1958). The recomputed qualified investment with respect to the 1955 portion of the cost of machine No. 1 is $6,000 ([illegible] applicable percentage) and X Corporation's credit allowed for the taxable year 1957 is $600 ([illegible]). The credit so allowed is increased by chapter 1 of the Code on X Corporation's tax for the taxable year 1958 by the $600 decrease in its credit allowed by the 1957 taxable year (that is, $1,500 original credit earned minus $900 recomputed credit allowed).

(c) [illegible]—(1) General rule. Notwithstanding the provisions of [illegible], subparagraph (2) of this paragraph, paragraph (a) of § 1.47-1 shall not apply to a disposition of section 38 property in a transaction to which section 381 (a) (relating to carryovers in certain corporate acquisitions) applies if the section 38 property described in the preceding sentence is disposed of, or ceases to qualify with respect to the [illegible] into account in computing the qualified investment. Thus, paragraph (a) of § 1.47-1 shall not apply with respect to the [illegible]

Reg. § 1.47-3(c)(7) continued

ing with the date of the disposition by, or cessation with respect to, the acquiring corporation.

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

Example (1). (i) X Corporation, a wholly owned subsidiary of Y Corporation, acquired and placed in service on January 2, 1968, an item of section 38 property with a basis of $30,000 and an estimated useful life of eight years. Both X and Y make their returns on the basis of a calendar year. The qualified investment with respect to such item was $12,000. For the taxable year 1968 X Corporation's credit carried of $360 was allowed under section 38 as a credit against its liability for tax. On January 15, 1969, X Corporation is liquidated under section 332 and all of its properties, including the item of section 38 property, are transferred to Y Corporation. The bases of the properties in the hands of Y Corporation are determined under section 334(b)(1).

(ii) Under subparagraph (3) of this paragraph, paragraph (a) of § 1.47-3 does not apply to the January 15, 1969, transfer to Y Corporation.

Example (2). (i) The facts are the same as in example (1) and in addition on February 2, 1969, Y Corporation sells the item of section 38 property to Z Corporation.

(ii) Under subparagraph (1) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the January 15, 1969, transfer to Y Corporation. However, paragraph (a) of § 1.47 applies to the February 2, 1969, sale of the property by Y Corporation. The actual useful life of the property in the hands of Y Corporation (that is, the period beginning on January 2, 1968, and ending on February 2, 1969).

(c) *Change in form of conducting trade or business.*—(1) *General rule.* (i) Notwithstanding the provisions of § 1.47-3, relating to "dispositions" and "cessations", paragraph (a) of § 1.47-1 shall not apply to section 38 property which is disposed of, or otherwise ceases to be section 38 property with respect to the taxpayer, before the close of the estimated useful life which was taken into account in computing the taxpayer's qualified investment by reason of a mere change in the form of conducting the trade or business in which such section 38 property is used, provided that the conditions set forth in subdivision (ii) of this subparagraph are satisfied.

(ii) The conditions referred to in subdivision (i) of this subparagraph are as follows:

(a) The section 38 property described in subdivision (i) of this subparagraph is retained as section 38 property by the taxpayer,

(b) The transferee (or in a case where the transfer is to a partnership, estate, trust, or dealing entity, one or more members of the partnership, beneficiary, or shareholders) of such section 38 property retains a substantial interest in such trade or business,

(c) Substantially all the assets (whether or not section 38 property) necessary to operate such trade or business are transferred by the taxpayer to the transferee in which such section 38 property is transferred, and

(d) The basis of such section 38 property in the hands of the transferee is determined in whole or in part by reference to the basis of such section 38 property in the hands of the transferor.

This subparagraph shall not apply to the transfer of section 38 property if paragraph (a) of this section, relating to termination or recapture under section 47(a) applies with respect to such transfer.

(2) For purposes of subparagraph (1) of this paragraph, a taxpayer (or in a case where the transferee is a partnership, estate, trust, or dealing entity, another corporation, the partners, beneficiary, or shareholders of such entity) shall be considered as having retained a substantial interest in a trade or business only if, after the change in form, the taxpayer is in such trade or business—

Regs. § 1.47-3(f)(2) continued

(i) Is substantial in relation to the total interest of all persons, or

(ii) Is equal to or greater than his interest prior to the change in form.

Thus, where a taxpayer owns a 5-percent interest in a partnership, and, after the incorporation of that partnership, the taxpayer retains at least a 5-percent interest in the corporation, the taxpayer will be considered as having retained a substantial interest in the trade or business as of the date of the change in form.

(3) Property held for the production of income. Subparagraph (1)(i) of this paragraph applies to section 38 property held for the production of income (within the meaning of section 167(a)(2)) as well as to section 38 property used in a trade or business.

(4) Leased property. In a case where a lessee of new section 38 property made a valid election, under § 1.48-4, to treat the lessor as having purchased such property for purposes of the credit allowed by section 38, in determining whether subparagraph (2)(i) of this paragraph applies to an acquisition of the lease and transfer of possession of such property, the condition contained in subparagraph (1)(ii)(a) of this paragraph is not applicable.

(5) Disposition or cessation. (i) If section 38 property described in subparagraph (1)(i) of this paragraph is disposed of by the transferee, or otherwise ceases to be section 38 property with respect to the transferee, before the close of the estimated useful life which was taken into account in computing the qualified investment of the transferee (or in a case where the transferee is a partnership, estate, trust, or electing small business corporation, the qualified investment of the partners, beneficiaries, or shareholders) then under paragraph (a) of § 1.47-1 such property ceases to be section 38 property with respect to the transferee (or such partners, beneficiaries, or shareholders), and a recapture determination shall be made with respect to such property. For purposes of recapturing qualified investment with respect to such property, the rate used in the preceding sentence is the percentage beginning with the date on which it was placed in service by the transferee and ending with the date of the disposition by, or cessation with respect to, the transferee.

(ii) If in any taxable year the transferee (or in a case where the transferee is a partnership, estate, trust, or electing small business corporation, the partners, beneficiary, or shareholder) of the section 38 property described in subparagraph (1)(i) of this paragraph, does not have a substantial interest in the trade or business directly or indirectly (through ownership in other entities provided that such other entities' basis in such interest was determined in whole or in part by reference to the basis of such interest in the hands of the transferee) then, under paragraph (a) of § 1.47-1, such property ceases to be section 38 property with respect to the transferee and he (or the partners, beneficiary, or shareholder) shall make a recapture determination. For purposes of recapturing qualified investment with respect to property described in this subdivision, the rate used shall be the percentage beginning with the date on which it was placed in service by the transferee and ending with the date on which the transferee (or the partners, beneficiary, or shareholder) ceased to retain a substantial interest in the trade or business. Any taxpayer who ceases to establish his interest in a trade or business under the rules of this subdivision shall include separate notice to disassociate his indirect interest in such trade or business with any such transfer or investment.

(iii) In the case of property described in subparagraph (1)(i) of this paragraph which is section 38 property, prior to the application of subdivision (ii) of this subparagraph, to the transferee in connection with the transfer,

(iv) [illegible] subdivision (ii) of this subparagraph, [illegible] or partnership, if the basis of a taxpayer in [illegible] such taxpayer has substantial interest, for purposes of subparagraph (1)(ii)

of §1.47-4 (relating to electing small business corporations), paragraph (a)(2) of §1.47-5 (relating to estates or trusts) or paragraph (a)(3) of §1.47-6 (relating to partnerships) shall apply, as the case may be.

(6) *Examples.* This paragraph may be illustrated by the following examples in each of which it is assumed that the transfer satisfies the conditions of subparagraph (1)(ii)(a), (c) and (d) of this paragraph.

Example (1). (i) On January 1, 1962, A, an individual, acquired and placed in service in his sole proprietorship an item of section 38 property with a basis of $12,000 and an estimated useful life of eight years. The qualified investment with respect to such item was $12,000. For the taxable year 1962 A's credit earned of $840 was allowed under section 38 as a credit against his liability for tax. On March 15, 1963, A transfers all of the assets used in his sole proprietorship to X Corporation, a newly formed corporation, in exchange for [illegible] percent of the stock of X Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of §1.47-1 does not apply to the March 15, 1963, transfer to X Corporation.

Example (2). (i) The facts are the same as in example (1) and in addition on February 2, 1964, X Corporation sells the item of section 38 property to Y Corporation.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of §1.47-1 does not apply to the March 15, 1963, transfer to X Corporation. However, under subparagraph (5)(i) of this paragraph, paragraph (a) of §1.47-1 applies to the February 2, 1964, sale of the item of section 38 property by X Corporation to Y Corporation. The actual useful life of the property is two years and one month (that is, the period beginning on January 1, 1962, and ending on February 1, 1964). The recomputed qualified investment [illegible] ($12,000) basis multiplied by [illegible] and A's recomputed credit earned for the taxable year 1962 [illegible] imposed by chapter 1 of the Code on A for 1964 is increased by the [illegible] decrease in his credit earned for the taxable year 1962 (that is, $840 credit earned minus [illegible] recomputed credit earned).

Example (3). (i) On January 1, 1962, partnership ABC, which makes its returns on the basis of a calendar year, acquired and placed in service an item of section 38 property with a basis of [illegible] and an estimated useful life of eight years. [illegible] on the basis of a calendar year and [illegible] equally. Each partner's share of the basis of such item of section 38 property is [illegible] percent, that is, [illegible]. On March 15, 1963, partnership ABC transfers all of [illegible] in the trade or business to the X Corporation, a newly formed corporation, in exchange for all of the stock of X Corporation and immediately thereafter [illegible] 20 percent of such stock to each of the 10 partners.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of §1.47-1 does not apply to the March 15, 1963 transfer by the ABC Partnership to X Corporation.

Example (4). (i) The facts are the same as in example (3) except that partnership ABC transfers 10 percent of the stock [illegible] to each [illegible] 20 percent to [illegible].

(ii) Under subparagraph (1)(ii) [illegible] of the partners [illegible] paragraph (a) of §1.47-1 does not apply to the March 15, [illegible]. Paragraph (a) of §1.47-1 [illegible] item of section 38 property [illegible] paragraph (a)(3) of §1.47-6.

Reg. § 1.47-3 (f) (6) continued

Example (5). (i) X Corporation operates a manufacturing business and a separate personal service business. On January 1, 1963, X acquired and placed in service a truck which qualified as section 38 property, in its manufacturing business. The truck had a basis of $10,000 and an estimated useful life of 8 years. On February 10, 1965, X transfers all the assets used in its manufacturing business to Partnership XY in exchange for a 50-percent interest in such partnership.

(ii) Under subparagraph (1)(i) of this paragraph, paragraph (a) of § 1.47-1 does not apply to the February 10, 1965, transfer to Partnership XY.

(g) *Sale and leaseback transactions.* Notwithstanding the provisions of § 1.47-2, relating to "disposition" and "cessation", paragraph (a) of § 1.47-1 shall not apply 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. If paragraph (a) of § 1.47-1 applies with respect to such property subsequent to the transaction, the actual useful life shall begin with the date on which such property was first placed in service by the vendor-lessee as owner.

(h) Certain property acquired after April 18, 1966—(1) In general. (i) *If section 38 property is disposed of in a [illegible] for purposes of section 1033 and the regulations thereunder, [illegible] in service or use to the property disposed of and which would be section 38 property but for the application of section 48 is placed in service to replace the property disposed of, the increase in income tax [illegible] from the recomputation under paragraph (a) of § 1.47-1 shall be reduced (but not below zero) by the [illegible] for the qualified investment of the replacement property (determined as if such property were section 38 property). The preceding sentence shall not apply unless the replacement is placed in service within 6 months after the disposition. If property placed in service as replacement property, [illegible] before the replaced property [illegible] the taxpayer's return [illegible] qualified investment will be considered [illegible] by the taxpayer that he expects to [illegible] the replacement property for its estimated useful life. If such property is disposed of before the end of such life, then the [illegible] qualified investment [illegible] of the replacement property will be recomputed for the year of replacement using the actual useful life of such property.*

(ii) The provisions of subdivision (i) of this subparagraph may be illustrated by the following example:

Example. On January 1, 1967, [illegible] acquired and placed in service a new machine with a basis of [illegible] and an estimated useful life of 8 years. [illegible] for a machine. [illegible] of the machine is [illegible] but less than 6 years, the [illegible] of the machine (2/3 percent of [illegible]) under paragraph (a) of § 1.47-1 [illegible] would be [illegible] (i.e., the original credit earned, [illegible], the recomputed credit earned). However, under the provisions of this subdivision, the increase [illegible] (but not below zero) by the [illegible] for the replacement property (determined as if such property were section 38 property). [illegible]

(2) [illegible]

Reg. § 1.47-3(f)(2) continued

leased from another, provided (i) an election with respect to the newly leased property could be made under section 48(d) but for section 49, and (ii) the lessee obtains the lessor's written statement that he will not claim such property as replacement property under this paragraph. The statement of the lessor shall contain the information specified in subdivisions (i) through (vii) of § 1.48-4(f)(1) and the statement (or a copy thereof) shall be retained in the records of the lessor and the lessee for a period of at least 3 years after the property is transferred to the lessee.

