Internal Revenue

bulletin

Bulletin No. 1999–52
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HIGHLIGHTS OF THIS ISSUE

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

INCOME TAX

Rev. Rul. 99–58, page 701.

Continuity of interest on repurchase of issuer's shares. This ruling holds that an open market repurchase of shares through a broker, following a potential reorganization, has no effect on continuity of interest in a potential reorganization.

T.D. 8847, page 701.

Final regulations under section 743, 755, and 1017 of the Code provide guidance to partnerships and their partners concerning the optional adjustments to the basis of partnership property, the allocation of basis adjustments among partnership assets, and the computation of a partner's share of the adjusted basis of depreciable partnership property.

Rev. Proc. 99–50, page 757.

Combined information reporting. Combined information reporting by a successor business entity following a merger or acquisition is permitted in certain situations. Rev. Proc. 90–57 and Rev. Rul. 69-556 modified and superseded.

EMPLOYEE PLANS

Notice 99–61, page 762.

Weighted average interest rate update. The weighted average interest rate for December 1999 and the resulting permissible range of interest rates used to calculate current liabilities for purposes of the full funding limitation of section 412(c)(7) of the Code are set forth.

EXEMPT ORGANIZATIONS

Announcement 99–115, page 763.

A list is given of organizations now classified as private foundations.

ADMINISTRATIVE

T.D. 8848, page 723.

This rule establishes the procedures under which the Service may use penalty mail to aid in the location and recovery of missing children.

Rev. Proc. 99–49, page 725.

Methods of accounting; automatic consent. Procedures are provided under which a taxpayer may obtain automatic consent of the Commissioner to change certain methods of accounting. REv. Proc. 98–60 modified and superseded.

Rev. Proc. 99–51, page 760.

This procedure amplifies section 5 of Rev. Proc. 99–3, which sets forth areas of the Code under the jurisdiction of the Associate Chief Counsel (Domestic) in which the Service will not issue advance rulings or determination letters. The following issue is added to those listed in section 5: Whether a state law limited partnership electing under section 301.7701–3 to be classified as an association taxable as a corporation has more than one class of stock for purposes of section 1361(b)(1)(D). Rev. Proc. 99–3 amplified.

Notice 99–59, page 761.

Tax avoidance using distributions of encumbered property. Taxpayers and their representatives are alerted that the purported losses arising from certain types of transactions are not properly allowable for federal income tax purposes. Also, the Service may impose penalties on participants in these transactions or, as applicable on persons who participate in the promotion or reporting of these transactions.

Notice 99–60, page 762.

Information reporting; royalty payments; Indians. Taxpayers are informed that the information reporting requirements of section 6050N of the Code do no apply to payments of royalties that are not subject to income tax because they are derived directly by a noncompetent Indian from allotted and restricted land under the General Allotment Act of similar acts.

Announcement 99–116, page 763.

This document corrects the Actions on Decisions published in 1999–35 I.R.B. 314. All 7 footnotes describing the "Acquiescence" or "Nonacquiescence" in each decision included the words "in result only," which were erroneous. The correct footnotes are printed in this announcement.

Social Security Contribution and Benefit Base for 2000 on page 763.
Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

The IRS Mission

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

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly and may be obtained from the Superintendent of Documents on a subscription basis. Bulletin contents are consolidated semiannually into Cumulative Bulletins, which are sold on a single-copy basis.

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

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

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

The Bulletin is divided into four parts as follows:

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

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions, and Subpart B, Legislation and Related Committee Reports.

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

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

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

For sale by the Superintendent of Documents, U.S. Government Printing Office, Washington, DC 20402.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 368.—Definitions Relating to Corporate Reorganizations

26 CFR 1.368–1(e): Continuity of interest.

Continuity of interest on repurchase of issuer's shares. This ruling holds that an open market repurchase of shares through a broker has no effect on continuity of interest in a potential reorganization.

Rev. Rul. 99-58

ISSUE

What is the effect on continuity of interest when a potential reorganization is followed by an open market reacquisition of P's stock?

FACTS

T merges into P, a corporation whose stock is widely held, and is publicly and actively traded. P has one class of common stock authorized and outstanding. In the merger, T shareholders receive 50 percent common stock of P and 50 percent cash. Viewed in isolation, the exchange would satisfy the continuity of interest requirement of § 1.368-1(e) of the Income Tax Regulations. However, in an effort to prevent dilution resulting from the issuance of P shares in the merger, P's preexisting stock repurchase program is modified to enable P to reacquire a number of its shares equal to the number issued in the acquisition of T. The number of shares repurchased will not exceed the total number of P shares issued and outstanding prior to the merger. The repurchases are made following the merger, on the open market, through a broker for the prevailing market price. P's intention to repurchase shares was announced prior to the T merger, but the repurchase program was not a matter negotiated with T or the T shareholders. There was not an understanding between the T shareholders and P that the T shareholders' ownership of P stock would be transitory. Because of the mechanics of an open market purchase, P does not know the identity of a seller of P stock, nor does a former T shareholder who receives P stock in the merger and subsequently sells it know whether P is the buyer. Without regard to the repurchase program, a market exists for the newly-issued P stock held by the former T shareholders. During the time P undertakes its repurchase program, there are sales of P stock on the open market, which may include sales of P shares by former T shareholders.

LAW AND ANALYSIS

Requisite to a reorganization under the Internal Revenue Code is a continuity of interest as described in § 1.368–1(e). Section 1.368–1(b). The general purpose of the continuity of interest requirement is "to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations." Section 1.368–1(e)(1)(i). To achieve this purpose, the regulation provides that a proprietary interest in the target corporation is not preserved to the extent that, "in connection with the potential reorganization, . . . stock of the issuing corporation furnished in exchange for a proprietary interest in the target corporation in the potential reorganization is redeemed." Id. However, for purposes of the continuity requirement, "a mere disposition of stock of the issuing corporation received in the potential reorganization to persons not related . . . to the issuing corporation is disregarded." Id. The regulation provides that all facts and circumstances will be considered in determining whether, in substance, a proprietary interest in the target corporation is preserved.

Under the facts set forth above, continuity of interest is satisfied. There was not an understanding between the T shareholders and P that the T shareholders' ownership of the P shares would be transitory. Further, because of the mechanics of an open market repurchase, the repurchase program does not favor participation by the former T shareholders. Therefore, even if it could be established that P has repurchased P shares from former T shareholders in the repurchase program, any such purchase would be coincidental. The merger and the stock repurchase together in substance would not resemble a sale of T stock to P by the former T shareholders and, thus, the repurchase would not be treated as "in connection with" the merger. Under the facts presented, a sale of P stock on the open market by a former T shareholder during the repurchase program will have the same effect on continuity of interest as a mere disposition to persons not related to P.

HOLDING

Under the facts presented, the open market repurchase of shares through a broker has no effect on continuity of interest in the potential reorganization.

DRAFTING INFORMATION

The principal author of this revenue ruling is Marie C. Milnes-Vasquez of the Office of Assistant Chief Counsel (Corporate). For further information regarding this revenue ruling, contact Ms. Milnes-Vasquez on (202) 622-7770 (not a toll-free call).

Section 743.—Optional Adjustment to Basis of Partnership Property

26 CFR 1.743-1: Optional adjustment to basis of partnership property.

T.D. 8847

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Adjustments Following Sales of Partnership Interests

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document finalizes regulations relating to the optional adjustments to the basis of partnership property following certain transfers of partnership interests under section 743, the calculation of gain or loss under section 751(a) following the sale or exchange of a partnership interest, the allocation of basis adjustments among partnership assets under section 755, the allocation of a partner's basis in its partnership interest to proper-

ties distributed to the partner by the partnership under section 732(c), and the computation of a partner's proportionate share of the adjusted basis of depreciable property (or depreciable real property) under section 1017. The changes will affect partnerships and partners where there are transfers of partnership interests, distributions of property, or elections under sections 108(b)(5) or (c). In addition, the final regulations under section 732(c) reflect changes to the law made by the Taxpayer Relief Act of 1997.

DATES: *Effective Dates*: These regulations are effective December 15, 1999.

Applicability Date: These regulations apply to transfers of partnership interests and distributions occurring on or after December 15, 1999.

FOR FURTHER INFORMATION CONTACT: Matthew Lay, (202) 622-3050.

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information in these final regulations have been reviewed and approved by the **Office of Management and Budget** in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1588. Responses to these collections of information are mandatory for partnerships that have made an election under section 754 and for which a section 743 transfer has been made, and for partnerships which distribute property in a transaction subject to section 732(d).

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number assigned by the **Office of Management and Budget**.

The estimated annual burden per respondent varies from 1 hour to 300 hours, depending on the individual circumstances, with an estimated average of 4 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be sent to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, OP:FS:FP, Washington, DC 20224, and to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Books or records relating to these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

This document (a) revises §§1.743-1 and 1.755-1 of the Income Tax Regulations (26 CFR part 1), and (b) amends §§1.732-1, 1.732-2, 1.734-1, 1.751-1, 1.754-1, and §1.1017-1 of the Income Tax Regulations.

On January 29, 1998, proposed regulations (REG 209682-94) were published in the **Federal Register** (63 FR 4408). Written comments were received in response to the notice of proposed rulemaking. One speaker provided testimony at a public hearing held on September 10, 1998.

After consideration of all the comments, the proposed regulations under sections 732, 734, 743, 751, 755, and 1017 are adopted, as revised by this Treasury Decision.

Explanation of Revisions and Summary of Contents

1. *Basis in Distributed Property*

(a) Mandatory application of section 732(d). Section 1.732-1(d)(4) of the current regulations requires transferees to apply the special basis rule in certain cases. In the preamble to the proposed regulations, the IRS and the Treasury Department requested comments on the proper scope of section 732(d), and specifically, under what circumstances, if any, the Secretary should continue to exercise his authority to mandate the application of section 732(d) to a transferee. Several commentators suggested that the mandatory application of section 732(d) no longer should be required, because the changes made to section 732(c) by the Taxpayer Relief Act of 1997, Public Law 105-34, 111 Stat. 788, 945-46 (1997), make the distortions targeted by the regulations less likely to occur. However, other commentators noted that distortions caused by section 732(c) still may occur. Accordingly, the rule contained in §1.732-1(d)(4), which requires the mandatory application of section 732(d) in certain cases, remains in effect.

(b) Statement required by partnership. Because partners, rather than partnerships, are required to report basis adjustments under section 732(d), the final regulations require partnerships to provide transferees with such information as is necessary for the transferees properly to compute basis adjustments made under section 732(d). This information must be provided if a transferee notifies a partnership that it plans to make the election under section 732(d) or if a partnership makes a distribution subject to the mandatory application of section 732(d).

(c) Effective date. One commentator asked for clarification regarding the application of the final regulations to section 732(d) adjustments. If section 732(d) applies to a distribution, it is necessary to calculate the basis adjustments which would have been required under section 743(b) if a section 754 election were in effect for the partnership in the taxable year in which the partnership interest was transferred to the partner. In calculating these basis adjustments, the partnership should apply the final regulations under section 743 and 755 if the distribution to which section 732(d) applies occurs after December 15, 1999.

2. *Basis Adjustments Under Section 743(b)*

(a) Coordination with section 704(c). Where a partnership adopts the remedial allocation method, the proposed regulations provide that the section 704(c) built-in gain portion of a basis adjustment under section 743(b) shall be recovered over the remaining cost recovery period for the section 704(c) built-in gain. Some commentators suggested that the final regulations should provide this treatment for the section 704(c) built-in gain portion of the adjustment regardless of the method elected by the partnership for allocating section 704(c) built-in gain and loss. The IRS and the Treasury Department continue to believe that, except for partnerships which adopt the remedial allocation method, it is appropriate for sections 704(c) and 743(b) to operate independently. Accordingly, this change has not been adopted.