[¶ 5982] Reg. § 1.47-4 (TD 6931, filed 10-6-67.) Electing small business corporation.

(a) In general.—(1) Disposition or cessation in hands of corporation. If an electing small business corporation (as defined in section 1371(b)) or a former electing small business corporation disposes of any section 38 property (or if any section 38 property otherwise ceases to be section 38 property in the hands of the corporation) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each shareholder who is treated under § 1.48-5 as the taxpayer with respect to such property. Each such recapture determination shall be made with respect to the pro rata share of the basis (or cost) of such property taken into account by such shareholder in computing his qualified investment. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the electing small business corporation and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the shareholder in connection with the same property. See definition of "recapture determination" in paragraph (a)(1) of § 1.47-1.

(2) [illegible]

(a) The basis (or cost) of section 38 property is apportioned under § 1.48-5, to a shareholder of an electing small business corporation who takes such basis (or cost) into account in computing his qualified investment, and

(b) [illegible]

[illegible]

(c) [illegible]

Reg. § 1.47-4(a)(5)(ii) continued:

tionate stock interest in the corporation on the date of the apportionment under § 1.43-5.

(iii) In determining a shareholder's proportionate stock interest in a former electing small business corporation for purposes of this subparagraph, the shareholder shall be considered to own stock in such corporation which he owns directly or indirectly (through ownership in other entities provided such other entities' bases in such stock are determined in whole or in part by reference to the basis of such stock in the hands of the transferor). For example, if A, who owns all of the 100 shares of the outstanding stock of corporation X, a corporation which was formerly an electing small business corporation, transfers on November 1, 1956, 70 shares of X stock to corporation Y in exchange for 90 percent of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own 10 percent of the stock of X, 20 percent directly and 63 percent indirectly (i.e., 90 percent of 70). Any taxpayer who seeks to establish his interest in the stock of a former electing small business corporation under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the corporation after any such transfer or transfers.

(b) Election of a small business corporation under section 1372.—(1) General rule. If a corporation makes a valid election under section 1372 to be an electing small business corporation (as defined in section 1371(b)), then on the last day of the taxable year immediately preceding the first taxable year for which such election is effective, any section 38 property the basis (or cost) of which was taken into account in computing the corporation's qualified investment in taxable years prior to the first taxable year for which the election is effective (and which has not been disposed of or otherwise ceased to be section 38 property with respect to the corporation prior to such last day) shall be considered as having ceased to be section 38 property with respect to such corporation and § 1.47-1 shall apply. However, if the corporation and each of the persons who are shareholders of the corporation on the first day of the first taxable year for which the election under section 1372 is to be effective, or on the date of such election, whichever is later, execute the agreement specified in subparagraph (2) of this paragraph, § 1.47-1 shall not apply to any such section 38 property by reason of the election by the corporation under section 1372.

(2) Agreement of shareholders and corporation. (i) The agreement referred to in subparagraph (1) of this paragraph shall be signed by the shareholders and the corporation, and shall recite that, in the event the section 38 property described in subparagraph (1) of this paragraph is later disposed of by, or ceases to be section 38 property with respect to, the corporation during a taxable year of the corporation for which the election under section 1372 is effective, each signer agrees (a) to notify the district director of such disposition or cessation, and (b) to be jointly and severally liable to pay to the district director an amount

Reg. § 1.47-1(b)(2)(i) continued

equal to the increase in tax provided by section 47. The amount of such increase shall be determined as if such property had ceased to be section 38 property as of the last day of the taxable year immediately preceding the first taxable year for which the election under section 1372 is effective, except that the actual useful life (within the meaning of paragraph (a) of § 1.47-1) of the property shall be considered to have ended on the date of the actual disposition by, or cessation in the hands of, the electing small business corporation.

(ii) The agreement shall set forth the name, address, and taxpayer account number of each party and the internal revenue district in which each such party files his or its income tax return for the taxable year which includes the last day of the corporation's taxable year immediately preceding the first taxable year for which the election under section 1372 is effective. The agreement may be signed on behalf of the corporation by any person who is duly authorized. The agreement shall be filed with the district director with whom the corporation files its income tax return for its taxable year immediately preceding the first taxable year for which the election under section 1372 is effective and shall be filed on or before the due date (including extensions of time) of such return. However, if the due date (including extensions of time) of such income tax return is on or before September 1, 1967, the agreement may be filed on or before December 31, 1967. For purposes of the two preceding sentences, the district director may, if good cause is shown, permit the agreement to be filed on a later date.

(c) Examples. This section may be illustrated by the following examples in each of which it is assumed that X Corporation, an electing small business corporation which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, three items of section 38 property. The basis and estimated useful life of each item of section 38 property are as follows:

Asset number	Basis	Estimated useful life
1	$30,000	4 years
2	30,000	6 years
3	30,000	8 years

On December 31, 1962, X Corporation had 20 shares of stock outstanding which were owned equally by A and B who make their returns on the basis of a calendar year. Under § 1.48-5, the total basis of section 38 properties was apportioned to the shareholders of X Corporation as follows:

	Useful life category		
	4 to 6 years	6 to 8 years	8 years or more
Total basis	$30,000	$30,000	$30,000
Shareholder A (10/20)	$15,000	$15,000	$15,000
Shareholder B (10/20)	15,000	15,000	15,000

Assuming that during 1962 shareholders A and B did not place in service any section 38 property and that they did not own any interests in other electing small business corporations, partnerships, estates, or trusts, the qualified investment of each shareholder is $30,000, computed as follows:

Basis	Applicable percentage	Qualified investment
$15,000	33⅓	$ 5,000
15,000	66⅔	10,000
15,000	100	15,000
		$30,000

For the taxable year 1962, each shareholder's credit amounted to $2,100 (7 percent of $30,000) was allowed under section 38 as a credit against his liability for tax.

Example (1). (i) On December 9, 1965, X Corporation sells asset No. 3 to Y Corporation.

Reg. §1.47-4(c) Example (1)(ii) continued

(ii) The actual useful life of asset No. 2 is three years and six months. The recomputed qualified investment with respect to each shareholder's share of the basis of asset No. 2 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962 each shareholder's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the shareholders for the taxable year 1962 is increased by the $1,050 decrease in his credit earned for the taxable year 1963 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example (3). (i) On December 3, 1954, shareholder A sells 5 of his 10 shares of stock in X Corporation to C, and on December 3, 1965, A sells his remaining 5 shares of stock to D. In addition, on January 2, 1966, X Corporation sells asset No. 3 to Y Corporation.

(ii) Under paragraph (c)(3) of this section, on December 3, 1964, 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to shareholder A since immediately after the December 3, 1964, sale A's proportionate stock interest in X Corporation is reduced to 50 percent of the proportionate stock interest in X Corporation which he held on December 31, 1962. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1964). A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Basis	Applicable percentage	Recomputed qualified investment
$7,500	33⅓	$ 2,500
7,500	66⅔	5,000
7,500	100	7,500
		$15,000

For the taxable year 1962 shareholder A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (c)(3) of this section, on December 3, 1965, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to shareholder A since immediately after the December 3, 1965, sale A's proportionate stock interest in X Corporation is reduced to zero. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1962, and ending with December 3, 1965). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 shareholder A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1965 is increased by $1,050 (that is, $2,100 ($2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1964).

(iv) The actual useful life of asset No. 2 which was sold on January 2, 1963, is three years and seven months. The recomputed qualified investment with respect to A's share of the basis of asset No. 2 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962 A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on shareholder A for the taxable year 1962 is increased by the $1,050 decrease

Reg. § 1.47-4(c) Example (2)(i-) *continued*

in his credit carried for the taxable year 1971 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 2 on January 2, 1972, by X Corporation has no effect on A.

(d) *Termination or revocation of an election under section 1372.* Section 38 property shall not be considered to be disposed of or to have ceased to be section 38 property solely by reason of a termination or revocation of a corporation's election under section 1372.

[¶ 5953] Reg. § 1.47-5 (TD 6931, filed 10-9-67.) Estates and trusts.

(a) *In general.*—(1) *Disposition or cessation in hands of estate or trust.* If an estate or trust disposes of any section 38 property (or if any section 38 property otherwise ceases to be section 38 property in the hands of the estate or trust) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to the estate or trust, and each beneficiary who is treated, under § 1.48-6, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the basis (or cost) of such property taken into account by such estate or trust and such beneficiary in computing its or his qualified investment. For purposes of each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the estate or trust and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph with respect to a taxpayer there shall be taken into account any prior recapture determinations made with respect to such taxpayer in connection with the same property. For definition of "recapture determination" see paragraph (a)(1) of § 1.47-4.

(2) *Disposition of interest.* (i) If—

(a) The basis (or cost) of section 38 property is apportioned, under § 1.48-6, to an estate or trust which, or to a beneficiary of an estate or trust who, takes such basis (or cost) into account in computing his qualified investment, and

(b) After the date on which such section 38 property was placed in service by the estate or trust and before the close of the estimated useful life of the property, such estate's, trust's, or such beneficiary's proportionate interest in the income of the estate or trust is reduced (for example, by a sale, or by the terms of the estate or trust instrument) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction, such section 38 property ceases to be section 38 property with respect to such estate, trust, or beneficiary to the extent of the actual reduction in such estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust. (For example, if 75% of the basis of section 38 property was apportioned to a beneficiary and if the proportionate interest in the income of the estate or trust is reduced from 50 percent to 30 percent (that is, 60 percent of the original interest), then 40% of the property shall be treated as having ceased to be section 38 property to the extent of $300). Accordingly, a recapture determination shall be made with respect to such estate, trust, or beneficiary. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the estate or trust and ending with the date on which it is treated as having ceased to be section 38 property with respect to the estate, trust, or beneficiary. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determination made with respect to the estate, trust, or beneficiary in connection with the same property.

(ii) The percentage referred to in subdivision (i)(b) of this subparagraph is 60% percent of the estate's, trust's, or beneficiary's proportionate interest in the

Reg. § 1.47-3(a)(2)(ii) continued

income of the estate or trust for the taxable year of the apportionment under § 1.48-6. However, once property has been treated under this subparagraph as having ceased to be section 38 property to any extent the percentage referred to shall be 331/3 percent of the estate's, trust's, or beneficiary's proportionate interest in the income of the estate or trust for the taxable year of the apportionment under § 1.48-6.

(iii) In determining a beneficiary's proportionate interest in the income of an estate or trust for purposes of this subparagraph, the beneficiary shall be considered to own any interest in such an estate or trust which he owns directly or indirectly (through ownership in other entities provided such other entities' basis in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the beneficiary). For example, if A, whose proportionate interest in the income of trust X is 50 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 50-percent interest in trust X. Any taxpayer who seeks to claim in his interest in an estate or trust under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the estate or trust after any such transfer or transaction.

(b) Examples. Paragraph (a) of this section may be illustrated by the following examples in each of which it is assumed that 2276 Trust, which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1969, three items of section 38 property. The useful and estimated useful life of each item of section 38 property are as follows:

Asset Number	Basis	Estimated useful life
1	$20,000	4 years
2	60,000	6 years
3	30,000	8 years

For the taxable year 1969 the income of 2276 Trust is $50,000, which is allocable equally to 2276 Trust and beneficiary A. Beneficiary A owned his interest in the trust of a calendar year. Under § 1.48-5, the total basis of the section 38 properties was apportioned to 2276 Trust and beneficiary A as follows:

		Useful life category		
		4 to 5 years	6 to 7 years	8 years or more
Total basis		$20,000	$60,000	$30,000
2276 Trust	($10,000)	($5,000)	($30,000)	($15,000)
	($,000)			
Beneficiary A	($,000)	$5,000	$30,000	$15,000
	($,000)			

Assuming that during 1969 beneficiary A did not place in service any section 38 property and that he did not cease any trade or business or other entity, during such taxable year, or partnership, his qualified investment for 1969 from 2276 Trust and of beneficiary A is $[illegible] each, computed as follows:

	Applicable percentage	Qualified investment
$,000	33⅓	$,000
$,000	66⅔	$,000
$,000	100	$,000
		$,000

For the taxable year 1969, 2276 Trust and beneficiary A each had a credit [illegible]

Reg. § 1.47-3(b) Examples continued

of $2,100 (7 percent of $30,000). Each such credit earned was allowed under section 38 as a credit against the liability for tax.

Example (2). (i) On December 2, 1965, XYZ Trust sells asset No. 3 to X Corporation.

(ii) The actual useful life of asset No. 3 is three years and six months. The recomputed qualified investment with respect to XYZ Trust's and beneficiary A's share of the basis of asset No. 3 is zero ($15,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1962, XYZ Trust's and beneficiary A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust and on beneficiary A for the taxable year 1965 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example (3). (i) On December 2, 1961, beneficiary A sells 50 percent of his interest in the income of XYZ Trust to B, and on December 3, 1963, A sells his remaining 50 percent interest to C. In addition, on January 2, 1960, XYZ Trust sells asset No. 3 to X Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1964, 50 percent of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to beneficiary A since immediately after the December 3, 1964, sale A's proportionate interest in the income of XYZ Trust is reduced to 50 percent of his proportionate interest in the income of XYZ Trust for the taxable year 1960. The actual useful life of the share of the bases of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1960, and ending with December 3, 1964). Beneficiary A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Basis	Applicable percentage	Qualified investment
$7,500	33⅓	$ 2,500
7,000	66⅔	5,000
7,500	100	7,500
		$15,000

For the taxable year 1962 beneficiary A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1964 is increased by the $1,050 decrease in his credit earned for the taxable year 1962 (that is $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1963, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to beneficiary A since immediately after the December 3, 1963, sale A's proportionate interest in the income of XYZ Trust is reduced to zero. The actual useful life of the share of the basis of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1960, and ending with December 3, 1963). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1962 beneficiary A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on beneficiary A for the taxable year 1963 is increased by $1,050 (that is, $2,100 (1962) original credit earned minus $1,050 recomputed credit earned) reduced by the $1,050 increase in tax for 1962).

(iv) The sole [illegible] of asset No. 3 [illegible] was sold on January 2, 1960,

Reg. § 1.47-3(c) Example (2)(iv) continued

[illegible] recomputed qualified investment with respect to [illegible] share of the basis of asset No. 3 is zero ($10,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1982, XYZ Trust's recomputed credit earned is $1,600 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on XYZ Trust for the taxable year 1982 is increased by the $1,000 decrease in its credit earned for the taxable year 1982 ($2,100 original credit earned minus $1,650 recomputed credit earned). The sale of asset No. 3 on January 2, 1983, has no effect on A.

[illegible] Reg. § 1.47-6 (TD 6981, filed 10-9-67.) Partnerships.

(c) In general. (1) Disposition or cessation in trade of partnership. If a partnership disposes of any partnership section 38 property (or if any partnership section 38 property otherwise ceases to be section 38 property in the hands of the partnership) before the close of the estimated useful life which was taken into account in computing qualified investment with respect to such property, a recapture determination shall be made with respect to each partner who is treated, under paragraph (f) of § 1.46-3, as a taxpayer with respect to such property. Each such recapture determination shall be made with respect to the share of the basis (or cost) of such property taken into account by such partner in computing his qualified investment. For purposes of each such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the partnership and ending with the date of the disposition or cessation. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the partner in connection with the same property. For definition of "recapture determination" see paragraph (i)(2) of § 1.47-1.

(2) Disposition of partner's interest. (i) If—

(a) The [illegible] (or cost) of partnership section 38 property is taken into account by a partner in computing his qualified investment, and

(b) After the date on which such partnership section 38 property was placed in service by the partnership and before the close of the estimated useful life of the property, such partner's proportionate interest in the general profits of the partnership (or in the particular item of property) is reduced (for example, by a sale, by a change in the partnership agreement, or by the admission of a new partner) below the percentage specified in subdivision (ii) of this subparagraph,

then, on the date of such reduction such partnership section 38 property ceases to be section 38 property with respect to such partner to the extent of the actual reduction in such partner's proportionate interest in the general profits of the partnership (or in the particular item of property). [illegible] Example. If [illegible] of section 38 property was taken into account by a partner and if his proportionate interest in the general profits of the partnership is reduced from 50 percent to 30 percent (a [illegible] 40 percent of his original interest), then such property shall be treated as ceasing to be section 38 property to the extent of 40% of [illegible]. A recapture determination must be made with respect to such partner. For purposes of such recapture determination the actual useful life of such property shall be the period beginning with the date on which it was placed in service by the partnership and ending with the date on which it is treated as having ceased to be section 38 property with respect to the partner. In making a recapture determination under this subparagraph there shall be taken into account any prior recapture determinations made with respect to the partner in connection with the same property.

(ii) [illegible] reduced below the percentage specified in this subdivision is [illegible] percentage of the partner in the general profits of the partnership (or in the particular item of property) for the year in which such partnership [illegible] section 38 property [illegible] treated under this subparagraph as having ceased to be section 38 property with respect to the partner [illegible]

Reg. § 1.47-6(a) (2) (ii) continued

in the general profits of the partnership (or in the particular item of property) for the year in which such property was placed in service.

(iii) In determining a partner's proportionate interest in the general profits of a partnership for purposes of this subparagraph, the partner shall be considered to own any interest in such a partnership which he owns directly or indirectly (through ownership in other entities provided the other entities' bases in such interest are determined in whole or in part by reference to the basis of such interest in the hands of the partner). For example, if A, whose proportionate interest in the general profits of partnership X is 20 percent, transfers all of such interest to corporation Y in exchange for all of the stock of Y in a transaction to which section 351 applies, then, for purposes of subdivision (i) of this subparagraph, A shall be considered to own a 20-percent interest in partnership X. Any taxpayer who seeks to establish his interest in a partnership under the rule of this subdivision shall maintain adequate records to demonstrate his indirect interest in the partnership after any such transfer or transfers.

(b) *Examples.* Paragraph (a) of this section may be illustrated by the following examples in each of which it is assumed that ABC Partnership, which makes its returns on the basis of the calendar year, acquired and placed in service on June 1, 1962, those items of section 38 property, the basis and estimated useful life of each item of section 38 property are as follows:

Asset number	Basis	Estimated useful life
1	$60,000	4 years
2	30,000	6 years
3	30,000	8 years

Partners A and B, who make their returns on the basis of a calendar year, share the profits and losses of ABC Partnership equally. Under paragraph (f) (2) of § 1.46-3, each partner's share of the basis of the partnership section 38 property is as follows:

Asset No.	Estimated useful life	Basis	Partners share of basis: A 50%	Partners share of basis: B 50%
1	4 years	$60,000	$30,000	$30,000
2	6 years	30,000	15,000	15,000
3	8 years	30,000	15,000	15,000

Assuming that during 1962 partners A and B did not place in service any section 38 property and that they did not own any interests in other partnerships, electing small business corporations, estates, or trusts, the qualified investment of each partner is $30,000, computed as follows:

Partnership asset No.	Share of basis	Applicable percentage	Qualified investment
1	$15,000	60%	$ 9,000
2	15,000	60%	10,000
3	15,000	100	15,000
			$30,000

For the taxable year 1962, each partner's tax credit of $4,000 (7 percent of $30,000) may be allowed under section 38 of the credit against his liability for tax.

Rule 3(a) (1). (i) On [illegible], 1962, ABC Partnership sells and ships [illegible] X Corporation.

(ii) The [illegible] months and six months [illegible] of the [illegible]

Reg. § 1.47-6(b) Example (1)(ii) continued

of asset No. 3 in 1982 ($10,000 share of basis multiplied by zero applicable percentage) and for the taxable year 1982, each partner's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on each of the partners for the taxable year 1985 is increased by the $1,050 decrease in his credit earned for the taxable year 1982 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

Example (2). (i) On December 3, 1981, partner A sells one-half of his 50 percent interest in ABC Partnership to C, and on December 3, 1985, A sells the remaining one-half of his interest to D. In addition, on January 2, 1985, ABC Partnership sells asset No. 3 to X Corporation.

(ii) Under paragraph (a)(2) of this section, on December 3, 1981, 50 percent of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to partner A since immediately after the December 3, 1981, sale A's proportionate interest in the general profits of ABC Partnership is reduced to 50 percent of his proportionate interest in the general profits of ABC Partnership for 1982. The actual useful life of the share of the basis of each of the section 38 properties which cease to be section 38 property with respect to A is two years and six months (that is, the period beginning with June 1, 1982, and ending with December 3, 1984). Partner A's recomputed qualified investment with respect to such properties is $15,000, computed as follows:

Partnership asset No.	Share of basis	Applicable percentage	Qualified investment
1	$7,500	33⅓	$ 2,500
2	7,500	66⅔	5,000
3	7,500	100	7,500
			$15,000

For the taxable year 1982 partner A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1984 is increased by the $1,050 decrease in his credit earned for the taxable year 1982 (that is, $2,100 original credit earned minus $1,050 recomputed credit earned).

(iii) Under paragraph (a)(2) of this section, on December 3, 1981, the remaining 50 percent of the share of the basis of each of the three items of section 38 property ceases to be section 38 property with respect to partner A since immediately after the December 3, 1981, sale A's proportionate interest in the general profits of ABC Partnership is reduced to zero. The actual useful life of the share of the basis of the section 38 properties which cease to be section 38 property with respect to A is three years and six months (that is, the period beginning with June 1, 1982, and ending with December 3, 1985). A's recomputed qualified investment with respect to such properties is zero. For the taxable year 1982 partner A's recomputed credit earned is zero. The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1985 is increased by $1,050 (that is, $2,100 original credit earned minus zero recomputed credit earned) reduced by the $1,050 increase in tax for 1982).

(iv) The actual useful life of [illegible] which [illegible] on January 2, 1985, is three years and seven months. It is recomputed and found [illegible] with respect to partner A's share of the basis of such [illegible]. It is zero ($10,000 share of basis multiplied by applicable percentage) and for the taxable year 1985, partner A's recomputed credit earned is $1,050 (7 percent of $15,000). The income tax imposed by chapter 1 of the Code on partner A for the taxable year 1985 is increased by the

Reg. § 1.47-6(b) Example (2)(iv) continued

$1,050 decrease in his credit earned for the taxable year 1962 ($2,100 original credit earned minus $1,050 recomputed credit earned). The sale of asset No. 2 on January 2, 1963, has no effect on A.

LAW [¶ 5065] SEC. 48. DEFINITIONS; SPECIAL RULES.

(a) Section 38 Property.—

(1) In general.—Except as provided in this subsection, the term "section 38 property" means—

(A) tangible personal property, or

(B) other tangible property (not including a building and its structural components) but only if such property—

(i) is used as an integral part of manufacturing, production, or extraction, or of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services, or

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

(C) elevators and escalators, but only if—

(i) the construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after June 30, 1963, or

(ii) the elevator or escalator is acquired after June 30, 1963, and the original use of such elevator or escalator commences with the taxpayer and commences after such date.

Such term includes only property with respect to which depreciation (or amortization in lieu of depreciation) is allowable and having a useful life (determined as of the time such property is placed in service) of 4 years or more.

(2) Property used outside the United States.—

(A) In general.—Except as provided in subparagraph (B), the term "section 38 property" does not include property which is used predominantly outside the United States.