In the preamble to the proposed regulations, comments were requested concerning the application of the remedial allocation method to contributed property where there are no distortions caused by the ceiling rule at the time the property was contributed to the partnership. Even if it is not clear that the ceiling rule will apply at the time the property is contributed because the adjusted basis of the contributed property is sufficient so that the non-contributing partners will be allocated their appropriate share of depreciation or amortization attributable to the property, the partnership's adoption of the remedial method still may be relevant due to allocations resulting from a subsequent disposition of the property. For instance, suppose that partners A and B form a partnership and agree that each partner will be allocated a 50 percent share of all partnership items, and that the partnership will make allocations under section 704(c) using the traditional method. A contributes depreciable property with an adjusted tax basis of $40 and a book value of $50, and B contributes $50 in cash. At the time of the contribution, it is not readily apparent that the ceiling rule will have any application. However, if, before any federal income tax depreciation accrues with respect to the contributed property, the property's value declines to $40, and the property is sold for that amount, there will be no tax gain or loss. The book loss of $10 would be shared equally between A and B. In this situation, the ceiling rule would prevent B from being allocated the $5 tax loss to which it otherwise would be entitled. However, if the partnership elected to use the remedial method with respect to the contributed property, B would be allocated a $5 tax loss, and A would be allocated a corresponding $5 tax gain. In addition, if a contributing partner transfers its interest in a partnership during a period when a section 754 election is in effect, the section 704(c) method adopted by the partnership will determine the recovery period for the built-in gain portion of the transferee's section 743(b) adjustment. The IRS and the Treasury Department believe that under the current regulations under section 704(c), a partnership may use the remedial method under §1.704-3, even where it is not readily apparent at the time the property is contributed that the ceiling rule will be applicable.

(b) Previously taxed capital. One commentator suggested that the second sentence in proposed §1.743-1(d)(2), relating to the correlation between a partner's interest in previously taxed capital and the partnership's capital accounts, is redundant and should be deleted. This suggestion has been adopted; however, no substantive change is intended by the deletion.

(c) Common basis election. Some commentators suggested that the provision in the proposed regulations that permitted the partners to elect to apply negative basis adjustments under section 743(b) to the partnership's common basis should be deleted. The commentators argued that the provision was contrary to the purpose of section 743(b), because it permitted basis adjustments under section 743(b) to affect nontransferring partners. The commentators also argued that the provision would be used by a small number of partnerships and would add unnecessary complexity to the regulations. In response to these suggestions, the provision that permitted the partners to elect to apply negative basis adjustments under section 743(b) to the partnership's common basis has been deleted.

(d) Statements by partners. Some commentators suggested modifying the statements which partners are required to provide to the partnership in the case of transfers which result in basis adjustments under section 743(b). Many of these suggestions have been adopted. For example, the regulations specify that the transferee of a partnership interest is required to provide the name, address, and taxpayer identification number of the transferor only if that information is ascertainable by the transferee. The regulations also specify that if a partnership interest is transferred to a nominee which is required to furnish the statement under §1.6031(c)-1T to the partnership, the nominee may satisfy the notice requirements of both the section 743 and 6031 regulations by providing a single statement with respect to that transfer, but only if the statement satisfies all requirements of both regulations.

The regulations require the transferee to sign the statement under penalties of perjury, and require the transferee to provide the amount of any liabilities assumed or taken subject to by the transferee, and any other information necessary for the partnership to compute the transferee's basis in the partnership interest. In order to assist the partnership in properly calculating depreciation and amortization deductions which may be subject to anti-churning provisions, the regulations require the transferee to describe its relationship, if any, to the transferor. Finally, the statement required by a transferee that acquires an interest by death must include the date of the decedent's death.

One commentator suggested that the statement required by a transferee that acquires a partnership interest by sale or exchange should be provided within 30 days of the sale or exchange, regardless of whether or not the transfer occurs at the end of the calendar year. This change has been adopted.

One commentator suggested that references to the tax matters partner in §1.743-1(k) of the proposed regulations (regarding the partnership's obligations where a partner's statement is clearly erroneous, or a partner fails to notify the partnership that an interest has been transferred and the partnership has actual knowledge of the transfer) should be changed. This commentator emphasized that while the tax matters partner has a specialized role with respect to consolidated administrative and judicial proceedings to determine the tax treatment of partnership items at the partnership level, the tax matters partner does not have any special responsibilities with respect to federal income tax reporting. The final regulations adopt this comment. Section 1.743-1(k) now refers to partners who are responsible for federal income tax reporting by the partnership.

(e) Oil and gas. One commentator suggested that the example described in §1.743-1(j)(6) should be changed to describe a non- oil and gas property. This change has been made. The commentator also suggested that in the case of domestic oil and gas properties that are depleted at the partner level, the transferee partner (rather than the partnership) should be required to make and allocate basis adjustments among such properties. The final regulations adopt this comment.

The same commentator suggested that the regulations should specify a method for adjusting the basis of section 613A(c)(7)(D) properties in order to account for percentage depletion made by a partner with respect to such properties. Under the principles of §1.743-1(j), percentage depletion should reduce first any carryover basis under §1.613A-3(e)(6)(iv). After the carryover basis has been recovered, any further percentage depletion should reduce the section 743 adjustment for the property.

3. *Sales of Partnership Interests*

One commentator suggested that references to fair market value should specify whether fair market value is determined taking into account section 7701(g), which generally provides that fair market value shall be treated as being not less than the amount of any nonrecourse indebtedness to which the property is subject. The regulations specify that for purposes of the hypothetical sale employed to determine the income or loss realized by a partner upon the sale or exchange of its interest in section 751 property, fair market value is determined taking into account section 7701(g). Basis adjustments under section 743(b) also are allocated by reference to a hypothetical transaction. The IRS and the Treasury Department intend to issue guidance in the near future which will provide rules for determining the fair market value of partnership assets in certain situations, including for purposes of allocating section 743(b) basis adjustments upon the transfer of a partnership interest. The IRS and the Treasury Department anticipate that the guidance will provide that section 7701(g) will apply in determining the fair market value of partnership assets for purposes of allocating section 743(b) basis adjustments.

One commentator suggested that where a partnership interest is sold or exchanged, the transferor and the transferee of a partnership interest should be permitted jointly to assign values to partnership assets in a written agreement. Because this approach is inconsistent with the hypothetical sale approach of the regulations, this suggestion has not been adopted.

4. *Elections Under Section 754*

One commentator requested that partnerships be granted a one-time right to revoke section 754 elections in effect for such partnerships. Given the significant changes to the rules made by these final regulations as compared to the regulations that were in effect at the time that section 754 elections previously were made, the IRS and Treasury believe that it is appropriate to provide for a one-time revocation of such elections. Accordingly, a partnership having an election in effect under section 754 for its taxable year that includes December 15, 1999 may revoke such election by attaching a statement to the partnership's return for that year. The return must be filed on or before the due date (including extensions) for the return for that year.

5. *Allocation of Basis Adjustments Among Partnership Assets*

(a) Income in respect of a decedent. One commentator requested that the final regulations illustrate the allocation of basis adjustments among partnership assets where one or more of such assets represents income in respect of a decedent. Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under section 691. Because the transferee's basis in its partnership interest does not include the value of assets which represent income in respect of a decedent, the section 743(b) adjustment likewise does not reflect the value of such assets. *George Edward Quick's Trust*, 54 TC 1336 (1970) (acq.), *aff'd per curiam*, 444 F.2d 90 (8th Cir. 1971); *Chrissie H. Woodhall*, 28 T.C.M. 1438 (1969), *aff'd*, 454 F.2d 226 (9th Cir. 1972); Rev. Rul. 66-325, 1966-2 C.B. 249. Where a partnership holds assets that represent income in respect of a decedent, the section 743(b) adjustment should be allocated solely to other assets. Accordingly, the final regulations provide that if a partnership interest is transferred as a result of the death of a partner, and the partnership holds assets representing income in respect of a decedent, no part of the basis adjustment under section 743(b) is allocated to these assets.

(b) Transferred basis transactions. One commentator called for a revised system for allocating basis adjustments under section 743(b) which are triggered by exchanges in which the transferee's basis in the interest is determined in whole or in part by reference to the transferor's basis in the interest. In many such cases, the net section 743(b) adjustment will be zero. However, a positive or negative section 743(b) adjustment may result, because the transferee's basis in the interest may not be equal to the transferee's share of the partnership's bases in its assets.

The IRS and the Treasury Department believe that, although these transferred basis transactions involve transfers which are subject to section 743(b), the new, comprehensive basis allocation rules in the proposed regulations should not be available. For example, where a partnership interest is contributed to a corporation in a transaction to which section 351 applies, or to a partnership in a transaction to which section 721(a) applies, the transferor merely has changed the form of its investment. If the allocation rules which apply to other section 743(b) transfers were applied to these exchanges, then partners could use these exchanges to shift basis from capital gain assets to ordinary income assets, or vice versa.

Therefore, the final regulations contain special basis allocation rules for transferred basis exchanges. The special rules generally are modeled on the rules for allocating basis adjustments under section 734(b). The final regulations do not contain a specific anti-abuse rule regarding the special basis allocation rules which are applicable to such transfers. However, there may be situations where taxpayers will attempt to undertake abusive transactions using these special rules. For instance, a partner could acquire a partnership interest during a year in which no section 754 election is in effect, and then (in a related transaction) contribute the property to a wholly-owned corporation in order to take advantage of the basis allocation rules applicable to transferred basis exchanges. In appropriate situations, the IRS may attack such abusive transactions under a variety of judicial doctrines, including substance over form or step transaction, or under §1.701-2 of the regulations.

(c) Unrealized receivables under section 751(c). One commentator requested that the final regulations illustrate the effect of depreciation recapture on the allocation of basis adjustments among partnership assets under section 755. For purposes of this section, the final regulations treat depreciation recapture, and any other properties or potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder, as separate assets that are ordinary income property.

(d) Special rules for securities partnerships and tiered partnerships. One commentator suggested that the regulations permit securities partnerships to allocate basis adjustments among partnership assets using an aggregation method. Another commentator requested that the regulations clarify how the regulations would apply to tiered partnerships. The IRS and the Treasury Department believe that a method for allocating basis adjustments among partnership assets on an aggregate basis is not consistent with the hypothetical sale of individual assets, which is required by the regulations. In addition, the IRS and Treasury Department believe that special rules for tiered partnerships would make the regulations more complex. Therefore, these changes have not been adopted.

6. *Other Comments*

One commentator suggested that for purposes of allocating basis adjustments among partnership assets, the values of all partnership assets should be determined by reference to the basis of the transferee or distributee partner in its partnership interest. This suggestion is being considered in connection with a separate project currently under review by the IRS and the Treasury Department.

One commentator suggested that the language of section 743 does not authorize regulations that permit both positive and negative adjustments as part of the same transaction. The IRS and the Treasury Department continue to believe that this aspect of the regulations is within the IRS's authority to administer sections 743 and 755.

Special Analyses

It has been determined that these final regulations are not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has been determined that a final regulatory flexibility analysis is required for the collection of information in this Treasury decision under 5 U.S.C. 604. This analysis is set forth below under the heading "Final Regulatory Flexibility Act Analysis." Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business. No comments were received regarding the impact of the regulations on small business.

Final Regulatory Flexibility Act Analysis

This analysis is required under the Regulatory Flexibility Act (5 U.S.C. chapter 6). In general, the regulations require a transferee that acquires an interest in a partnership with an election under section 754 in effect to notify the partnership of the transfer. This notification must include the name and taxpayer identification number of the transferee and the transferee's basis in the acquired partnership interest. The partnership is required to include a statement with its Form 1065, U.S. Partnership Return of Income, for the taxable year in which the partnership acquires knowledge of the transfer. This statement must identify the name and taxpayer identification number of the transferee, the computation of the basis adjustment, and the allocation of that adjustment to partnership properties. These requirements will ensure that the partnership has notice that a transfer has occurred and that the proper basis adjustments are computed. The legal basis for these requirements is contained in sections 743(b), 6001, and 7805(a).