(B) Exceptions.—Subparagraph (A) shall not apply to—

(i) any aircraft which is registered by the Administrator of the Federal Aviation Agency and which is operated to and from the United States or is operated under contract with the United States;

(ii) rolling stock of a domestic railroad corporation subject to part I of the Interstate Commerce Act, which is used within and without the United States;

(iii) any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States;

(iv) any motor vehicle of a United States person (as defined in section 7701(a)(30)) which is operated to and from the United States;

(v) any container of a United States person which is used in the transportation of property to and from the United States;

(vi) any property (other than a vessel or an aircraft) of a United States person which is used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 67 Stat. 462, sec. 2(a)); and

(vii) any property which is owned by a [illegible] corporation (other than a corporation entitled to the benefits of section 931 or 931(b)), or by a United States citizen (other than a citizen entitled to the benefits of section 931, 932, 933, or 934(c)) and which is used predominantly in a possession of the United States by such a corporation or such a citizen, or by a corporation created or organized in, or under the laws of, a possession of the United States.

(C) Property used for lodging.—Property which is used predominantly to furnish lodging or in connection with the furnishing of lodging shall not be treated as section 38 property. The preceding sentence shall not apply to—

(i) [illegible] using it in lodging facilities in the foreign country of which the persons using it are residents, or

(ii) [illegible]

(D) property used by a hotel or motel in connection with the trade or business of furnishing lodging where the predominant portion of the accommodations is used by transients.

(4) Property used by certain tax-exempt organizations.—Property used by an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by this chapter shall be treated as section 38 property only if such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511. *If the property is debt-financed property (as defined in section 514(b)), the basis or cost of such property for purposes of computing qualified investment under section 46(c) shall include only that percentage of the basis or cost which is the same percentage as is used under section 514(a), for the year the property is placed in service, in computing the amount of gross income to be taken into account during such taxable year with respect to such property.*

(5) Property used by governmental units.—Property used by the United States, any State or political subdivision thereof, any international organization, or any agency or instrumentality of any of the foregoing shall not be treated as section 38 property.

(6) Livestock.—Livestock shall not be treated as section 38 property.

(b) New Section 38 Property.—For purposes of this subpart, the term "new section 38 property" means section 38 property—

(1) the construction, reconstruction, or erection of which is completed by the taxpayer after December 31, 1961, or

(2) acquired after December 31, 1961, if the original use of such property commences with the taxpayer and commences after such date.

In applying section 46(c)(3)(A) in the case of property described in paragraph (1), there shall be taken into account only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961.

(c) Used Section 38 Property.—

(1) In general.—For purposes of this subpart, the term "used section 38 property" means section 38 property acquired by purchase after December 31, 1961, which is not new section 38 property. Property shall not be treated as "used section 38 property" if, after its acquisition by the taxpayer, it is used by any person who held such property before such acquisition (or by a person who bears a relationship, described in section 179(d)(2)(A) or (B) to a person who held such property before such acquisition).

(2) Limitations.—

(A) In general.—The cost of used section 38 property taken into account under section 46(c)(1)(C) for any taxable year shall not exceed $50,000 (or, in the case of a husband and wife who file a separate return, $25,000) unless the taxpayer shall elect (at such time and in such manner as the Secretary or his delegate shall by regulations prescribe) the items to be taken into account, but only to the extent of an aggregate cost of $150,000. Such an election, once made, may be changed only in such manner, and to the extent, provided by such regulations.

(B) Married individuals.—In the case of a husband or wife who files a separate return, the limitation under subparagraph (A) shall be $75,000 in lieu of $50,000. This subparagraph shall not apply if the spouse of the taxpayer has no used section 38 property which may be taken into account or qualified investment for the taxable year of such spouse which ends within or with the taxpayer's taxable year.

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[1] Sec. 46(a)(3). Amended by sec. 50(f) of P.L. 88-272, 78 Stat. 19, 110 (1964). Applies to taxable years beginning after 1963.

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[2] Sec. 46(b). Amended by sec. 50(g), (h), and (i) of P.L. 88-272, 78 Stat. 19, 110 (1964). Applies to taxable years beginning after 1963.

(C) *Controlled groups.*—In the case of a controlled group, the [illegible] amount specified under subparagraph (A) shall be allocated to each component member of the group by apportioning $20,000 among the component members of such group in accordance with their respective amounts of used section 38 property which may be taken into account.

(D) Partnerships.—In the case of a partnership, the limitation contained in subparagraph (A) shall apply with respect to the partnership and with respect to each partner.

(3) Definitions.—For purposes of this subsection—

(A) Purchase.—The term "purchase" has the meaning assigned to such term by section 179(d)(2).

(B) Cost.—The cost of any section 38 property does not include so much of the basis of such property as is determined by reference to the adjusted basis of other property held at any time by the person acquiring such property. If property is disposed of (other than by reason of its destruction or damage by fire, storm, shipwreck, or other casualty, or its theft) and used section 38 property similar or related in service or use is acquired as a replacement therefor in a transaction to which the preceding sentence does not apply, the cost of the used section 38 property acquired shall be first reduced by the adjusted basis of the property replaced. The cost of used section 38 property shall not be reduced with respect to the adjusted basis of any property disposed of if, by reason of section 47, such disposition involved an increase of tax or a reduction of the unused credit carryback or carryovers described in section 39(b).

(C) *Controlled Group.*—The term "*controlled group*" has the meaning assigned to such term by *section 1563(a)*, except that [illegible] "more than 50 percent" shall be substituted for the phrase "at least 80 percent" each place it appears in *section 1563(a)(1)*.

(D) [illegible] Property.—A person (other than a person referred to in section 50(b)) who is a lessor of property (whether such property was, subsequent to such lessor's acquisition, subjected to additional investment by the lessor or by the lessee) may elect with respect to any [illegible] property to treat the lessee as having acquired such property for an amount equal to—

(i) except as provided in paragraph (2), the fair market value of such property, or

(ii) if such property is leased by a corporation which is a component member of a controlled group (as defined in section 1563(a), or section 1563(a)(5)) to another corporation which is a component member of the same controlled group, the basis of such property to the lessor.

The election provided by the preceding sentence may be made only with respect to property which would be section 38 property in the hands of the lessee. For purposes of the preceding sentence and section 48(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. In a lease to which the election provided by this subsection with respect to any property, the lessee shall be treated for all purposes of this subpart as having acquired such property. In the case of property [illegible] property which is leased and is property of a kind which can [illegible] leased [illegible] the basis of the property shall be deemed to have elected to treat the [illegible] lessee as having acquired such property for purposes of applying the last sentence of section 50(d)(5). In the case of section 38 property which (i) is leased after October 9, 1962 (otherwise pursuant to a binding contract to lease entered into before October 10, 1962), (ii) is not [illegible] property which

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[1] [illegible]
(A) [illegible]
(B) [illegible]
(C) [illegible]
(D) [illegible]
(E) [illegible]
(F) [illegible]
(G) [illegible]

respect to the lessor but is suspension period property if acquired by the lessee, and (iii) is property of the same kind which the lessor ordinarily sold to customers before October 10, 1969, or ordinarily leased before such date and made an election under this subsection, the lessor of such property shall be deemed to have made an election under this subsection with respect to such property.

(c) Subchapter S Corporations.—In the case of an electing small business corporation (as defined in section 1371)—

(1) the qualified investment for each taxable year shall be apportioned pro rata among the persons who are shareholders of such corporation on the last day of such taxable year; and

(2) any person to whom any investment has been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such investment, and such investment shall not (by reason of such apportionment) lose its character as an investment in new section 38 property or used section 38 property, as the case may be.

(f) Estates and Trusts.—In the case of an estate or trust—

(1) the qualified investment for any taxable year shall be apportioned between the estate or trust and the beneficiaries on the basis of the income of the estate or trust allocable to each,

(2) any beneficiary to whom any investment has been apportioned under paragraph (1) shall be treated (for purposes of this subpart) as the taxpayer with respect to such investment, and such investment shall not (by reason of such apportionment) lose its character as an investment in new section 38 property or used section 38 property, as the case may be, and

(3) the [illegible] amount specified in subparagraphs (A) and (B) of section [illegible](3) applicable to such estate or trust shall be reduced by an amount which bears the same ratio to [illegible] as the amount of the qualified investment allocated to the estate or trust under paragraph

(1) bears to the [illegible] of the qualified investment.

(g) [Repealed by section 538(c)(1) of the Tax Reform Act of 1976 (P.L. 94-455, 2-28-76).]

(h) [illegible] and Certain.—For purposes of this subpart—

(1) General rule.—Section 38 property which is suspension period property shall not be treated as new or used section 38 property.

(2) Suspension period property defined.—Except as otherwise provided in [illegible] paragraph (1), the term "suspension period property" means section 38 property—

(A) the physical construction, reconstruction, or erection of which (i) is begun during the suspension period, or (ii) is begun, pursuant to an order placed with the taxpayer before May 21, 1970, or

(B) which (i) is acquired by the taxpayer during the suspension period, or (ii) is acquired by the taxpayer pursuant to a contract entered into during such period, before May 21, 1970.

In applying subparagraph (A) to any section 38 property, there shall be taken into account only that portion of the basis which is properly attributable to construction, reconstruction, or erection before May 21, 1970.

(3) Property not suspension period property.—To the extent that any property is constructed, reconstructed, or erected, or acquired pursuant to a contract which was on October 9, 1969, and at all times thereafter, binding on the taxpayer, such property shall not be treated as suspension period property.

(4) Rapid amortization [illegible].—If—

(A) pursuant to a right of the taxpayer in existence on October 9, 1969 (which was not terminated by the end of any time after such date and before the [illegible] property [illegible] in paragraph (1), the taxpayer is contractually required, or is entitled at his option, to enter into a lease [illegible] property [illegible] necessary to the planned use of the [illegible] by the taxpayer, and

(B) [illegible] property [illegible] the taxpayer [illegible] the property of a person who is [illegible] lease [illegible]

[illegible] Tax Act [illegible]

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up such building as so equipped is attributable to either property the construction, reconstruction, or erection of which was begun by the taxpayer before October 10, 1963, or property the acquisition of which by the taxpayer occurred before such date,

then all section 38 property comprising such building, or so equipped (and any industrial section 38 property adjacent to such building which is necessary to the planned use of the building) shall be treated as section 38 property which is not suspension period property. For purposes of subparagraph (B) of the preceding sentence, the rules of paragraphs (5) and (6) shall be applied. For purposes of this paragraph, a special purpose structure shall be treated as a building.

(5) Plant facility rule.—

(A) General rule.—If—

(i) Pursuant to a plant of the taxpayer in existence on October 9, 1963 (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

(ii) the construction, reconstruction, or erection of such plant facility was commenced by the taxpayer before October 10, 1963, 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 October 10, 1963, or property the acquisition of which by the taxpayer occurred before such date,

then all section 38 property comprising such plant facility shall be treated as section 38 property which is not suspension period property. For purposes of clause (iii) of the preceding sentence, the rules of paragraphs (3) and (6) 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 are not a significant portion) and which is—

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

(ii) located on a single site, and

(iii) identified, on October 9, 1963, 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 October 10, 1963, 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 October 10, 1963, 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.

(6) Building or equipment rule.—Any piece of machinery or equipment—

(A) more than 50 percent of the cost of which (determined on the basis of fair market value) was paid by the taxpayer on October 9, 1963, or was acquired by the taxpayer pursuant to a binding contract which was in effect on such date (but excluding options to purchase or to construct or lease), and

(Text continued on page 5936)

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(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 not suspension period property.

(7) *Certain lease-back transactions, etc.*—Where a person who is a party to a binding contract described in paragraph (3) transfers rights in such contract (or in the property to which such contract relates) to another person but is 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 rights such other person shall, for purposes of paragraph (3), succeed to the position of the transferor with respect to such binding contract and such property. The preceding sentence shall apply, in any case in which the lessor does not make an election under subsection (d), only if a party to such contract retains a right to use the property under a long-term lease.