If an interest is transferred in a partnership holding domestic oil and gas properties that are depleted at the partner level under 613A(c)(7)(D), the regulations require the transferee partner (rather than the partnership) to make and allocate basis adjustments under section 743(b) among such properties.

There were approximately 1,494,000 partnerships in 1994. However, these regulations apply only to partnerships that have made an election under section 754. The election under section 754 is generally not made unless there has been a transfer of a partnership interest or a distribution by the partnership. Moreover, the effects of the election attach to specific items of partnership property and may provide only temporary benefits for the partners. Except for the one-time revocation which is allowed in connection with the promulgation of these final regulations, the election cannot be revoked without the consent of the Secretary. The IRS and the Treasury Department believe that most partnerships do not make the election under section 754. Therefore, most partnerships will not be affected by the regulations in any given year.

After a partner conveys information to the partnership concerning a transfer of a partnership interest, the partnership must adjust the partner's interest in the basis of partnership property. Because these basis adjustments will affect the partner's share of depreciation or amortization deductions and amounts of gain or loss on the disposition of certain items of partnership property, the partnership must prepare and maintain special entries on its books. However, in many cases, partnership returns are prepared using computer software that can prepare and maintain these special entries after the initial year.

The IRS and the Treasury Department are not aware of any federal rules that may duplicate, overlap, or conflict with the rule.

As an alternative to the disclosure described above, the IRS and the Treasury Department considered, but rejected, a rule that would have required the partners, and not the partnerships, to make the basis adjustments and to determine the effects of the basis adjustments on the partners' distributive shares. This alternative was rejected because the IRS and the Treasury Department believe that partnerships generally have better access to the information necessary to report section 743 basis adjustments properly. To require the partners rather than the partnerships to bear the burden of reporting would require the partnerships to provide the partners with significant amounts of information not otherwise needed by the partners. There are no known alternative rules that are less burdensome to the partnerships and their partners but that accomplish the purpose of the statute.

Finally, because partners, rather than partnerships, are required to report basis adjustments under section 732(d), the final regulations require partnerships to provide transferees with such information as is necessary for the transferees properly to compute basis adjustments made under section 732(d). This information must be provided if a transferee notifies a partnership that it plans to make the election under section 732(d) or if a partnership makes a distribution subject to the mandatory application of section 732(d). The IRS and the Treasury Department believe that this requirement will apply under limited circumstances to a small percentage of partnerships.

Drafting Information

The principal author of these regulations is Matthew Lay of the Office of the Assistant Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are ammended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read as follows:

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

Section 1.732-1 also issued under 26 U.S.C. 732.

Section 1.732-2 also issued under 26 U.S.C. 732.

Section 1.734-1 also issued under 26 U.S.C. 734.

Section 1.743-1 also issued under 26 U.S.C. 743.

Section 1.751-1 also issued under 26 U.S.C. 751.

Section 1.755-1 also issued under 26 U.S.C. 755. * * *

Section 1.1017-1 also issued under 26 U.S.C. 1017. * * *

Par. 2. Section 1.732-1 is amended as follows:

1. Revise paragraph (c).
2. Revise paragraph (d)(1)(ii).
3. Revise the last sentence of paragraph (d)(1)(v).
4. Revise paragraph (d)(1)(vi).
5. Revise paragraph (d)(4)(iii).
6. Remove the flush text and *Examples 1* and *2* following paragraph (d)(4)(iii).
7. Add paragraph (d)(5).

The additions and revisions read as follows:

§1.732-1 Basis of distributed property other than money.

* * * * *

(c) *Allocation of basis among properties distributed to a partner*—(1) *General rule*—(i) *Unrealized receivables and inventory items*. The basis to be allocated to properties distributed to a partner under section 732(a)(2) or (b) is allocated first to any unrealized receivables (as defined in section 751(c)) and inventory items (as defined in section 751(d)(2)) in an amount equal to the adjusted basis of each such property to the partnership immediately before the distribution. If the basis to be allocated is less than the sum of the adjusted bases to the partnership of the distributed unrealized receivables and inventory items, the adjusted basis of the distributed property must be decreased in the manner provided in paragraph (c)(2)(i) of this section.

(ii) *Other distributed property*. Any basis not allocated to unrealized receivables or inventory items under paragraph (c)(1)(i) of this section is allocated to any other property distributed to the partner in the same transaction by assigning to each distributed property an amount equal to the adjusted basis of the property to the partnership immediately before the distribution. However, if the sum of the adjusted bases to the partnership of such other distributed property does not equal the basis to be allocated among the distributed property, any increase or decrease required to make the amounts equal is allocated among the distributed property as provided in paragraph (c)(2) of this section.

(2) *Adjustment to basis allocation*—(i) *Decrease in basis*. Any decrease to the basis of distributed property required under paragraph (c)(1) of this section is allocated first to distributed property with unrealized depreciation in proportion to each property's respective amount of unrealized depreciation before any decrease (but only to the extent of each property's unrealized depreciation). If the required decrease exceeds the amount of unrealized depreciation in the distributed property, the excess is allocated to the distributed property in proportion to the adjusted bases of the distributed property, as adjusted pursuant to the immediately preceding sentence.

(ii) *Increase in basis*. Any increase to the basis of distributed property required under paragraph (c)(1)(ii) of this section is allocated first to distributed property (other than unrealized receivables and inventory items) with unrealized appreciation in proportion to each property's respective amount of unrealized appreciation before any increase (but only to the extent of each property's unrealized appreciation). If the required increase exceeds the amount of unrealized appreciation in the distributed property, the excess is allocated to the distributed property (other than unrealized receivables or inventory items) in proportion to the fair market value of the distributed property.

(3) *Unrealized receivables and inventory items*. If the basis to be allocated upon a distribution in liquidation of the partner's entire interest in the partnership is greater than the adjusted basis to the partnership of the unrealized receivables and inventory items distributed to the partner, and if there is no other property distributed to which the excess can be allocated, the distributee partner sustains a capital loss under section 731(a)(2) to the extent of the unallocated basis of the partnership interest.

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

Example 1. A is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of $650. PRS distributes inventory items and Assets X and Y to A in liquidation of A's entire partnership interest. The distributed inventory items have a basis to the partnership of $100 and a fair market value of $200. Asset X has an adjusted basis to the partnership of $50 and a fair market value of $400. Asset Y has an adjusted basis to the partnership and a fair market value of $100. Neither Asset X nor Asset Y consists of inventory items or unrealized receivables. Under this paragraph (c), A's basis in its partnership interest is allocated first to the inventory items in an amount equal to their adjusted basis to the partnership. A, therefore, has an adjusted basis in the inventory items of $100. The remaining basis, $550, is allocated to the distributed property first in an amount equal to the property's adjusted basis to the partnership. Thus, Asset X is allocated $50 and Asset Y is allocated $100. Asset X is then allocated $350, the amount of unrealized appreciation in Asset X. Finally, the remaining basis, $50, is allocated to Assets X and Y in proportion to their fair market values: $40 to Asset X (400/500 x $50), and $10 to Asset Y (100/500 x $50). Therefore, after the distribution, A has an adjusted basis of $440 in Asset X and $110 in Asset Y.

Example 2. B is a one-fourth partner in partnership PRS and has an adjusted basis in its partnership interest of $200. PRS distributes Asset X and Asset Y to B in liquidation of its entire partnership interest. Asset X has an adjusted basis to the partnership and fair market value of $150. Asset Y has an adjusted basis to the partnership of $150 and a fair market value of $50. Neither of the assets consists of inventory items or unrealized receivables. Under this paragraph (c), B's basis is first assigned to the distributed property to the extent of the partnership's basis in each distributed property. Thus, Asset X and Asset Y are each assigned $150. Because the aggregate adjusted basis of the distributed property, $300, exceeds the basis to be allocated, $200, a decrease of $100 in the basis of the distributed property is required. Assets X and Y have unrealized depreciation of zero and $100, respectively. Thus, the entire decrease is allocated to Asset Y. After the distribution, B has an adjusted basis of $150 in Asset X and $50 in Asset Y.

Example 3. C, a partner in partnership PRS, receives a distribution in liquidation of its entire partnership interest of $6,000 cash, inventory items having an adjusted basis to the partnership of $6,000, and real property having an adjusted basis to the partnership of $4,000. C's basis in its partnership interest is $9,000. The cash distribution reduces C's basis to $3,000, which is allocated entirely to the inventory items. The real property has a zero basis in C's hands. The partnership bases not carried over to C for the distributed properties are lost unless an election under section 754 is in effect requiring the partnership to adjust the bases of remaining partnership properties under section 734(b).

Example 4. Assume the same facts as in *Example 3* of this paragraph except C receives a distribution in liquidation of its entire partnership interest of $1,000 cash and inventory items having a basis to the partnership of $6,000. The cash distribution reduces C's basis to $8,000, which can be allocated only to the extent of $6,000 to the inventory items. The remaining $2,000 basis, not allocable to the distributed property, constitutes a capital loss to partner C under section 731(a)(2). If the election under section 754 is in effect, see section 734(b) for adjustment of the basis of undistributed partnership property.

(5) *Effective date*. This paragraph (c) applies to distributions of property from a partnership that occur on or after December 15, 1999.

(d) * * * (1) * * *

(ii) Where an election under section 754 is in effect, see section 743(b) and §§1.743-1 and 1.732-2.

* * * * *

(v) * * * (For a shift of transferee's basis adjustment under section 743(b) to like property, see §1.743-1(g).)

(vi) The provisions of this paragraph (d)(1) may be illustrated by the following example:

Example. (i) Transferee partner, T, purchased a one-fourth interest in partnership PRS for $17,000. At the time T purchased the partnership interest, the election under section 754 was not in effect and the partnership inventory had a basis to the partnership of $14,000 and a fair market value of $16,000. T's purchase price reflected $500 of this difference. Thus, $4,000 of the $17,000 paid by T for the partnership interest was attributable to T's share of partnership inventory with a basis of $3,500. Within 2 years after T acquired the partnership interest, T retired from the partnership and received in liquidation of its entire partnership interest the following property:

	Assets	
	Adjusted Basis to PRS	Fair Market Value
Cash	$1,500	$1,500
Inventory	$3,500	$4,000
Asset X	$2,000	$4,000
Asset Y	$4,000	$5,000

(ii) The fair market value of the inventory received by T was one-fourth of the fair market value of all partnership inventory and was T's share of such property. It is immaterial whether the inventory T received was on hand when T acquired the interest. In accordance with T's election under section 732(d), the amount of T's share of partnership basis that is attributable to partnership inventory is increased by $500 (one-fourth of the $2,000 difference between the fair market value of the property, $16,000, and its $14,000 basis to the partnership at the time T purchased its interest). This adjustment under section 732(d) applies only for purposes of distributions to T, and not for purposes of partnership depreciation, depletion, or gain or loss on disposition. Thus, the amount to be allocated among the properties received by T in the liquidating distribution is $15,500 ($17,000, T's basis for the partnership interest, reduced by the amount of cash received, $1,500). This amount is allocated as follows: The basis of the inventory items received is $4,000, consisting of the $3,500 common partnership basis, plus the basis adjustment of $500 which T would have had under section 743(b). The remaining basis of $11,500 ($15,500 minus $4,000) is allocated among the remaining property distributed to T by assigning to each property the adjusted basis to the partnership of such property and adjusting that basis by any required increase or decrease. Thus, the adjusted basis to T of Asset X is $5,111 ($2,000, the adjusted basis of Asset X to the partnership, plus $2,000, the amount of unrealized appreciation in Asset X, plus $1,111 ($4,000/$9,000 multiplied by $2,500)). Similarly, the adjusted basis of Asset Y to T is $6,389 ($4,000, the adjusted basis of Asset Y to the partnership, plus $1,000, the amount of unrealized appreciation in Asset Y, plus, $1,389 ($5,000/$9,000 multiplied by $2,500)).