(8) *Certain lease and contract obligations.*—Where, pursuant to a binding lease or contract in force in effect on October 9, 1975, a lessor or lessee is obligated to construct, reconstruct, erect, or acquire property specified in such lease or contract, any property so constructed, reconstructed, erected, or acquired by the lessor or lessee which is section 38 property shall be treated as property which is not suspension period 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 October 9, 1975, cover real property constituting 65 percent or more of the project (determined on the basis of rental value). For purposes of the preceding sentence 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. Where, pursuant to a binding contract in effect on October 9, 1975, (i) 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 (ii) the other party 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 treated as property which is not suspension period property. Clause (ii) of the preceding sentence shall not apply if a political subdivision of a State is the other party to the contract and is required by the contract to make substantial expenditures which benefit the taxpayer.

(9) *Certain transfers of property.*—

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

(i) a transfer by reason of death, or

(ii) a transaction in a case 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 332, 351, 361, 371(b), 374(c), 721, or 731,

and such property (or the property acquired under such contract) would not be treated as suspension period property in the hands of the decedent or the transferor, such property shall not be treated as suspension period property in the hands of the transferee.

(B) If—

(i) property or rights under a contract are acquired in a transaction to which subparagraph (A) applies,

(ii) the transferor [illegible] before October 10, 1975, [illegible] binding contract in effect October 9, 1975, and

(iii) such property (or the property acquired under such contract) would not be treated as suspension period property in the hands of the distributing corporation.

such property shall not be treated as suspension period property in the hands of the distributee.

(10) *Property acquired from affiliated corporations.*—For purposes of this subsection, 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 the preceding sentence, 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)).

(11) *Certain tangible property constructed during suspension period and leased more than once.*—Any tangible personal property constructed or reconstructed by a person shall not be suspension period property if—

(A) such person leases such property after the close of the suspension period and the original use of such property commences after the close of such period,

(B) such reconstruction or reconstruction, and such lease or leases, were not pursuant to a contract entered into during the suspension period, and

(C) an election is made under subsection (d) with respect to such property which satisfies the requirements of such subsection.

(12) *Water and air pollution control facilities.*—

(A) *In general.*—Any water pollution control facility or air pollution control facility shall be treated as property which is not suspension period property.

(B) *Water pollution control facility.*—For purposes of subparagraph (A), the term "water pollution control facility" means any section 38 property which—

(i) is used primarily to control water pollution by removing, altering, or disposing of wastes, including the necessary intermediate equipment and facilities (such as pumping stations and other auxiliaries) and disposal area improvements; and

(ii) is certified by the State water pollution control agency (as defined in section 13(s) of the Federal Water Pollution Control Act) as being in conformity with the State program or requirements for control of water pollution and is certified by the Secretary of Interior as being in compliance with the applicable rules and regulations of Federal agencies and the general policy of the United States for cooperation with the States in the prevention or control of water pollution in the Federal Water Pollution Control Act.

(C) *Air pollution control facility.*—For purposes of subparagraph (A), the term "air pollution control facility" means any section 38 property which—

(i) is used primarily to control atmospheric pollution or contamination

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lion by removing, altering, or disposing of atmospheric pollutants or contaminants; and

(ii) is certified by the State to the pollution control agency (as defined in section 302(b) of the Clean Air Act) as being in conformity with the State program or requirements for control of air pollution and is certified by the Secretary of Health, Education and Welfare as being in compliance with the applicable regulations of Federal agencies and the general policies of the United States for cooperation with the States in the prevention and abatement of air pollution under the Clean Air Act.

(D) Standards for facility.—Subparagraph (A) shall apply in the case of any facility only if the taxpayer constructs, reconstructs, erects, or acquires such facility in furtherance of Federal, State, or local standards for the control of water pollution or atmospheric pollutants or contaminants.

(13) Certain replacement property.—Section 38 property constructed, reconstructed, erected, or acquired by the taxpayer shall be treated as property which is not suspension period property to the extent such property is placed in service to replace property which was—

(A) Destroyed or damaged by fire, storm, shipwreck, or other casualty, or

(B) Stolen,

But only to the extent the basis (in the case of new section 38 property) of such section 38 property does not exceed the adjusted basis of the property destroyed, damaged, or stolen.

(i) Exemption From Suspension of $3,000 of Investment.—(1) In general.—In the case of property acquired by the taxpayer by purchase for use in his trade or business which would (but for this subsection) be suspension period property, the taxpayer may select items to which this subsection applies, to the extent of an aggregate cost, for the suspension period, of $20,000. Any item so selected shall be treated as property which is not suspension period property by reason of this subpart (other than for purposes of paragraphs (4), (7), (8), (7), (9), (9), and (10) of subsection (f)).

(2) Applicable rules.—Under regulations prescribed by the Secretary or his delegate, rules similar to the rules provided by paragraphs (2) and (3) of subsection (e) shall be applied for purposes of this subsection. Paragraph (6) shall not apply with respect to any item to which this subsection applies.

(j) Suspension period.—For purposes of this subpart, the term "suspension period" means the period beginning on October 10, 1966, and ending on March 9, 1967.

(k) Cross References.—

For application of this subpart to certain regulated companies, see section 807(e)(2).

[¶ 5003] Committee Reports (P.L. 91-172, 6-13-67).—Restoration of investment credit. The House, Senate, and Conference Committee Reports appear in 1967-2 CB at pp. 506, 570, and 603. See, also, 1970 P-H Fed. ¶ 5003.

[¶ 5003] Committee Reports (P.L. 89-800, 11-8-66).—Repeal of investment credit. The House, Senate, and Conference Committee Reports appear in 1966-2 CB at pp. 635, 643, and 670. See, also, 1970 P-H Fed. ¶ 5003.

[¶ 5003] 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 ¶ 5020; 5003.

Reg. § 1.48-1 (TD 6731, filed 5-7-64; amended by TD 6838, filed 7-19-65; TD 6953, filed 6-20-68; TD 6971, filed 9-11-68.) Definitions of section 38 property.

(a) In general. Property which qualifies for the credit allowed by section 38 is known as "section 38 property". Except as otherwise provided in this section, the term "section 38 property" means property (1) with respect to which depreciation (or amortization in lieu of depreciation) is allowable to the taxpayer, (2) which has an estimated useful life of 4 years or more (determined as of the time such property is placed in service), and (3) which is either (i) tangible personal property, (ii) other tangible property (not including a building and its structural components) but only if such other property is used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or is a research or storage facility used in connection with any of the foregoing activities, or (iii) an elevator or escalator which satisfies the conditions of section 48(a)(1)(C). The determination of whether property qualifies as section 38 property in the hands of the taxpayer for purposes of the credit allowed by section 38 must be made with respect to the first taxable year in which such property is placed in service by the taxpayer. See paragraph (d) of § 1.46-3. For the meaning of "estimated useful life", see paragraph (e) of § 1.46-3.

(b) Depreciation allowable. (1) Property is not section 38 property unless a deduction for depreciation (or amortization in lieu of depreciation) with respect to such property is allowable to the taxpayer for the taxable year. A deduction for depreciation is allowable if the property is of a character subject to the allowance for depreciation under section 167 and the basis (or cost) of the property is recovered through a method of depreciation, including, for example, the unit of production method and the retirement method as well as methods of depreciation which measure the life of the property in terms of years. If property is placed in service (within the meaning of paragraph (d) of § 1.46-3) in a trade or business (or in the production of income), but under the taxpayer's depreciation practice the period for depreciation with respect to such property begins in a taxable year subsequent to the taxable year in which such property is placed in service, then a deduction for depreciation shall be treated as allowable with respect to such property in the earlier taxable year (or years). Thus, for example, if a machine is placed in service in a trade or business in 1968, but the period for depreciation with respect to such machine begins in 1969, because the taxpayer uses an averaging convention (see § 1.167(a)-10) in computing depreciation, then, for purposes of determining whether the machine qualifies as section 38 property, a deduction for depreciation shall be treated as allowable in 1968.

(2) If, for the taxable year in which property is placed in service, a deduction for depreciation is allowable to the taxpayer only with respect to a part of such property, then only the proportionable part of the property with respect to which such deduction is allowable qualifies as section 38 property for the purpose of determining the amount of credit allowable under section 38. Thus, for example, if property is used 80 percent of the time in a trade or business and is used 20 percent of the time for personal purposes, only 80 percent of the basis (or cost) of such property qualifies as section 38 property. Further, property does not qualify to the extent that a deduction for depreciation thereon is disallowed under section 274 (relating to disallowance of certain entertainment, etc., expenses).

(3) If the cost of property is not recovered through a method of depreciation but through a deduction of the full cost in one taxable year, for purposes of subparagraph (1) of this paragraph a deduction for depreciation with respect to such property is not allowable to the taxpayer. However, if an adjustment with respect

Reg. § 1.48-1(b)(3) continued

to the income tax return for such taxable year requires the cost of such property to be recovered through a method of depreciation, a deduction for depreciation will be considered as allowable to the taxpayer.

(4) If depreciation sustained on property is not an allowable deduction for the taxable year but is added to the basis of property being constructed, reconstructed, or erected by the taxpayer, for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable for the taxable year with respect to the property on which depreciation is sustained. Thus, if $1,000 of depreciation sustained with respect to property no. 1, which is placed in service in 1964 by taxpayer A, is not allowable to A as a deduction for 1964 but is added to the basis of property being constructed by A (property no. 2), for purposes of subparagraph (1) of this paragraph a deduction for depreciation shall be treated as allowable to A for 1964 with respect to property no. 1. However, the $1,000 amount is not included in the basis of property no. 2 for purposes of determining A's qualified investment with respect to property no. 2. See paragraph (c)(1) of § 1.46-3.

(c) Definition of tangible personal property. If property is tangible personal property it may qualify as section 38 property irrespective of whether it is used as an integral part of an activity (or constitutes a research or storage facility used in connection with such activity) specified in paragraph (a) of this section. Local law shall not be controlling for purposes of determining whether property is or is not "tangible" or "personal". Thus, the fact that under local law property is held to be personal property or tangible property shall not be controlling. Conversely, property may be personal property for purposes of the investment credit even though under local law the property is considered to be a fixture and therefore real property. For purposes of this section, the term "tangible personal property" means any tangible property except land and improvements thereto, such as buildings or

Reg. § 1.48-1(e) continued

other inherently permanent structures (including items which are structural components of such buildings or structures). Thus, buildings, swimming pools, paved parking areas, wharves and docks, bridges, and fences are not tangible personal property. Tangible personal property includes all property (other than structural components) which is contained in or attached to a building. Thus, such property as production machinery, printing presses, transportation and office equipment, refrigerators, grocery counters, testing equipment, display racks and shelves, and neon and other signs, which is contained in or attached to a building constitutes tangible personal property for purposes of the credit allowed by section 38. Further, all property which is in the nature of machinery (other than structural components of a building or other inherently permanent structure) shall be considered tangible personal property even though located outside a building. Thus, for example, a gasoline pump, hydraulic car lift, or automatic vending machine, although annexed to the ground, shall be considered tangible personal property.

(c) *Other tangible property.*—(1) *In general.* In addition to tangible personal property, any other tangible property, but not including a building and its structural components) used as an integral part of manufacturing, production, or extraction, or as an integral part of furnishing transportation, communications, electrical energy, gas, water, or sewage disposal services by a person engaged in a trade or business of furnishing any such service, or which constitutes a research or storage facility used in connection with any of the foregoing activities, may qualify as section 38 property.

(2) *Manufacturing, production, and extraction.* For purposes of the credit allowed by section 38, the terms "manufacturing", "production", and "extraction" include the construction, reconstruction, or creation of property out of scrap, salvage, or junk material, as well as from new or raw material, by processing, manufacturing, refining, or changing the forms of an article or by combining or assembling two or more articles, and include the cultivation of the soil, the raising of livestock, and the mining of minerals. Thus, section 38 property would include, for example, property used as an integral part of the extracting, processing, or refining of metallic and nonmetallic minerals, including oil, gas, rock, marble, or slate; the construction of roads, bridges, or houses; the processing of meat, fish or other foodstuffs; the cultivation of orchards, gardens, or nurseries; the operation of sawmills, the production of lumber, lumber products or other building materials; the fabrication or treatment of textiles, paper, leather goods, or glass; and the rebuilding, as distinguished from the mere repairing, of machinery.

(3) *Transportation and communications businesses.* Examples of transportation businesses include railroads, airlines, bus companies, shipping or trucking companies, and oil pipeline companies. Examples of communications businesses include telephone or telegraph companies and radio or television broadcasting companies.

(4) *Integral part.* In order to qualify for the credit, property (other than tangible personal property and research or storage facilities used in connection with any of the activities specified in subparagraph (1) of this paragraph) must be used as an integral part of one or more of the activities specified in subparagraph (1) of this paragraph. Property such as pipelines, parking areas, inherently permanent structures, [illegible] facilities, or swimming pools, although used in the operation of a business normally is not used as an integral part of any of such specified activities. Property is used as an integral part of one of such activities if it is used directly in that activity and is essential to its completion. Thus, for example, in determining whether property is used as an integral part of manu-

Reg. § 1.48-1 (d) (3) (ii) continued

including, all property used by the taxpayer in acquiring or transporting raw materials or supplies to the point where the actual processing commences (such as docks, railroad tracks and bridges), or in processing raw materials into the taxpayer's final product, would be considered as property used as an integral part of manufacturing. Specific examples of property which normally would be used as an integral part of one of the specified activities are blast furnaces, oil and gas pipelines, railroad tracks and signals, telephone poles, bin housing devices, oil derricks, and fences used to confine livestock. Property shall be considered used as an integral part of one of the specified activities if so used either by the owner of the property or by the lessee of the property.

(3) Research or storage facilities. If property (other than a building and its structural components) constitutes a research or storage facility and if it is used in connection with an activity specified in subparagraph (2) of this paragraph, such property may qualify as section 38 property even though it is not used as an integral part of such activity. Examples of research facilities include wind tunnels and test stands. Examples of storage facilities include oil and gas storage tanks and grain storage bins. Although a research or storage facility must be used in connection with, for example, a manufacturing process, the taxpayer-owner of such facility need not be engaged in the manufacturing process.

(c) Exclusion of buildings and structural components. (1) Buildings and structural components thereof do not qualify as section 38 property. The term "building" generally means any structure or edifice enclosing a space within its walls, and usually covered by a roof, the purpose of which is, for example, to provide shelter or housing, or to provide working, office, parking, display, or sales space. The term includes, for example, apartment houses, factory and office buildings, warehouses, barns, garages, theaters, and hotels, and stores. Such term includes any such structure constructed by or for a lessee even if such structure must be removed, or ownership of such structure reverts to the lessor, at the termination of the lease. Such term does not include (i) a structure which is essentially an item of machinery or equipment, or (ii) any other structure which is so closely associated with the machinery or equipment which it supports, houses, or serves that it must be replaced, retired, or abandoned contemporaneously with such machinery or equipment, and which is depreciated over the life of such machinery or equipment. Thus, the term "building" does not include such structures as oil and gas storage tanks, grain storage bins, silos, fluidizing towers, blast furnaces, coke ovens, brick kilns, and coal tipples.

(2) The term "structural components" includes such parts of a building as walls, partitions, floors, and ceilings, as well as any permanent coverings therefor such as paneling or tiling; windows and doors; all components (whether in, or attached to the building) of central (i) heating or (ii) plumbing systems, including motors, compressors, pipes and ducts; pipelines and plumbing fixtures, such as sinks and bathtubs; electric wiring and lighting fixtures; chimneys; stairs, escalators, and elevators, including all components thereof; sprinkler systems; fire escapes; and other components relating to the operation or maintenance of a building. However, the term "structural components" does not include machinery the sole justification for the installation of which is the fact that such machinery is required to meet temperature or humidity conditions which are peculiar to the operation of other machinery or equipment which is located in the building, or which is necessary for the performance of certain processes which are carried on in the building, and not merely the "more pleasant" working conditions which are usually provided by air conditioning. Thus, machinery which is installed in a building solely to provide air conditioning for the benefit of employees, customers, or patients, and not for the benefit of machinery or equipment, is not section 38 property. Similarly, air conditioning

Reg. § 1.48-1(c)(3) continued

and humidification systems installed in a textile plant in order to maintain the temperature or humidity within a narrow optimum range which is critical in processing particular types of yarn or cloth is not included within the term "structural components". For special rules with respect to an elevator or escalator, the construction, reconstruction, or erection of which is completed by the taxpayer after June 8, 1962, or which is acquired after June 30, 1963, and the original use of which commences with the taxpayer and commences after such date, see section 48(a)(1)(C) and paragraph (m) of this section.

(f) Intangible property. Intangible property, such as patents, copyrights, and subscription lists, does not qualify as section 38 property. The cost of intangible property, in the case of a patent or copyright, includes all costs of purchasing or producing the item patented or copyrighted. Thus, in the case of a motion picture or television film or tape, the cost of the intangible property includes a manuscript and scenario, the cost of wardrobe and set design, the salaries of cameramen, actors, directors, etc., and all other costs properly includible in the basis of such film or tape. In the case of a book, the cost of the intangible property includes all costs of producing the original copyrighted manuscript, including the cost of illustration, research, and clerical and stenographic help. However, if tangible depreciable property is used in the production of such intangible property, see paragraph (a)(1) of this section.

(g) Property predominantly used outside the United States.—(1) General rule. (i) Except as provided in subparagraph (2) of this paragraph, the term "section 38 property" does not include property which is used predominantly outside the United States (as defined in section 7701 (a)(9)) during the taxable year. The determination of whether property is used predominantly outside the United States during the taxable year shall be made by comparing the period of time in such year during which the property is physically located within the United States with the period of time in such year during which the property is physically located within the United States. If the property is physically located outside the United States during more than 50 percent of the taxable year, such property shall be considered used predominantly outside the United States during that year. If property is placed in service on the first day of the taxable year, the determination of whether such property is physically located outside the United States during more than 50 percent of the taxable year shall be made with respect to the period beginning on the date on which the property is placed in service and ending on the last day of such taxable year.

(ii) The determination of whether a credit is allowable to the taxpayer with respect to any property shall be made only with respect to the taxable year in which the property is placed in service by the taxpayer. Property used predominantly outside the United States during the taxable year in which it is placed in service by the taxpayer is not section 38 property with respect to such taxpayer, regardless of the fact that the property is predominantly returned to the United States in a later year. Furthermore, if property is used predominantly in the United States in the year in which it is placed in service by the taxpayer, and a credit under section 38 is allowed with respect to such property, but such property is thereafter in any one year used predominantly outside the United States, such property ceases to be section 38 property with respect to the taxpayer and is subject to the application of section 47.

(iii) Subparagraph (2) of this paragraph applies whether property is used predominantly outside the United States by the use of the property by the lessee of the property, by the lessor of the property, or by both. For purposes of this subparagraph, property is leased to a person if the property is used by such person pursuant to a lease, sublease, or other arrangement.

Reg. § 1.48-1(g)(1)(iii) continued

allowed by section 38, the determination of whether such property is physically located outside the United States during more than 50 percent of the taxable year shall be made with respect to the taxable year of the lessee; however, if the lessee does not make such an election, such determination shall be made with respect to the taxable year of the lessor.

(2) *Exceptions.* The provisions of subparagraph (1) of this paragraph do not apply to—

(i) Any aircraft which is registered by the administrator of the Federal Aviation Agency, and which (a) is operated, whether on a scheduled or nonscheduled basis, to and from the United States, or (b) is placed in service by the taxpayer during a taxable year ending after March 8, 1961, and is operated under contract with the United States, provided that use of the aircraft under the contract constitutes its principal use outside the United States during the taxable year. The term "to and from the United States" is not intended to exclude an aircraft which makes flights from one point in a foreign country to another such point, as long as such aircraft returns to the United States with some degree of frequency;

(ii) Rolling stock, of a domestic railroad corporation subject to part I of the Interstate Commerce Act, which is used within and without the United States. For purposes of this subparagraph, the term "rolling stock" means locomotives, freight and passenger train cars, floating equipment, and miscellaneous transportation equipment on wheels, the expenditures for which are chargeable (or, in the case of leased property, would be chargeable) to the appropriate investment accounts in the uniform system of accounts for railroad companies prescribed by the Interstate Commerce Commission;

(iii) Any vessel documented under the laws of the United States which is operated in the foreign or domestic commerce of the United States. A vessel is documented under the laws of the United States if it is registered, enrolled, or licensed under the laws of the United States or the [illegible] United States Coast Guard. Vessels operated in the foreign or domestic commerce of the United States include those documented for use in foreign trade, coastwise trade, or fisheries;

(iv) Any motor vehicle of a United States person (as defined in section 7701(a)(30)) which is operated to and from the United States with some degree of frequency;

(v) Any container of a United States person which is used in the transportation of property to and from the United States;

(vi) Any property (other than a vessel or an aircraft) of a United States person which is used for the purpose of exploring for, developing, removing, or transporting resources from the outer Continental Shelf (within the meaning of section 2 of the Outer Continental Shelf Lands Act, as amended and supplemented; 43 U.S.C., sec. 1331). Thus for example, drilling equipment may be section 38 property; and

(vii) Any property placed in service after December 31, 1961 which (a) is owned by a domestic corporation (other than a corporation electing to be treated as under section 931 or 936(b)) or by a United States citizen (other than a citizen entitled to the benefits of section 931, 932, 933, or 936(c)), and (b) is used predominantly in a possession of the United States during the taxable year by such a corporation or such a citizen, or by a corporation created or organized in, or under the laws of, a possession of the United States (as [illegible], property placed in service after December 31, 1961, which is owned by a domestic corporation not

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[1] Paragraph (g)(1)(iii) added by T.D. 6879, 1966-1 C.B. [illegible].
(1) "Coastal Zone of Continental [illegible]

Reg. § 1.46-3 (g) (2) (vii) continued:

entitled to the benefits of section 931 or 934(b), which is leased to a corporation organized under the laws of a United States possession, and which is used by such lessee predominantly in a possession of the United States may qualify as section 38 property. However, property which is owned by a corporation not entitled to the benefits of section 931 or 934(b) but which is leased to a domestic corporation entitled to such benefits would not qualify as section 38 property. The determination of whether property is used predominantly in a possession of the United States during the taxable year shall be made under principles similar to those described in subparagraph (1) of this paragraph. For example, if a machine is placed in service in a possession of the United States on July 1, 1966, by a calendar year taxpayer and if it is physically located in such a possession during more than 50 percent of the period beginning on July 1, 1966 and ending on December 31, 1966, then such machine shall be considered used predominantly in a possession of the United States during the taxable year 1966.

(3) Property used for lodging.—(i) In general. (a) Except as provided in subparagraph (2) of this paragraph, the term "section 38 property" does not include property which is used predominantly to furnish lodging or is used predominantly in connection with the furnishing of lodging during the taxable year. Property used in the living quarters of a lodging facility, including beds and other furniture, refrigerators, ranges, and other equipment, shall be considered as used predominantly to furnish lodging. The term "lodging facility" includes an apartment house, hotel, motel, dormitory, or any other facility (or part of a facility) where sleeping accommodations are provided and let, except that such term does not include a facility used primarily as a means of transportation (such as an aircraft, vessel, or a railroad car) or used primarily to provide medical or convalescent services, even though sleeping accommodations are provided.

(ii) Property which is used predominantly in the operation of a lodging facility or in servicing tenants shall be considered used in connection with the furnishing of lodging. Whether property is [illegible] a lodging facility or furnishing lodging. Thus, for example, lobby furniture, office equipment, and laundry and kitchen equipment used in the operation of an apartment house or in serving tenants would be considered used predominantly in connection with the furnishing of lodging. However, property which is used in furnishing, to the non-guests of a lodging facility or its tenants, electrical energy, water, sewage disposal services, gas, telephone service, or other similar services shall not be treated as property used in connection with the furnishing of lodging. Thus, such items as gas and electric meters, telephone poles and lines, [illegible] and [illegible] equipment, and water and gas mains, [illegible] by a public utility would not be considered as property used in connection with the furnishing of lodging.