* * * * *

(4) * * *

(iii) A basis adjustment under section 743(b) would change the basis to the transferee partner of the property actually distributed.

(5) *Required statements*. If a transferee partner notifies a partnership that it plans to make the election under section 732(d) under paragraph (d)(3) of this section, or if a partnership makes a distribution to which paragraph (d)(4) of this section applies, the partnership must provide the transferee with such information as is necessary for the transferee properly to compute the transferee's basis adjustments under section 732(d).

* * * * *

Par. 3. Section 1.732-2 is amended by revising the sentence at the end of the *Example* in paragraph (b) to read as follows:

§1.732-2 Special partnership basis of distributed property.

* * * * *

(b) * * *

Example. * * * See §1.743-1(g).

* * * * *

Par. 4. In §1.734-1, paragraph (e) is added to read as follows:

§1.734-1 Optional adjustment to basis of undistributed partnership property.

* * * * *

(e) *Recovery of adjustments to basis of partnership property*—(1) *Increases in basis*. For purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the distribution of property to a partner, then the increased portion of the basis must be taken into account as if it were newly-purchased recovery property placed in service when the distribution occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.

(2) *Decreases in basis*. For purposes of section 168, if the basis of a partnership's recovery property is decreased as a result of the distribution of property to a partner, then the decrease in basis must be accounted for over the remaining recovery period of the property beginning with the recovery period in which the basis is decreased.

(3) *Effective date*. This paragraph (e) applies to distributions of property from a partnership that occur on or after December 15, 1999.

Par. 5. Section 1.743-1 is revised to read as follows:

§1.743-1 Optional adjustment to basis of partnership property.

(a) *Generally*. The basis of partnership property is adjusted as a result of the transfer of an interest in a partnership by sale or exchange or on the death of a partner only if the election provided by section 754 (relating to optional adjustments to the basis of partnership property) is in effect with respect to the partnership. Whether or not the election provided in section 754 is in effect, the basis of partnership property is not adjusted as the result of a contribution of property, including money, to the partnership.

(b) *Determination of adjustment*. In the case of the transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership that has an election under section 754 in effect—

(1) Increases the adjusted basis of partnership property by the excess of the transferee's basis for the transferred partnership interest over the transferee's share of the adjusted basis to the partnership of the partnership's property; or

(2) Decreases the adjusted basis of partnership property by the excess of the transferee's share of the adjusted basis to the partnership of the partnership's property over the transferee's basis for the transferred partnership interest.

(c) *Determination of transferee's basis in the transferred partnership interest*. In the case of the transfer of a partnership interest by sale or exchange or as a result of the death of a partner, the transferee's basis in the transferred partnership interest is determined under section 742 and §1.742-1. See also section 752 and §§1.752-1 through 1.752-5.

(d) *Determination of transferee's share of the adjusted basis to the partnership of the partnership's property*—(1) *Generally*. A transferee's share of the adjusted basis to the partnership of partnership property is equal to the sum of the transferee's interest as a partner in the partnership's previously taxed capital, plus the transferee's share of partnership liabilities. Generally, a transferee's interest as a partner in the partnership's previously taxed capital is equal to—

(i) The amount of cash that the transferee would receive on a liquidation of the partnership following the hypothetical transaction, as defined in paragraph (d)(2) of this section (to the extent attributable to the acquired partnership interest); increased by

(ii) The amount of tax loss (including any remedial allocations under §1.704-3(d)), that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest); and decreased by

(iii) The amount of tax gain (including any remedial allocations under §1.704-3(d)), that would be allocated to the transferee from the hypothetical transaction (to the extent attributable to the acquired partnership interest).

(2) *Hypothetical transaction defined.* For purposes of paragraph (d)(1) of this section, the hypothetical transaction means the disposition by the partnership of all of the partnership's assets, immediately after the transfer of the partnership interest, in a fully taxable transaction for cash equal to the fair market value of the assets.

(3) *Examples*. The provisions of this paragraph (d) are illustrated by the following examples:

Example 1. (i) A is a member of partnership PRS in which the partners have equal interests in capital and profits. The partnership has made an election under section 754, relating to the optional adjustment to the basis of partnership property. A sells its interest to T for $22,000. The balance sheet of the partnership at the date of sale shows the following:

Assets		
	Adjusted Basis	Fair Market Value
Cash	$5,000	$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable assets	20,000	40,000
Total	$55,000	$76,000

Liabilities and Capital		
	Adjusted Per Books	Fair Market Value
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	$55,000	$76,000

(ii) The amount of the basis adjustment under section 743(b) is the difference between the basis of T's interest in the partnership and T's share of the adjusted basis to the partnership of the partnership's property. Under section 742, the basis of T's interest is $25,333 (the cash paid for A's interest, $22,000, plus $3,333, T's share of partnership liabilities). T's interest in the partnership's previously taxed capital is $15,000 ($22,000, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $7,000, the amount of tax gain allocated to T from the hypothetical transaction). T's share of the adjusted basis to the partnership of the partnership's property is $18,333 ($15,000 share of previously taxed capital, plus $3,333 share of the partnership's liabilities). The amount of the basis adjustment under section 743(b) to partnership property therefore, is $7,000, the difference between $25,333 and $18,333.

Example 2. A, B, and C form partnership PRS, to which A contributes land (Asset 1) with a fair market value of $1,000 and an adjusted basis to A of $400, and B and C each contribute $1,000 cash. Each partner has $1,000 credited to it on the books of the partnership as its capital contribution. The partners share in profits equally. During the partnership's first taxable year, Asset 1 appreciates in value to $1,300. A sells its one-third interest in the partnership to T for $1,100, when an election under section 754 is in effect. The amount of tax gain that would be allocated to T from the hypothetical transaction is $700 ($600 section 704(c) built-in gain, plus one-third of the additional gain). Thus, T's interest in the partnership's previously taxed capital is $400 ($1,100, the amount of cash T would receive if PRS liquidated immediately after the hypothetical transaction, decreased by $700, T's share of gain from the hypothetical transaction). The amount of T's basis adjustment under section 743(b) to partnership property is $700 (the excess of $1,100, T's cost basis for its interest, over $400, T's share of the adjusted basis to the partnership of partnership property).

(e) *Allocation of basis adjustment.* For the allocation of the basis adjustment under this section among the individual items of partnership property, see section 755 and the regulations thereunder.

(f) *Subsequent transfers.* Where there has been more than one transfer of a partnership interest, a transferee's basis adjustment is determined without regard to any prior transferee's basis adjustment. In the case of a gift of an interest in a partnership, the donor is treated as transferring, and the donee as receiving, that portion of the basis adjustment attributable to the gifted partnership interest. The provisions of this paragraph (f) are illustrated by the following example:

Example. (i) A, B, and C form partnership PRS. A and B each contribute $1,000 cash, and C contributes land with a basis and fair market value of $1,000. When the land has appreciated in value to $1,300, A sells its interest to T1 for $1,100 (one-third of $3,300, the fair market value of the partnership property). An election under section 754 is in effect; therefore, T1 has a basis adjustment under section 743(b) of $100.

(ii) After the land has further appreciated in value to $1,600, T1 sells its interest to T2 for $1,200 (one-third of $3,600, the fair market value of the partnership property). T2 has a basis adjustment under section 743(b) of $200. This amount is determined without regard to any basis adjustment under section 743(b) that T1 may have had in the partnership assets.

(iii) During the following year, T2 makes a gift to T3 of fifty percent of T2's interest in PRS. At the time of the transfer, T2 has a $200 basis adjustment under section 743(b). T2 is treated as transferring $100 of the basis adjustment to T3 with the gift of the partnership interest.

(g) *Distributions—(1) Distribution of adjusted property to the transferee—(i) Coordination with section 732.* If a partnership distributes property to a transferee and the transferee has a basis adjustment for the property, the basis adjustment is taken into account under section 732. See §1.732-2(b).

(ii) *Coordination with section 734*. For certain adjustments to the common basis of remaining partnership property after the distribution of adjusted property to a transferee, see §1.734-2(b).

(2) *Distribution of adjusted property to another partner— (i) Coordination with section 732*. If a partner receives a distribution of property with respect to which another partner has a basis adjustment, the distributee does not take the basis adjustment into account under section 732.

(ii) *Reallocation of basis.* A transferee with a basis adjustment in property that is distributed to another partner reallocates the basis adjustment among the remaining items of partnership property under §1.755-1(c).

(3) *Distributions in complete liquidation of a partner's interest*. If a transferee receives a distribution of property (whether or not the transferee has a basis adjustment in such property) in liquidation of its interest in the partnership, the adjusted basis to the partnership of the distributed property immediately before the distribution includes the transferee's basis adjustment for the property in which the transferee relinquished an interest (either because it remained in the partnership or was distributed to another partner). Any basis adjustment for property in which the transferee is deemed to relinquish its interest is reallocated among the properties distributed to the transferee under §1.755-1(c).

(4) *Coordination with other provisions*. The rules of sections 704(c)(1)(B), 731, 737, and 751 apply before the rules of this paragraph (g).

(5) *Example*. The provisions of this paragraph (g) are illustrated by the following example:

Example. (i) A, B, and C are equal partners in partnership PRS. Each partner originally contributed $10,000 in cash, and PRS used the contributions to purchase five nondepreciable capital assets. PRS has no liabilities. After five years, PRS's balance sheet appears as follows:

	Assets	
	Adjusted Basis	Fair Market Value
Asset 1	$10,000	$10,000
Asset 2	4,000	6,000
Asset 3	6,000	6,000
Asset 4	7,000	4,000
Asset 5	3,000	13,000
Total	$30,000	$39,000

	Capital	
	Adjusted Per Books	Fair Market Value
Partner A	$10,000	$13,000
Partner B	10,000	13,000
Partner C	10,000	13,000
Total	$30,000	$39,000

(ii) A sells its interest to T for $13,000 when PRS has an election in effect under section 754. T receives a basis adjustment under section 743(b) in the partnership property that is equal to $3,000 (the excess of T's basis in the partnership interest, $13,000, over T's share of the adjusted basis to the partnership of partnership property, $10,000). The basis adjustment is allocated under section 755, and the partnership's balance sheet appears as follows:

	Assets		
	Adjusted Basis	Fair Market Value	Basis Adjustment
Asset 1	$10,000	$10,000	$ 0.00
Asset 2	4,000	6,000	666.67
Asset 3	6,000	6,000	0.00
Asset 4	7,000	4,000	(1,000.00)
Asset 5	3,000	13,000	3,333.33
Total	$30,000	$39,000	$3,000.00

	Capital		
	Adjusted Per Books	Fair Market Value	Special Basis
Partner T	$10,000	$13,000	$3,000
Partner B	10,000	13,000	0
Partner C	10,000	13,000	0
Total	$30,000	$39,000	$3,000

(iii) Assume that PRS distributes Asset 2 to T in partial liquidation of T's interest in the partnership. T has a basis adjustment under section 743(b) of $666.67 in Asset 2. Under paragraph (g)(1)(i) of this section, T takes the basis adjustment into account under section 732. Therefore, T will have a basis in Asset 2 of $4,666.67 following the distribution.

(iv) Assume instead that PRS distributes Asset 5 to C in complete liquidation of C's interest in PRS. T has a basis adjustment under section 743(b) of $3,333.33 in Asset 5. Under paragraph (g)(2)(i) of this section, C does not take T's basis adjustment into account under section 732. Therefore, the partnership's basis for purposes of sections 732 and 734 is $3,000. Under paragraph (g)(2)(ii) of this section, T's $3,333.33 basis adjustment is reallocated among the remaining partnership assets under §1.755-1(c).

(v) Assume instead that PRS distributes Asset 5 to T in complete liquidation of its interest in PRS. Under paragraph (g)(3) of this section, immediately prior to the distribution of Asset 5 to T, PRS must adjust the basis of Asset 5. Therefore, immediately prior to the distribution, PRS's basis in Asset 5 is equal to $6,000, which is the sum of (A) $3,000, PRS's common basis in Asset 5, plus (B) $3,333.33, T's basis adjustment to Asset 5, plus (C) ($333.33), the sum of T's basis adjustments in Assets 2 and 4. For purposes of sections 732 and 734, therefore, PRS will be treated as having a basis in Asset 5 equal to $6,000.

(h) *Contributions of adjusted property—(1) Section 721(a) transactions.* If, in a transaction described in section 721(a), a partnership (the upper tier) contributes to another partnership (the lower tier) property with respect to which a basis adjustment has been made, the basis adjustment is treated as contributed to the lower-tier partnership, regardless of whether the lower-tier partnership makes a section 754 election. The lower tier's basis in the contributed assets and the upper tier's basis in the partnership interest received in the transaction are determined with reference to the basis adjustment. However, that portion of the basis of the upper tier's interest in the lower tier attributable to the basis adjustment must be segregated and allocated solely to the transferee partner for whom the basis adjustment was made. Similarly, that portion of the lower tier's basis in its assets attributable to the basis adjustment must be segregated and allocated solely to the upper tier and the transferee. A partner with a basis adjustment in property held by a partnership that terminates under section 708(b)(1)(B) will continue to have the same basis adjustment with respect to property deemed contributed by the terminated partnership to the new partnership under §1.708-1(b)(1)(iv), regardless of whether the new partnership makes a section 754 election.

(2) *Section 351 transactions—(i) Basis in transferred property.* A corporation's adjusted tax basis in property transferred to the corporation by a partnership in a transaction described in section 351 is determined with reference to any basis adjustments to the property under section 743(b) (other than any basis adjustment that reduces a partner's gain under paragraph (h)(2)(ii) of this section).

(ii) *Partnership gain.* The amount of gain, if any, recognized by the partnership on a transfer of property by the partnership to a corporation in a transfer described in section 351 is determined without reference to any basis adjustment to the transferred property under section 743(b). The amount of gain, if any, recognized by the partnership on the transfer that is allocated to a partner with a basis adjustment in the transferred property is adjusted to reflect the partner's basis adjustment in the transferred property.

(iii) *Basis in stock.* The partnership's adjusted tax basis in stock received from a corporation in a transfer described in section 351 is determined without reference to the basis adjustment in property transferred to the corporation in the section 351 exchange. A partner with a basis adjustment in property transferred to the corporation, however, has a basis adjustment in the stock received by the partnership in the section 351 exchange in an amount equal to the partner's basis adjustment in the transferred property, reduced by any basis adjustment that reduced the partner's gain under paragraph (h)(2)(ii) of this section.

(iv) *Example.* The following example illustrates the principles of this paragraph (h):

Example. (i) A, B, and C are equal partners in partnership PRS. The partnership's only asset, Asset 1, has an adjusted tax basis of $60 and a fair market value of $120. Asset 1 is a nondepreciable capital asset and is not section 704(c) property. A has a basis in its partnership interest of $40, and a positive section 743(b) adjustment of $20 in Asset 1. In a transaction to which section 351 applies, PRS contributes Asset 1 to X, a corporation, in exchange for $15 in cash and X stock with a fair market value of $105.

(ii) Under paragraph (h)(2)(ii) of this section, PRS realizes $60 of gain on the transfer of Asset 1 to X ($120, its amount realized, minus $60, its adjusted basis), but recognizes only $15 of that gain under section 351(b)(1). Of this amount, $5 is allocated to each partner. A must use $5 of its basis adjustment in Asset 1 to offset A's share of PRS's gain. Under paragraph (h)(2)(iii) of this section, PRS's basis in the stock received from X is $60. However, A has a basis adjustment in the stock received by PRS equal to $15 (its basis adjustment in Asset 1, $20, reduced by the portion of the adjustment which reduced A's gain, $5). Under paragraph (h)(2)(i) of this section, X's basis in Asset 1 equals $75 (PRS's common basis in the asset, $60, plus A's basis adjustment under section 743(b), $20, less the portion of the adjustment which reduced A's gain, $5).

(i) [Reserved].

(j) *Effect of basis adjustment*—(1) *In general*. The basis adjustment constitutes an adjustment to the basis of partnership property with respect to the transferee only. No adjustment is made to the common basis of partnership property. Thus, for purposes of calculating income, deduction, gain, and loss, the transferee will have a special basis for those partnership properties the bases of which are adjusted under section 743(b) and this section. The adjustment to the basis of partnership property under section 743(b) has no effect on the partnership's computation of any item under section 703.

(2) *Computation of partner's distributive share of partnership items*. The partnership first computes its items of income, deduction, gain, or loss at the partnership level under section 703. The partnership then allocates the partnership items among the partners, including the transferee, in accordance with section 704, and adjusts the partners' capital accounts accordingly. The partnership then adjusts the transferee's distributive share of the items of partnership income, deduction, gain, or loss, in accordance with paragraphs (j)(3) and (4) of this section, to reflect the effects of the transferee's basis adjustment under section 743(b). These adjustments to the transferee's distributive shares must be reflected on Schedules K and K-1 of the partnership's return (Form 1065). These adjustments to the transferee's distributive shares do not affect the transferee's capital account.

(3) *Effect of basis adjustment in determining items of income, gain, or loss*—(i) *In general*. The amount of a transferee's income, gain, or loss from the sale or exchange of a partnership asset in which the transferee has a basis adjustment is equal to the transferee's share of the partnership's gain or loss from the sale of the asset (including any remedial allocations under §1.704-3(d)), minus the amount of the transferee's positive basis adjustment for the partnership asset (determined by taking into account the recovery of the basis adjustment under paragraph (j)(4)(i)(B) of this section) or plus the amount of the transferee's negative basis adjustment for the partnership asset (determined by taking into the account the recovery of the basis adjustment under paragraph (j)(4)(ii)(B) of this section).

(ii) *Examples*. The following examples illustrate the principles of this paragraph (j)(3):

Example 1. A and B form equal partnership PRS. A contributes nondepreciable property with a fair market value of $50 and an adjusted tax basis of $100. PRS will use the traditional allocation method under §1.704-3(b). B contributes $50 cash. A sells its interest to T for $50. PRS has an election in effect to adjust the basis of partnership property under section 754. T receives a negative $50 basis adjustment under section 743(b) that, under section 755, is allocated to the nondepreciable property. PRS then sells the property for $60. PRS recognizes a book gain of $10 (allocated equally between T and B) and a tax loss of $40. T will receive an allocation of $40 of tax loss under the principles of section 704(c). However, because T has a negative $50 basis adjustment in the nondepreciable property, T recognizes a $10 gain from the partnership's sale of the property.

Example 2. A and B form equal partnership PRS. A contributes nondepreciable property with a fair market value of $100 and an adjusted tax basis of $50. B contributes $100 cash. PRS will use the traditional allocation method under §1.704-3(b). A sells its interest to T for $100. PRS has an election in effect to adjust the basis of partnership property under section 754. Therefore, T receives a $50 basis adjustment under section 743(b) that, under section 755, is allocated to the nondepreciable property. PRS then sells the nondepreciable property for $90. PRS recognizes a book loss of $10 (allocated equally between T and B) and a tax gain of $40. T will receive an allocation of the entire $40 of tax gain under the principles of section 704(c). However, because T has a $50 basis adjustment in the property, T recognizes a $10 loss from the partnership's sale of the property.

Example 3. A and B form equal partnership PRS. PRS will make allocations under section 704(c) using the remedial allocation method described in §1.704-3(d). A contributes nondepreciable property with a fair market value of $100 and an adjusted tax basis of $150. B contributes $100 cash. A sells its partnership interest to T for $100. PRS has an election in effect to adjust the basis of partnership property under section 754. T receives a negative $50 basis adjustment under section 743(b) that, under section 755, is allocated to the property. The partnership then sells the property for $120. The partnership recognizes a $20 book gain and a $30 tax loss. The book gain will be allocated equally between the partners. The entire $30 tax loss will be allocated to T under the principles of section 704(c). To match its $10 share of book gain, B will be allocated $10 of remedial gain, and T will be allocated an offsetting $10 of remedial loss. T was allocated a total of $40 of tax loss with respect to the property. However, because T has a negative $50 basis adjustment to the property, T recognizes a $10 gain from the partnership's sale of the property.

(4) *Effect of basis adjustment in determining items of deduction*—(i) *Increases*—(A) *Additional deduction*. The amount of any positive basis adjustment that is recovered by the transferee in any year is added to the transferee's distributive share of the partnership's depreciation or amortization deductions for the year. The basis adjustment is adjusted under section 1016(a)(2) to reflect the recovery of the basis adjustment.

(B) *Recovery period*—(1) *In general*. Except as provided in paragraph (j)(4)(i)(B)(2) of this section, for purposes of section 168, if the basis of a partnership's recovery property is increased as a result of the transfer of a partnership interest, then the increased portion of the basis is taken into account as if it were newly-purchased recovery property placed in service when the transfer occurs. Consequently, any applicable recovery period and method may be used to determine the recovery allowance with respect to the increased portion of the basis. However, no change is made for purposes of determining the recovery allowance under section 168 for the portion of the basis for which there is no increase.

(2) *Remedial allocation method*. If a partnership elects to use the remedial allocation method described in §1.704-3(d) with respect to an item of the partnership's recovery property, then the portion of any increase in the basis of the item of the partnership's recovery property under section 743(b) that is attributable to section 704(c) built-in gain is recovered over the remaining recovery period for the partnership's excess book basis in the property as determined in the final sentence of §1.704-3(d)(2). Any remaining portion of the basis increase is recovered under paragraph (j)(4)(i)(B)(1) of this section.

(C) *Examples*. The provisions of this paragraph (j)(4)(i) are illustrated by the following examples:

Example 1. (i) A, B, and C are equal partners in partnership PRS, which owns Asset 1, an item of depreciable property that has a fair market value in excess of its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, increases the basis of Asset 1 with respect to T.

(ii) Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 1 is $1,000. Also assume that, under paragraph (j)(4)(i)(B) of this section, the amount of the basis adjustment under section 743(b) that T recovers during the year is $500. The total amount of depreciation deductions from Asset 1 reported by T is equal to $1,500.

Example 2. (i) A and B form equal partnership PRS. A contributes property with an adjusted basis of $100,000 and a fair market value of $500,000. B contributes $500,000 cash. When PRS is formed, the property has five years remaining in its recovery period. The partnership's adjusted basis of $100,000 will, therefore, be recovered over the five years remaining in the property's recovery period. PRS elects to use the remedial allocation method under §1.704-3(d) with respect to the property. If PRS had purchased the property at the time of the partnership's formation, the basis of the property would have been recovered over a 10-year period. The $400,000 of section 704(c) built-in gain will, therefore, be amortized under §1.704-3(d) over a 10-year period beginning at the time of the partnership's formation.