(iii) Exceptions.—(a) Nonlodging commercial facility. A nonlodging commercial facility which is available to patrons not using the lodging facility on the same basis as it is available to [illegible] of lodging facilities [illegible] property which is used predominantly to furnish [illegible] in connection with the furnishing of lodging. Examples of [illegible] facilities include restaurants, drug stores, grocery stores, and meeting rooms located in a lodging facility.

(b) Property used by a hotel or motel. Property used by a hotel, motel, inn, or other similar facility primarily in connection with the [illegible] of furnishing lodging [illegible] lodging is predominantly in connection with the furnishing of lodging, provided that the predominant purpose for [illegible] in the hotel, motel, etc., is used by customers. During the [illegible] service, the [illegible]

Regs. § 1.48-1(d)(3)(ii) continued

more than one-half of the living quarters of a hotel, motel, inn, or other similar establishment is used in furnishing (or is available to accommodate) transient guests on a transient basis, none of the property used by such hotel, motel, etc., in the trade or business of furnishing lodging shall be considered as property which is used predominantly to furnish lodging or predominantly in connection with the furnishing of lodging. Accommodations shall be considered used on a transient basis if the rental period is normally less than 30 days.

(i) [Reserved]

(3) *Property used by certain tax-exempt organizations.* The term "section 38 property" does not include property used by an organization (other than a cooperative described in section 521) which is exempt from the tax imposed by chapter 1 of the Code unless such property is used predominantly in an unrelated trade or business the income of which is subject to tax under section 511. The term "property used by an organization" means (i) property owned by the organization (whether or not leased to another person), and (ii) property leased to the organization. Thus, for example, a coin processing or copying machine which is located in an organization exempt from tax would be considered as property used by such organization. Property (other than property predominantly in an unrelated trade or business) leased by another person to an organization exempt from tax or leased by such an organization to another person is not section 38 property to either the lessor or the lessee, and in either case the lessor may not elect under § 1.48-4 to treat the basis of such property as having been purchased upon property for purposes of the credit allowed by section 38. This paragraph shall not apply to property leased on a casual or short-term basis to an organization exempt from tax.

(4) *Property used by foreign governments and international organizations.* The term "section 38 property" does not include property used by the United States, any State (including the District of Columbia or political subdivision thereof), any foreign government, an international organization (as defined in section 7701(a)(18)), or any agency or instrumentality of the United States, of any State or political subdivision thereof, or of any international organization. The term "property used by the United States, etc." means (i) property owned by any such governmental unit (whether or not leased to another person), and (ii) property leased to any such governmental unit. Thus, for example, a coin processing or copying machine which is leased to any such governmental unit would be considered as property used by such governmental unit. Property leased by another person to any such governmental unit or leased by such governmental unit to another person is not section 38 property to either the lessor or the lessee, and in either case the lessor may not elect under § 1.48-4 to treat the basis of such property as having been purchased upon property for purposes of the credit allowed by section 38. This paragraph shall not apply to property leased on a casual or short-term basis to any such governmental unit.

(j) *Livestock.* The term "section 38 property" does not include livestock. The term "livestock" includes cattle, hogs, sheep, goats, and horses (and other animals, regardless of their use, of a type with which they are part of the programs for which they are held).

(m) *Elevators and escalators.*—(1) *In general.* Under section 48(a)(2)(C), an elevator or escalator qualifies as section 38 property if—

(i) The construction, reconstruction, or erection of the elevator or escalator is completed by the taxpayer after December 31, 1970, or

(ii) The elevator or escalator is acquired after December 31, 1970, and if the original use of such elevator or escalator commences with the taxpayer, such commencement of such use.

Reg. § [illegible](m)(4) continued

In the case of construction, reconstruction, or erection of an elevator or escalator commenced before January 1, 1962, and completed after June 30, 1963, there shall be taken into account in determining the qualified investment under section 46(c) only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961. Further, if the construction, reconstruction, or erection of such property is commenced after December 31, 1961, and is completed after June 30, 1963, the entire basis of the elevator or escalator shall be taken into account in determining qualified investment under section 46(c). Also, if an elevator or escalator is reconstructed by the taxpayer after June 30, 1963, the basis attributable to such reconstruction may be taken into account in determining the qualified investment under section 46(c), irrespective of the fact that the original construction or erection of such elevator or escalator may have occurred before January 1, 1962. Paragraph (b) of § 1.48-2 shall be applied in determining the date of acquisition, original use, and basis attributable to construction, reconstruction, or erection.

(3) Definition of elevator and escalator. For purposes of this section the term "elevator" means a cage or platform and its hoisting machinery for conveying persons or freight to or from different levels and ordinarily related equipment which is essential to its operation. The term includes, for example, guide rails and rollers, motors and controllers, control [illegible]s and landing buttons, and elevator gates and doors which are essential to the operation of the elevator. The term "elevator" does not, however, include a structure which is essentially a building or an integral part of the building. The term "escalator" means moving stairways and functionally related equipment which is essential to its operation. For purposes of determining qualified investment under section 46(c) and § 1.46-3, the basis of an elevator or escalator does not include the cost of any structural alterations to the building, such as the cost of reinforcing or shaft or hoistway alterations to the floor, walls, or ceiling, over those which would otherwise be necessary in order to install or maintain the elevator or escalator.

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

Example (1). If an elevator with a total basis of $100,000 is completed after June 30, 1963, and the portion attributable to construction by the taxpayer after December 31, 1961, is determined by engineering estimates or by cost accounting records to be $70,000, only the $70,000 portion may be taken into account as an investment in new section 38 property in computing qualified investment.

Example (2). If [illegible] is reconstructed by the taxpayer after December 31, 1961, and is completed after June 30, 1963, the entire basis of $200,000 may be taken into account as an investment in new section 38 property.

Example (3). [illegible] Example (2) except that construction of the elevator was completed before June 30, 1963, the elevator would be considered to be section 38 property.

Example (4). In 1951, a taxpayer constructed an elevator, which had been constructed and placed in service in 1950 and which had an adjusted basis in 1951 of $[illegible]. The taxpayer reconstructed the elevator in 1962 at a cost of $[illegible]. The basis of the elevator which may be taken into account as qualified investment in new section 38 property [illegible] the basis attributable to the reconstruction, irrespective of whether the reconstruction is [illegible].

Reg. § [illegible]

[¶ 5079] Reg. § 1.48-2 (TD 6781, filed 5-7-64.) "New section 38 property."

(c) *In general.* Section 48(b) defines "new section 38 property" as section 38 property—

(1) The construction, reconstruction or erection of which is completed by the taxpayer after December 31, 1961, or

(2) Which is acquired by the taxpayer after December 31, 1961, provided that the original use of such property commences with the taxpayer and commences after such date.

In the case of construction, reconstruction, or erection of such property commenced before January 1, 1962 and completed after December 31, 1961, there shall be taken into account as the basis of new section 38 property in determining qualified investment only that portion of the basis which is properly attributable to construction, reconstruction, or erection after December 31, 1961. See § 1.48-1 for the definition of section 38 property.

(b) *Special rules for determining date of acquisition, original use, and basis attributable to construction, reconstruction, or erection.* For purposes of paragraph (a) of this section, the principles set forth in paragraph (a) (1) and (2) of § 1.167(c)-1 shall be applied. Thus, for example, the following rules are applicable:

(1) Property is considered as constructed, reconstructed, or erected by the taxpayer if the work is done for him in accordance with his specifications.

(2) The portion of the basis of property attributable to construction, reconstruction, or erection after December 31, 1961, consists of all costs of construction, reconstruction, or erection allocable to the period after December 31, 1961 (including the cost or other basis of materials entering into such work (but not including, in the case of reconstruction of property, the adjusted basis of the retained original property as of the time such reconstruction is commenced).

(3) It is not necessary that such construction, reconstruction, or erection be completed after December 31, 1961, or that they be put in use.

(4) If construction or erection by the taxpayer began after December 31, 1961, the entire cost or other basis of such construction or erection may be taken into account as the basis of new section 38 property.

(5) Construction, reconstruction, or erection by the taxpayer begins when physical work is started on such construction, reconstruction, or erection.

(6) Property shall be deemed to be acquired when reduced to physical possession, or control.

(7) The term "original use" means the first use to which the property is put, whether or not such use corresponds to the use of such property by the taxpayer. For example, a reconditioned or rebuilt machine acquired by the taxpayer will not be treated as being put to original use by the taxpayer. The question of whether property is reconditioned or rebuilt property is a question of fact. Property will not be treated as reconditioned or rebuilt merely because it could be so used part.

If the cost of reconstruction of property which is capitalized and recovered through depreciation or charged against the depreciation reserve, such cost may be taken into account as the basis of new section 38 property even though it is charged against the depreciation reserve.

(c) *Examples.* This section may be illustrated by the following examples:

Example (1). If a machine with a [illegible] is completed after December 31, 1961, and the portion attributable to its construction by the taxpayer after December 31, [illegible] constitutes [illegible] of the cost of the machine, the taxpayer in computing qualified investment in new section 38 property may take into account as the basis of such property only [illegible] of the cost of the machine.

Example (2). In 1962, a taxpayer reconditions a machine, which is completed

Reg. § 1.48-1(e) Example (2) continued

and placed in service in 1962 and which has an adjusted basis in 1965 of $10,000. The cost of reconditioning amounts to an additional $10,000. The basis of the machine which shall be taken into account in computing qualified investment in new section 38 property for 1965 is $20,000 whether he contracts to have it reconditioned or reconditions it himself, and irrespective of whether the materials used for reconditioning are new or not.

Example (3). In 1961, a taxpayer pays the entire purchase price of $10,000 for section 38 property to be delivered in 1962. In 1965 he takes possession of the property and commences the original use of the asset in that year. The $10,000 amount shall be taken into account in computing qualified investment in new section 38 property for 1965.

Example (4). A taxpayer, instead of reconditioning his old machine buys a "factory reconditioned" or "rebuilt" machine in 1965 to replace it. The reconditioned or rebuilt machine is not new section 38 property since such taxpayer is not the first user of the machine. See, however, § 1.48-3 (relating to used section 38 property).

Example (5). In 1962, a taxpayer buys from X for $30,000 an item of section 38 property which has been previously used by X. The taxpayer in 1965 makes an expenditure on the property of $5,000 of the type that must be capitalized. Regardless of whether the $5,000 is added to the basis of such property or is capitalized in a separate account, such amount shall be taken into account by the taxpayer in computing qualified investment in new section 38 property for 1965. No part of the $30,000 purchase price may be taken into account for such purpose. See, however, § 1.48-3 (relating to used section 38 property).

(¶ 5971) The Regulations below doesn't reflect the changes made by the '69 Tax Reform Act in Sec. 48(c), explained at ¶ 5925.

New § 1.48-2 (39 Fed. Reg. 3746, Jan. 30, 1974; amended by T.D. 6760, filed 10-9-64.) Used section 38 property.

(a) In general. (1) Section 48(c) provides that "used section 38 property" means section 38 property acquired by purchase after December 31, 1961, which is not "new section 38 property". See §§ 1.48-1 and 1.48-2, respectively, for definitions of section 38 property and new section 38 property. In determining whether property is acquired by purchase, the provisions of paragraph (c) (1) of § 1.167(a)-3 shall apply, except that (i) "1954" shall be substituted for "1954", and (ii) the definition of "related group" in paragraph (b) (3) of this section shall be substituted for the definition of such term in paragraph (c) of § 1.167(a)-3.

(2) (i) Property that is not [illegible] section 38 property if, after its acquisition by the taxpayer, it is used by (a) a person who used such property before such acquisition, or (b) a person who bears a relationship described in section 179(d)(2)(A) or (B) to a person who used such property before such acquisition. Thus, for example, if property is used by a person and is later sold by him under a sale and leaseback arrangement, that property, in the hands of the purchaser-lessor is not new section 38 property because the property, after its acquisition, is being used by the same person who used it before its acquisition. Similarly, where a lessee has been leasing property and subsequently purchases it (whether or not the lease contains an option to purchase), such property is not used section 38 property with respect to the purchaser because the property is being used by a person (the lessee) who used it before the acquisition. In addition, if property owned by a lessor is sold subject to the lease, as is often done in connection with sale-leaseback transactions, the property will not qualify as new section 38 property with respect to the purchaser-lessor if, after the purchase, the property is used by a person who used the property prior to the purchase.