(ii)(A)Except for the depreciation deductions, PRS's expenses equal its income in each year of the first two years commencing with the year the partnership is formed. After two years, A's share of the adjusted basis of partnership property is $120,000, while B's is $440,000:

Capital Accounts

	A		B	
	Book	Tax	Book	Tax
Initial Contribution	$500,000	$100,000	$500,000	$500,000
Depreciation Year 1	(30,000)		(30,000)	(20,000)
Remedial		10,000		(10,000)
	470,000	110,000	470,000	470,000
Depreciation Year 2	(30,000)		(30,000)	(20,000)
Remedial		10,000		(10,000)
	$440,000	$120,000	$440,000	$440,000

(B) A sells its interest in PRS to T for its fair market value of $440,000. A valid election under section 754 is in effect with respect to the sale of the partnership interest. Accordingly, PRS makes an adjustment, pursuant to section 743(b), to increase the basis of partnership property. Under section 743(b), the amount of the basis adjustment is equal to $320,000. Under section 755, the entire basis adjustment is allocated to the property.

(iii) At the time of the transfer, $320,000 of section 704(c) built-in gain from the property was still reflected on the partnership's books, and all of the basis adjustment is attributable to section 704(c) built-in gain. Therefore, the basis adjustment will be recovered over the remaining recovery period for the section 704(c) built-in gain under §1.704-3(d).

(ii) *Decreases*—(A) *Reduced deduction*. The amount of any negative basis adjustment allocated to an item of depreciable or amortizable property that is recovered in any year first decreases the transferee's distributive share of the partnership's depreciation or amortization deductions from that item of property for the year. If the amount of the basis adjustment recovered in any year exceeds the transferee's distributive share of the partnership's depreciation or amortization deductions from the item of property, then the transferee's distributive share of the partnership's depreciation or amortization deductions from other items of partnership property is decreased. The transferee then recognizes ordinary income to the extent of the excess, if any, of the amount of the basis adjustment recovered in any year over the transferee's distributive share of the partnership's depreciation or amortization deductions from all items of property.

(B) *Recovery period*. For purposes of section 168, if the basis of an item of a partnership's recovery property is decreased as the result of the transfer of an interest in the partnership, then the decrease is recovered over the remaining useful life of the item of the partnership's recovery property. The portion of the decrease that is recovered in any year during the recovery period is equal to the product of—

(1) The amount of the decrease to the item's adjusted basis (determined as of the date of the transfer); multiplied by

(2) A fraction, the numerator of which is the portion of the adjusted basis of the item recovered by the partnership in that year, and the denominator of which is the adjusted basis of the item on the date of the transfer (determined prior to any basis adjustments).

(C) *Examples*. The provisions of this paragraph (j)(4)(ii) are illustrated by the following examples:

Example 1. (i) A, B, and C are equal partners in partnership PRS, which owns Asset 2, an item of depreciable property that has a fair market value that is less than its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, decreases the basis of Asset 2 with respect to T.

(ii) Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 2 is $1,000. Also assume that, under paragraph (j)(4)(ii)(B) of this section, the amount of the basis adjustment under section 743(b) that T recovers during the year is $500. The total amount of depreciation deductions from Asset 2 reported by T is equal to $500.

Example 2. (i) A and B form equal partnership PRS. A contributes property with an adjusted basis of $100,000 and a fair market value of $50,000. B contributes $50,000 cash. When PRS is formed, the property has five years remaining in its recovery period. The partnership's adjusted basis of $100,000 will, therefore, be recovered over the five years remaining in the property's recovery period. PRS uses the traditional allocation method under §1.704-3(b) with respect to the property. As a result, B will receive $5,000 of depreciation deductions from the property in each of years 1-5, and A, as the contributing partner, will receive $15,000 of depreciation deductions in each of these years.

(ii) Except for the depreciation deductions, PRS's expenses equal its income in each of the first two years commencing with the year the partnership is formed. After two years, A's share of the adjusted basis of partnership property is $70,000, while B's is $40,000. A sells its interest in PRS to T for its fair market value of $40,000. A valid election under section 754 is in effect with respect to the sale of the partnership interest. Accordingly, PRS makes an adjustment, pursuant to section 743(b), to decrease the basis of partnership property. Under section 743(b), the amount of the adjustment is equal to ($30,000). Under section 755, the entire adjustment is allocated to the property.

(iii) The basis of the property at the time of the transfer of the partnership interest was $60,000. In each of years 3 through 5, the partnership will realize depreciation deductions of $20,000 from the property. Thus, one third of the negative basis adjustment ($10,000) will be recovered in each of years 3 through 5. Consequently, T will be allocated, for tax purposes, depreciation of $15,000 each year from the partnership and will recover $10,000 of its negative basis adjustment. Thus, T's net depreciation deduction from the partnership in each year is $5,000.

Example 3. (i) A, B, and C are equal partners in partnership PRS, which owns Asset 2, an item of depreciable property that has a fair market value that is less than its adjusted tax basis. C sells its interest in PRS to T while PRS has an election in effect under section 754. PRS, therefore, decreases the basis of Asset 2 with respect to T.

(ii) Assume that in the year following the transfer of the partnership interest to T, T's distributive share of the partnership's common basis depreciation deductions from Asset 2 is $500. PRS allocates no other depreciation to T. Also assume that, under paragraph (j)(4)(ii)(B) of this section, the amount of the negative basis adjustment that T recovers during the year is $1,000. T will report $500 of ordinary income because the amount of the negative basis adjustment recovered during the year exceeds T's distributive share of the partnership's common basis depreciation deductions from Asset 2.

(5) *Depletion*. Where an adjustment is made under section 743(b) to the basis of partnership property subject to depletion, any depletion allowance is determined separately for each partner, including the transferee partner, based on the partner's interest in such property. See §1.702-1(a)(8). For partnerships that hold oil and gas properties that are depleted at the partner level under section 613A(c)(7)(D), the transferee partner (and not the partnership) must make the basis adjustments, if any, required under section 743(b) with respect to such properties. See §1.613A-3(e)(6)(iv).

(6) *Example*. The provisions of paragraph (j)(5) of this section are illustrated by the following example:

Example. A, B, and C each contributes $5,000 cash to form partnership PRS, which purchases a coal property for $15,000. A, B, and C have equal interests in capital and profits. C subsequently sells its partnership interest to T for $100,000 when the election under section 754 is in effect. T has a basis adjustment under section 743(b) for the coal property of $95,000 (the difference between T's basis, $100,000, and its share of the basis of partnership property, $5,000). Assume that the depletion allowance computed under the percentage method would be $21,000 for the taxable year so that each partner would be entitled to $7,000 as its share of the deduction for depletion. However, under the cost depletion method, at an assumed rate of 10 percent, the allowance with respect to T's one-third interest which has a basis to him of $100,000 ($5,000, plus its basis adjustment of $95,000) is $10,000, although the cost depletion allowance with respect to the one-third interest of A and B in the coal property, each of which has a basis of $5,000, is only $500. For partners A and B, the percentage depletion is greater than cost depletion and each will deduct $7,000 based on the percentage depletion method. However, as to T, the transferee partner, the cost depletion method results in a greater allowance and T will, therefore, deduct $10,000 based on cost depletion. See section 613(a).

(k) *Returns*—(1) *Statement of adjustments*—(i) *In general*. A partnership that must adjust the bases of partnership properties under section 743(b) must attach a statement to the partnership return for the year of the transfer setting forth the name and taxpayer identification number of the transferee as well as the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(ii) *Special rule*. Where an interest is transferred in a partnership which holds oil and gas properties that are depleted at the partner level under section 613A(c)(7)(D), the transferee must attach a statement to the transferee's return for the year of the transfer, setting forth the computation of the basis adjustment under section 743(b) which is allocable to such properties and the specific properties to which the adjustment has been allocated.

(iii) *Example*. The provisions of paragraph (k)(1)(ii) of this section are illustrated by the following example:

Example. (i) Partnership XYZ owns a single section 613A(c)(7)(D) domestic oil and gas property (Property) and other non-depletable assets. A, a partner in XYZ with an adjusted tax basis in Property of $100 (excluding any prior adjustments under section 743(b)), sells its partnership interest to B for $800 cash. Under §1.613A-3(e)(6)(iv), A's adjusted basis of $100 in Property carries over to B.

(ii) Under section 755, XYZ determines that Property accounts for 50% of the fair market value of all partnership assets. The remaining 50% of B's purchase price ($400) is attributable to non-depletable property. XYZ must provide a statement to B containing the portion of B's adjusted basis attributable to non-depletable property ($400). Under this paragraph (k)(1), XYZ must report basis adjustments under section 743(b) to non-depletable property. B must report basis adjustments under section 743(b) to Property.

(2) *Requirement that transferee notify partnership*—(i) *Sale or exchange*. A transferee that acquires, by sale or exchange, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within 30 days of the sale or exchange. The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the transferee and (if ascertainable) of the transferor, the taxpayer identification numbers of the transferee and (if ascertainable) of the transferor, the relationship (if any) between the transferee and the transferor, the date of the transfer, the amount of any liabilities assumed or taken subject to by the transferee, and the amount of any money, the fair market value of any other property delivered or to be delivered for the transferred interest in the partnership, and any other information necessary for the partnership to compute the transferee's basis.

(ii) *Transfer on death*. A transferee that acquires, on the death of a partner, an interest in a partnership with an election under section 754 in effect for the taxable year of the transfer, must notify the partnership, in writing, within one year of the death of the deceased partner. The written notice to the partnership must be signed under penalties of perjury and must include the names and addresses of the deceased partner and the transferee, the taxpayer identification numbers of the deceased partner and the transferee, the relationship (if any) between the transferee and the transferor, the deceased partner's date of death, the date on which the transferee became the owner of the partnership interest, the fair market value of the partnership interest on the applicable date of valuation set forth in section 1014, and the manner in which the fair market value of the partnership interest was determined.

(iii) *Nominee reporting*. If a partnership interest is transferred to a nominee which is required to furnish the statement under section 6031(c)(1) to the partnership, the nominee may satisfy the notice requirement contained in this paragraph (k)(2) by providing the statement required under §1.6031(c)-1T, provided that the statement satisfies all requirements of §1.6031(c)-1T and this paragraph (k)(2).

(3) *Reliance*. In making the adjustments under section 743(b) and any statement or return relating to such adjustments under this section, a partnership may rely on the written notice provided by a transferee pursuant to paragraph (k)(2) of this section to determine the transferee's basis in a partnership interest. The previous sentence shall not apply if any partner who has responsibility for federal income tax reporting by the partnership has knowledge of facts indicating that the statement is clearly erroneous.

(4) *Partnership not required to make or report adjustments under section 743(b) until it has notice of the transfer*. A partnership is not required to make the adjustments under section 743(b) (or any statement or return relating to those adjustments) with respect to any transfer until it has been notified of the transfer. For purposes of this section, a partnership is notified of a transfer when either—

(i) The partnership receives the written notice from the transferee required under paragraph (k)(2) of this section; or

(ii) Any partner who has responsibility for federal income tax reporting by the partnership has knowledge that there has been a transfer of a partnership interest.

(5) *Effect on partnership of the failure of the transferee to comply*. If the transferee fails to provide the partnership with the written notice required by paragraph (k)(2) of this section, the partnership must attach a statement to its return in the year that the partnership is otherwise notified of the transfer. This statement must set forth the name and taxpayer identification number (if ascertainable) of the transferee. In addition, the following statement must be prominently displayed in capital letters on the first page of the partnership's return for such year, and on the first page of any schedule or information statement relating to such transferee's share of income, credits, deductions, etc.: "RETURN FILED PURSUANT TO §1.743-1(k)(5)." The partnership will then be entitled to report the transferee's share of partnership items without adjustment to reflect the transferee's basis adjustment in partnership property. If, following the filing of a return pursuant to this paragraph (k)(5), the transferee provides the applicable written notice to the partnership, the partnership must make such adjustments as are necessary to adjust the basis of partnership property (as of the date of the transfer) in any amended return otherwise to be filed by the partnership or in the next annual partnership return of income to be regularly filed by the partnership. At such time, the partnership must also provide the transferee with such information as is necessary for the transferee to amend its prior returns to properly reflect the adjustment under section 743(b).