Prop. § 1.48-8(e)(2) continued

(ii) For purposes of applying subdivision (i) of this subparagraph, (a) property used by a partnership shall be considered as used by such partner, and (b) property shall not be considered as used by a person before its acquisition if such property was used only on a casual basis by such person.

(iii) In determining whether a person bears a relationship described in section 179(d)(2)(A) or (B) to a person who used property before its acquisition by the taxpayer, the provisions of paragraph (c)(1) (i) and (ii) of § 1.179-3 shall apply, except that the definition of "affiliated group" in paragraph (c), (c) of this section shall be substituted for the definition of such term in paragraph (c) of § 1.179-3.

(3) The provisions of this paragraph may be illustrated by the following examples:

Example (1). Corporation P acquires properties 1 and 2 in 1968 and uses them in its trade or business until 1972. In 1972, corporation P sells such properties to corporation X, which leases back property 1 to corporation P and leases property 2 to corporation S, a wholly-owned subsidiary of corporation P. Property 1 is not used section 38 property in the hands of corporation X because, after its acquisition by corporation X, it is used by a person (corporation P) who used it prior to such acquisition. Property 2 is not used section 38 property because, after its acquisition by corporation X, it is used by a person (corporation S) who is related, within the meaning of section 179(d)(2)(B), to a person (corporation P) who used it before such acquisition.

Example (2). In 1962, corporation L leases property from corporation T. In 1964, corporation L acquires the property that it previously had been leasing. This property acquired by corporation L is not used section 38 property because such property is used after such acquisition by the same person (corporation L) who used the property before its acquisition (corporation L).

Example (3). Corporation X buys property in 1962 and leases such property to corporation Y. Corporation X in 1965 sells the property to A, subject to the lease. The property acquired by A is not used section 38 property if such property continues to be used by corporation Y, because corporation Y used the property before its acquisition by A.

Example (4). A owns a building which he rents out to a number of different users, including B. In 1962, B used the building from February 16 to March 19 and again on October 16 and 19. B purchases the building from A on December 7, 1962. The prior use of the property by B does not disqualify such property as used section 38 property to B, because he used such property only on a casual basis prior to its purchase.

Example (5). C places machine 1 in service in his individually owned business during 1968. During 1968, C sells machine 1 to partnership CDE in which he shares one-third of the profits and losses. The machine 1 so used is not section 38 property to partnership CDE because it is used after acquisition by the same person (partner C) who used the property before acquisition. Similarly, if partnership CDE places machine 2 in service during 1971 and sells that machine to partner C during 1973, machine 2 would not be used section 38 property to partner C. Moreover, if P buys partner C's interest in partnership CDE, such acquisition would not result in the acquisition of used section 38 property by P (whether or not the optional adjustment to basis of partnership property provided by section 743 applies) because

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

the partnership property is used, after F acquires his interest, by the same persons (partners D and E) who used the property before the acquisition.

(b) *Cost.* (1) The cost of used section 38 property is equal to the basis of such property, but does not include so much of such basis as is determined by reference to the adjusted basis of other property (whether or not section 38 property) held at any time by the taxpayer acquiring such used section 38 property.

(2) If property (whether or not section 38 property) is disposed of by the taxpayer (other than by reason of its destruction or damage by fire, storm, shipwreck, or other casualty, or its theft) and used section 38 property similar or related in service or use is acquired as a replacement therefor in a transaction in which the basis of the replacement property is not determined by reference to the adjusted basis of the property replaced, then the cost of the used section 38 property so acquired shall be its basis reduced by the adjusted basis of the property replaced. The preceding sentence shall apply only if the taxpayer acquires (or enters into a contract to acquire) the replacement property within a period of 60 days before or after the date of the disposition.

(3) Notwithstanding subparagraphs (1) and (2) of this paragraph, the cost of used section 38 property shall not be reduced with respect to the adjusted basis of any property disposed of if, by reason of section 47, such disposition resulted in an increase of tax or a reduction of investment credit carrybacks or carryovers described in section 46(b).

(c) The provisions of this paragraph may be illustrated by the following examples:

Example (1). In 1972, A acquires machine 2 (an item of used section 38 property which has a sales price of $5,000) by trading in machine 1 (an item of section 38 property acquired in 1968), and by paying an additional $4,000 cash. The adjusted basis of machine 1 is $1,000. Under the provisions of sections 1012 and 1031(d), the basis of machine 2 is $5,000 ($1,000 adjusted basis of machine 1 plus cash expended of $4,000). The cost of machine 2 which may be taken into account in computing qualified investment for 1972 is $4,000 (basis of $5,000 less $1,000 adjusted basis of machine 1).

Example (2). The facts are the same as in example (1) except that machine 2 has a sales price of $6,000. The trade-in allowance on machine 1 is $2,000. The result is the same as in example (1). That is, the basis of machine 2 is $5,000 ($1,000 plus $4,000); therefore, the cost of machine 2 which may be taken into account in computing qualified investment for 1972 is $4,000 (basis of $5,000 less $1,000 adjusted basis of machine 1).

Example (3). On September 15, 1972, B sells truck 1, which he acquired in 1961 and which has an adjusted basis in his hands of $1,200. On October 15, 1972, he purchases for $2,000 truck 2 (an item of used section 38 property) as a replacement therefor. The cost of truck 2 which may be taken into account in computing qualified investment is $800 ($2,000 less $1,200).

Example (4). In 1969 C acquires property 1, an item of new section 38 property with a basis of $16,000 and a useful life of eight years or more. He is allowed a credit under section 38 of $1,120 (7 percent of $16,000) with respect to such property. In 1972, C acquires property 2 (an item of used section 38 property) by trading in property 1 and by paying an additional amount in cash. Section 47(c) applies to the disposition of property 1 and C's tax liability for 1969 is increased by $280. Since the application of section 47(a) results in an in-

Reg. § 1.46-3(b)(2) Example (1) 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 limitations—(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 (2) 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 $20,000, 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 ($70,000 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 § 1.1378; in the case of estates and trusts, see paragraph (a)(2) of § 1.667(a)-2. 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 (2) of this paragraph. The $50,000 limitation applies to each partner, as well as the partnership.

Reg. § 1.46-3(e) continued:

(C) Selection of $50,000 cost. (i) 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 (i) 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 basis of cost of a proprietor 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 year in the 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 placed in service during the taxable year three items of used section 38 property, each with a cost of $50,000, 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.

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

Example (1). B, who operates a sole proprietorship, purchases and places in service in 1962 used section 38 property with a cost of $75,000. His spouse, W, is a shareholder in an electing small business corporation which purchased and placed in service during the fiscal year ending June 30, 1963, used section 38 property with a cost of $90,000. 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 $36,000 (60 percent of $60,000) 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 B on his separate return is $50,000. The cost of used section 38 property that may be taken into account by W on her separate return is $36,000. On the other hand, if the corporation had made an investment in used section 38 property, it could take $50,000 of the $60,000 cost into account.

Example (2). A, B, and C are 1/3 owners of 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. A sole proprietor operates a sole proprietorship. In 1962, the partnership has qualified purchases and places in service the following used section 38 property:

Reg. §1.46-3(c)(5) Example (2) continued

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

(i) Selection by partnership. In accordance with subparagraph (5)(ii) of this paragraph, the partnership selects property no. 1 and $20,000 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	5 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 (5)(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 $8,000 (partnership property of $10,000 and individually owned property of $20,000), takes into account the entire $10,000.

(iii) Qualified investment of partner X. His total qualified investment in real section 38 property for 1970 is $50,000, computed as follows:

Property	Estimated useful life	Selected cost	Applicable percentage	Qualified investment
No. 1	5 years	$ 5,000	33⅓	$ 1,650
No. 2	7 years	15,000	66⅔	10,000
No. 5	6 years	30,000	66⅔	20,000
Total		$50,000		$31,650

(iv) Qualified investment of partner Y. His total qualified investment in real section 38 property for 1970 is $60,000 (100 percent of $60,000), of which he selected $50,000 of the cost of property no. 6 which has a useful life of 10 years or more.

[Illegible] 1970, $ [illegible]

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	5,000	66⅔	3,333
No. 7	4 years	30,000	33⅓	12,000
Total		$46,000		$19,333

(d) [1] *The 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 that 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 employer identification 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) for the common parent's return is before July 16, 1963, 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)(ii) and paragraph (b)(1) of § 1.441-2 apply in determining the last day of such a taxable year.

(2) *Cost 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

[1] Amended 6/7/63. Paragraph (e)(1) modified by T.D. 6561, which reads as:
(e) "[Reserved]"

Reg. §1.48-8(a)(2)(i) 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 the 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 furnished by such each member pursuant to the requirements in subparagraph (a)(3)(iii) of this paragraph.

(6) Short taxable years. 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 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 (2)(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.

(7) Short taxable years. If a corporation during its taxable year is a member of more than one affiliated group 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.

(8) Foreign and possessions corporations. (i) A foreign corporation not engaged in trade or business within the United States (hereinafter referred to in this subparagraph as a "foreign corporation") which is not a common parent shall not be considered a member of an affiliated group unless it files with its return a copy of the statement required by subparagraph (3)(iii) of this paragraph.

Reg. § 1.48-3(c)(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 15th 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 $100,000. The membership of the affiliated group is recorded at 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 $50,000, that is, an amount which bears the same ratio to $50,000 as the cost of 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 the members of the affiliated group ($100,000 + $100,000) for such taxable year (including July 1, 1962–June 30, 1963). Similarly, the cost of used section 38 property taken into account by S for its fiscal year ending July 31, 1963, may not exceed $50,000.

Reg. § 1.48-3(c)(8) continued

Example (3). (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

$$\$33{,}333\left(\frac{\$200{,}000}{\$300{,}000}\times\$50{,}000\right),$$ respectively, under an amended apportionment.

(e) [¶ 5972] Regulation.—The Regulation below does not reflect the changes made by P.L. 89-800, 11-8-66, P.L. 90-26, 6-15-67, and the '69 Tax Reform Act in Sec. 48 explained at ¶ 5929 and 5968.

Reg. § 1.48-4 (TD 6731, filed 5-7-64; amended by TD 6958, filed 7-19-68; TD 6959, 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. § 1.48-1(e)(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 § 1.48-1. 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 § 1.48-1, 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 § 1.48-1, such property is not section 38 property. For purposes of this subparagraph, if the lessee 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 § 1.48-2) 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 lease as a purchase has been filed in the manner and within the time prescribed in paragraph (i) or (j) of this section.

(5) The lessor is not a person referred to in section 48(d), that is, a regulated investment company, a real estate investment trust, a corporation to which section 593 applies or a mutual savings bank, a domestic building and loan association or similar association to which section 594 applies, a cooperative bank, or a corporation exempt from taxation under subchapter F, chapter 1 of the Code; or a cooperative organization described in section 521(a).

(6) In the case of property, construction of which is transferred by a lessor to a lessee before January 1, 1964, 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 type of qualifying lease. In the case of the purchase of property by the lessor, the lessor shall be treated as though he were the actual owner of the property for purposes of the credit allowed by section 38. Thus, the lessor shall be entitled to the credit allowed by section 38 with respect to such property for the taxable year in which the lessor acquires such property, even though the lessee shall not be entitled to a credit allowed by section 38 with respect to such property. If the leased property is disposed of by the lessor, 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.)

(f) *Original use.* For purposes of this section only, the lessor and the lessee may both be considered the first original users of the leased property. The determination of whether leased property is "original use" property in the hands of the lessee shall be made under paragraph (b)(2) of this section. The determination of whether the lessor is the original user of leased property shall be made under paragraph (b)(2) of this section, except that the lessor shall be considered the original user of the property if he acquires the property from the manufacturer, producer, or vendor before the property is first leased, regardless of the length of time between the acquisition of the property by the lessor and the first lease of the property. Thus, if a manufacturer, producer, or vendor constructs, reconstructs, or erects property and leases it to a lessor before any other person uses the property, the property will be considered original use property in the hands of the lessor.

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