(l) *Effective date*. This section applies to transfers of partnership interests that occur on or after December 15, 1999.

Par. 6. Section 1.751-1 is amended by:

1. Revising paragraphs (a)(2) and (a)(3).
2. Revising paragraph (c)(3).
3. Removing paragraph (c)(4)(x).
4. Adding a sentence at the end of paragraph (f).
5. Revising *Example 1* of paragraph (g).

The addition and revisions read as follows:

§1.751-1 Unrealized receivables and inventory items.

* * * * *

(a) * * *

(2) *Determination of gain or loss*. The income or loss realized by a partner upon the sale or exchange of its interest in section 751 property is the amount of income or loss from section 751 property (including any remedial allocations under §1.704-3(d)) that would have been allocated to the partner (to the extent attributable to the partnership interest sold or exchanged) if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the partner's transfer of the interest in the partnership. Any gain or loss recognized that is attributable to section 751 property will be ordinary gain or loss. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 and the amount of ordinary income or loss determined under this paragraph (a)(2) is the transferor's capital gain or loss on the sale of its partnership interest.

(3) *Statement required*. A partner selling or exchanging any part of an interest in a partnership that has any section 751 property at the time of sale or exchange must submit with its income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information—

(i) The date of the sale or exchange;

(ii) The amount of any gain or loss attributable to the section 751 property; and

(iii) The amount of any gain or loss attributable to capital gain or loss on the sale of the partnership interest.

* * * * *

(c) *Unrealized receivables*. * * *

(3) In determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

* * * * *

(f) * * * The rules contained in paragraphs (a)(2) and (a)(3) of this section apply to transfers of partnership interests that occur on or after December 15, 1999.

(g) * * *

Example 1. (i)(A) A and B are equal partners in personal service partnership PRS. B transfers its interest in PRS to T for $15,000 when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

	Assets	
	Adjusted Basis	Fair Market Value
Cash	$ 3,000	$ 3,000
Loans Receivable	10,000	10,000
Capital Assets	7,000	5,000
Unrealized Receivables	0	14,000
Total	20,000	32,000

	Liabilities and Capital	
	Adjusted Per Books	Fair Market Value
Liabilities	$ 2,000	$ 2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	20,000	32,000

(B) None of the assets owned by PRS is section 704(c) property, and the capital assets are nondepreciable. The total amount realized by B is $16,000, consisting of the cash received, $15,000, plus $1,000, B's share of the partnership liabilities assumed by T. See section 752. B's undivided half-interest in the partnership property includes a half-interest in the partnership's unrealized receivables items. B's basis for its partnership interest is $10,000 ($9,000, plus $1,000, B's share of partnership liabilities). If section 751(a) did not apply to the sale, B would recognize $6,000 of capital gain from the sale of the interest in PRS. However, section 751(a) does apply to the sale.

(ii) If PRS sold all of its section 751 property in a fully taxable transaction immediately prior to the transfer of B's partnership interest to T, B would have been allocated $7,000 of ordinary income from the sale of PRS's unrealized receivables. Therefore, B will recognize $7,000 of ordinary income with respect to the unrealized receivables. The difference between the amount of capital gain or loss that the partner would realize in the absence of section 751 ($6,000) and the amount of ordinary income or loss determined under paragraph (a)(2) of this section ($7,000) is the transferor's capital gain or loss on the sale of its partnership interest. In this case, B will recognize a $1,000 capital loss.

* * * * *

Par. 7. Section 1.754-1 is amended as follows:

1. Designate the text following the heading of paragraph (c) as paragraph (c)(1).

2. Add a heading to newly designated paragraph (c)(1).

3. Add paragraph (c)(2).

The additions read as follows:

§1.754-1 Time and manner of making election to adjust basis of partnership property.

* * * * *

(c) *Revocation of election*—(1) *In general*. * * *

(2) *Revocations made for first taxable year ending after December 15, 1999*. Notwithstanding paragraph (c)(1) of this section, any partnership having an election in effect under this section for its taxable year that includes December 15, 1999 may revoke such election by attaching a statement to the partnership's return for such year. For the revocation to be valid, the statement must be filed not later than the time prescribed by §1.6031(a)-1(e) (including extensions thereof) for filing the return for such taxable year, and must set forth the name and address of the partnership revoking the election, be signed by any one of the partners who is authorized to sign the partnership's federal income tax return, and contain a declaration that the partnership revokes its election under section 754 to apply the provisions of section 734(b) and 743(b). In addition, the following statement must be prominently displayed in capital letters on the first page of the partnership's return for such year: "RETURN FILED PURSUANT TO §1.754-1(c)(2)."

Par. 8. Section 1.755-1 is revised to read as follows:

§1.755-1 Rules for allocation of basis.

(a) *Generally*. A partnership that has an election in effect under section 754 must adjust the basis of partnership property under the provisions of section 734(b) and section 743(b) pursuant to the provisions of this section. The basis adjustment is first allocated between the two classes of property described in section 755(b). These classes of property consist of capital assets and section 1231(b) property (capital gain property), and any other property of the partnership (ordinary income property). For purposes of this section, properties and potential gain treated as unrealized receivables under section 751(c) and the regulations thereunder shall be treated as separate assets that are ordinary income property. The portion of the basis adjustment allocated to each class is then allocated among the items within the class. Adjustments under section 743(b) are allocated under paragraph (b) of this section. Adjustments under section 734(b) are allocated under paragraph (c) of this section.

(b) *Adjustments under section 743(b)*—(1) *Generally*. (i) For exchanges in which the transferee's basis in the interest is determined in whole or in part by reference to the transferor's basis in the interest, paragraph (b)(5) of this section shall apply. For all other transfers which result in a basis adjustment under section 743(b), paragraphs (b)(2) through (b)(4) of this section shall apply. Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one class of property may be an increase while the portion allocated to the other class is a decrease. This would be the case even though the total amount of the basis adjustment is zero. Except as provided in paragraph (b)(5) of this section, the portion of the basis adjustment allocated to one item of property within a class may be an increase while the portion allocated to another is a decrease. This would be the case even though the basis adjustment allocated to the class is zero.

(ii) *Hypothetical transaction*. For purposes of paragraphs (b)(2) through (b)(4) of this section, the allocation of the basis adjustment under section 743(b) between the classes of property and among the items of property within each class are made based on the allocations of income, gain, or loss (including remedial allocations under §1.704-3(d)) that the transferee partner would receive (to the extent attributable to the acquired partnership interest) if, immediately after the transfer of the partnership interest, all of the partnership's property were disposed of in a fully taxable transaction for cash in an amount equal to the fair market value of such property (the hypothetical transaction).

(2) *Allocations between classes of property*—(i) *In general*. The amount of the basis adjustment allocated to the class of ordinary income property is equal to the total amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the sale of all ordinary income property in the hypothetical transaction. The amount of the basis adjustment to capital gain property is equal to—

(A) The total amount of the basis adjustment under section 743(b); less

(B) The amount of the basis adjustment allocated to ordinary income property under the preceding sentence; provided, however, that in no event may the amount of any decrease in basis allocated to capital gain property exceed the partnership's basis (or in the case of property subject to the remedial allocation method, the transferee's share of any remedial loss under §1.704-3(d) from the hypothetical transaction) in capital gain property. In the event that a decrease in basis allocated to capital gain property would otherwise exceed the partnership's basis in capital gain property, the excess must be applied to reduce the basis of ordinary income property.

(ii) *Examples*. The provisions of this paragraph (b)(2) are illustrated by the following examples:

Example 1. (i) A and B form equal partnership PRS. A contributes $50,000 and Asset 1, a nondepreciable capital asset with a fair market value of $50,000 and an adjusted tax basis of $25,000. B contributes $100,000. PRS uses the cash to purchase Assets 2, 3, and 4. After a year, A sells its interest in PRS to T for $120,000. At the time of the transfer, A's share of the partnership's basis in partnership assets is $75,000. Therefore, T receives a $45,000 basis adjustment.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted Basis	Fair Market Value
Capital Gain Property:		
Asset 1	$ 25,000	$ 75,000
Asset 2	100,000	117,500
Ordinary Income Property:		
Asset 3	$ 40,000	$ 45,000
Asset 4	10,000	2,500
Total	$175,000	$240,000

(iii) If PRS sold all of its assets in a fully taxable transaction at fair market value immediately after the transfer of the partnership interest to T, the total amount of capital gain that would be allocated to T is equal to $46,250 ($25,000 section 704(c) built-in gain from Asset 1, plus fifty percent of the $42,500 appreciation in capital gain property). T would also be allocated a $1,250 ordinary loss from the sale of the ordinary income property.

(iv) The amount of the basis adjustment that is allocated to ordinary income property is equal to ($1,250) (the amount of the loss allocated to T from the hypothetical sale of the ordinary income property).

(v) The amount of the basis adjustment that is allocated to capital gain property is equal to $46,250 (the amount of the basis adjustment, $45,000, less ($1,250), the amount of loss allocated to T from the hypothetical sale of the ordinary income property).

Example 2. (i) A and B form equal partnership PRS. A and B each contribute $1,000 cash which the partnership uses to purchase Assets 1, 2, 3, and 4. After a year, A sells its partnership interest to T for $1,000. T's basis adjustment under section 743(b) is zero.

(ii) Immediately after the transfer of the partnership interest to T, the adjusted basis and fair market value of PRS's assets are as follows:

	Assets	
	Adjusted Basis	Fair Market Value
Capital Gain Property:		
Asset 1	$ 500	$ 750
Asset 2	500	500
Ordinary Income Property:		
Asset 3	$ 500	$ 250
Asset 4	500	500
Total	$2,000	$2,000

(iii) If, immediately after the transfer of the partnership interest to T, PRS sold all of its assets in a fully taxable transaction at fair market value, T would be allocated a loss of $125 from the sale of the ordinary income property. Thus, the amount of the basis adjustment to ordinary income property is ($125). The amount of the basis adjustment to capital gain property is $125 (zero, the amount of the basis adjustment under section 743(b), less ($125), amount of the basis adjustment allocated to ordinary income property).

(3) *Allocation within the class*—(i) *Ordinary income property*. The amount of the basis adjustment to each item of property within the class of ordinary income property is equal to—

(A) The amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; reduced by

(B) The product of—

(1) Any decrease to the amount of the basis adjustment to ordinary income property required pursuant to the last sentence of paragraph (b)(2)(i) of this section; multiplied by

(2) A fraction, the numerator of which is the fair market value of the item of property to the partnership and the denominator of which is the total fair market value of all of the partnership's items of ordinary income property.

(ii) *Capital gain property*. The amount of the basis adjustment to each item of property within the class of capital gain property is equal to—

(A) The amount of income, gain, or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of the item; minus

(B) The product of—

(*1*) The total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all items of capital gain property, minus the amount of the positive basis adjustment to all items of capital gain property or plus the amount of the negative basis adjustment to capital gain property; multiplied by

(*2*) A fraction, the numerator of which is the fair market value of the item of property to the partnership, and the denominator of which is the fair market value of all of the partnership's items of capital gain property.

(iii) *Examples.* The provisions of this paragraph (b)(3) are illustrated by the following examples:

Example 1. (i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section. Of the $45,000 basis adjustment, $46,250 was allocated to capital gain property. The amount allocated to ordinary income property was ($1,250).

(ii) Asset 1 is a capital gain asset, and T would be allocated $37,500 from the sale of Asset 1 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 1 is $37,500.

(iii) Asset 2 is a capital gain asset, and T would be allocated $8,750 from the sale of Asset 2 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 2 is $8,750.

(iv) Asset 3 is ordinary income property, and T would be allocated $2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is $2,500.

(v) Asset 4 is ordinary income property, and T would be allocated ($3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is ($3,750).

Example 2. (i) Assume the same facts as Example 1 in paragraph (b)(2)(ii) of this section, except that A sold its interest in PRS to T for $110,000 rather than $120,000. T, therefore, receives a basis adjustment under section 743(b) of $35,000. Of the $35,000 basis adjustment, ($1,250) is allocated to ordinary income property, and $36,250 is allocated to capital gain property.

(ii) Asset 3 is ordinary income property, and T would be allocated $2,500 from the sale of Asset 3 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 3 is $2,500.

(iii) Asset 4 is ordinary income property, and T would be allocated ($3,750) from the sale of Asset 4 in the hypothetical transaction. Therefore, the amount of the adjustment to Asset 4 is ($3,750).

(iv) Asset 1 is a capital gain asset, and T would be allocated $37,500 from the sale of Asset 1 in the hypothetical transaction. Asset 2 is a capital gain asset, and T would be allocated $8,750 from the sale of Asset 2 in the hypothetical transaction. The total amount of gain that would be allocated to T from the sale of the capital gain assets in the hypothetical transaction is $46,250, which exceeds the amount of the basis adjustment allocated to capital gain property by $10,000. The amount of the adjustment to Asset 1 is $33,604 ($37,500 minus $3,896 ($10,000 x $75,000/192,500)). The amount of the basis adjustment to Asset 2 is $2,646 ($8,750 minus $6,104 ($10,000 x $117,500/192,500)).

(4) *Income in respect of a decedent*—(i) *In general*. Where a partnership interest is transferred as a result of the death of a partner, under section 1014(c) the transferee's basis in its partnership interest is not adjusted for that portion of the interest, if any, which is attributable to items representing income in respect of a decedent under section 691. See §1.742-1. Accordingly, if a partnership interest is transferred as a result of the death of a partner, and the partnership holds assets representing income in respect of a decedent, no part of the

basis adjustment under section 743(b) is allocated to these assets. See §1.743-1(b).

(ii) The provisions of this paragraph (b)(4) are illustrated by the following example:

Example. (i) A and B are equal partners in personal service partnership PRS. As a result of B's death, B's partnership interest is transferred to T when PRS's balance sheet (reflecting a cash receipts and disbursements method of accounting) is as follows:

Assets	Adjusted Basis	Fair Market Value
Capital Asset	$ 2,000	$ 5,000
Unrealized Receivables	0	15,000
Total	2,000	20,000

Liabilities and Capital	Adjusted Per Books	Fair Market Value
Capital:		
A	1,000	10,000
B	1,000	10,000
Total	2,000	20,000

(ii) None of the assets owned by PRS is section 704(c) property, and the capital asset is nondepreciable. The fair market value of T's partnership interest on the applicable date of valuation set forth in section 1014 is $10,000. Of this amount, $2,500 is attributable to T's share of the partnership's capital asset, and $7,500 is attributable to T's 50% share of the partnership's unrealized receivables. The partnership's unrealized receivables represent income in respect of a decedent. Accordingly, under section 1014(c), T's basis in its partnership interest is not adjusted for that portion of the interest which is attributable to the unrealized receivables. Therefore, T's basis in its partnership interest is $2,500.

(iii) At the time of the transfer, B's share of the partnership's basis in partnership assets is $1,000. Accordingly, T receives a $1,500 basis adjustment under section 743(b). Under this paragraph (b)(4), the entire basis adjustment is allocated to the partnership's capital asset.

(5) *Transferred basis exchanges*—(i) *In general*. This paragraph (b)(5) applies to basis adjustments under section 743(b) which result from exchanges in which the transferee's basis in the interest is determined in whole or in part by reference to the transferor's basis in the interest. For example, this paragraph applies if a partnership interest is contributed to a corporation in a transaction to which section 351 applies or to a partnership in a transaction to which section 721(a) applies.

(ii) *Allocations between classes of property*. If the total amount of the basis adjustment under section 743(b) is zero, then no adjustment to the basis of partnership property will be made under this paragraph (b)(5). If there is an increase in basis to be allocated to partnership assets, such increase must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net gain or net income, as the case may be, to the transferee. Where, under the preceding sentence, an increase in basis may be allocated to both capital gain assets and ordinary income assets, the increase shall be allocated to each class in proportion to the net gain or net income, respectively, which would be allocated to the transferee from the sale of all assets in each class. If there is a decrease in basis to be allocated to partnership assets, such decrease must be allocated to capital gain property or ordinary income property, respectively, only if the total amount of gain or loss (including any remedial allocations under §1.704-3(d)) that would be allocated to the transferee (to the extent attributable to the acquired partnership interest) from the hypothetical sale of all such property would result in a net loss to the transferee. Where, under the preceding sentence, a decrease in basis may be allocated to both capital gain assets and ordinary income assets, the decrease shall be allocated to each class in proportion to the net loss which would be allocated to the transferee from the sale of all assets in each class.

(iii) *Allocations within the classes*—(A) *Increases*. If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to the transferee's share of the respective amounts of unrealized appreciation before such increase (but only to the extent of the transferee's share of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to the transferee's share of the amount that would be realized by the partnership upon the hypothetical sale of each asset in the class.

(B) *Decreases*. If there is a decrease

in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to the transferee's shares of the respective amounts of unrealized depreciation before such decrease (but only to the extent of the transferee's share of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to the transferee's shares of their adjusted bases (as adjusted under the preceding sentence).

(C) *Limitation in decrease of basis*. Where, as the result of a transaction to which this paragraph (b)(5) applies, a decrease in basis must be allocated to capital gain assets, ordinary income assets, or both, and the amount of the decrease otherwise allocable to a particular class exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in that class, the transferee's negative basis adjustment is limited to the transferee's share of the partnership's adjusted basis in all depreciated assets in that class.

(D) *Carryover adjustment*. Where a transferee's negative basis adjustment under section 743(b) cannot be allocated to any asset, because the adjustment exceeds the transferee's share of the adjusted basis to the partnership of all depreciated assets in a particular class, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(iv) *Examples*. The provisions of this paragraph (b)(5) are illustrated by the following examples:

Example 1. A is a member of partnership LTP, which has made an election under section 754. The three partners in LTP have equal interests in capital and profits. Solely in exchange for a partnership interest in UTP, A contributes its interest in LTP to UTP in a transaction described in section 721. At the time of the transfer, A's basis in its partnership interest ($5,000) equals its share of inside basis (also $5,000). Under section 723, UTP's basis in its interest in LTP is $5,000. LTP's only two assets on the date of contribution are inventory with a basis of $5,000 and a fair market value of $7,500, and a nondepreciable capital asset with a basis of $10,000 and a fair market value of $7,500. The amount of the basis adjustment under section 743(b) to partnership property is $0 ($5,000, UTP's basis in its interest in LTP, minus $5,000, UTP's share of LTP's basis in partnership assets). Because UTP acquired its interest in LTP in a transferred basis exchange, and the total amount of the basis adjustment under section 743(b) is zero, UTP receives no special basis adjustments under section 743(b) with respect to the partnership property of LTP.

Example 2. (i) A purchases a partnership interest in LTP at a time when an election under section 754 is not in effect. The three partners in LTP have equal interests in capital and profits. During a later year for which LTP has an election under section 754 in effect, and in a transaction that is unrelated to A's purchase of the LTP interest, A contributes its interest in LTP to UTP in a transaction described in section 721 (solely in exchange for a partnership interest in UTP). At the time of the transfer, A's adjusted basis in its interest in LTP is $20,433. Under section 721, A recognizes no gain or loss as a result of the contribution of its partnership interest to UTP. Under section 723, UTP's basis in its partnership interest in LTP is $20,433. The balance sheet of LTP on the date of the contribution shows the following:

Assets	Adjusted Basis	Fair Market Value
Cash	$ 5,000	$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Nondepreciable capital asset	20,000	40,000
Total	$55,000	$76,000

Liabilities and Capital	Adjusted Per Books	Fair Market Value
Liabilities	$10,000	$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	$55,000	$76,000

(ii) The amount of the basis adjustment under section 743(b) is the difference between the basis of UTP's interest in LTP and UTP's share of the adjusted basis to LTP of partnership property. UTP's interest in the previously taxed capital of LTP is $15,000 ($22,000, the amount of cash UTP would receive if LTP liquidated immediately after the hypothetical transaction, decreased by $7,000, the amount of tax gain allocated to UTP from the hypothetical transaction). UTP's share of the adjusted basis to LTP of partnership property is $18,333 ($15,000 share of previously taxed capital, plus

$3,333 share of LTP's liabilities). The amount of the basis adjustment under section 743(b) to partnership property therefore, is $2,100 ($20,433 minus $18,333).

(iii) The total amount of gain that would be allocated to UTP from the hypothetical sale of capital gain property is $6,666.67 (one-third of the excess of the fair market value of LTP's nondepreciable capital asset, $40,000, over its basis, $20,000). The total amount of gain that would be allocated to UTP from the hypothetical sale of ordinary income property is $333.33 (one-third of the excess of the fair market value of LTP's inventory, $21,000, over its basis, $20,000). Under paragraph (b)(5), LTP must allocate $2,000 ($6,666.67 divided by $7,000 times $2,100) of UTP's basis adjustment to the nondepreciable capital asset. LTP must allocate $100 ($333.33 divided by $7,000 times $2,100) of UTP's basis adjustment to the inventory.

(c) *Adjustments under section 734(b)*—(1) *Allocations between classes of property*—(i) *General rule*. Where there is a distribution of partnership property resulting in an adjustment to the basis of undistributed partnership property under section 734(b)(1)(B) or (b)(2)(B), the adjustment must be allocated to remaining partnership property of a character similar to that of the distributed property with respect to which the adjustment arose. Thus, when the partnership's adjusted basis of distributed capital gain property immediately prior to distribution exceeds the basis of the property to the distributee partner (as determined under section 732), the basis of the undistributed capital gain property remaining in the partnership is increased by an amount equal to the excess. Conversely, when the basis to the distributee partner (as determined under section 732) of distributed capital gain property exceeds the partnership's adjusted basis of such property immediately prior to the distribution, the basis of the undistributed capital gain property remaining in the partnership is decreased by an amount equal to such excess. Similarly, where there is a distribution of ordinary income property, and the basis of the property to the distributee partner (as determined under section 732) is not the same as the partnership's adjusted basis of the property immediately prior to distribution, the adjustment is made only to undistributed property of the same class remaining in the partnership.

(ii) *Special rule*. Where there is a distribution resulting in an adjustment under section 734(b)(1)(A) or (b)(2)(A) to the basis of undistributed partnership property, the adjustment is allocated only to capital gain property.

(2) Allocations within the classes—(i) *Increases*. If there is an increase in basis to be allocated within a class, the increase must be allocated first to properties with unrealized appreciation in proportion to their respective amounts of unrealized appreciation before such increase (but only to the extent of each property's unrealized appreciation). Any remaining increase must be allocated among the properties within the class in proportion to their fair market values.

(ii) *Decreases*. If there is a decrease in basis to be allocated within a class, the decrease must be allocated first to properties with unrealized depreciation in proportion to their respective amounts of unrealized depreciation before such decrease (but only to the extent of each property's unrealized depreciation). Any remaining decrease must be allocated among the properties within the class in proportion to their adjusted bases (as adjusted under the preceding sentence).

(3) *Limitation in decrease of basis*. Where a decrease in the basis of partnership assets is required under section 734(b)(2) and the amount of the decrease exceeds the adjusted basis to the partnership of property of the required character, the basis of such property is reduced to zero (but not below zero).

(4) *Carryover adjustment*. Where, in the case of a distribution, an increase or a decrease in the basis of undistributed property cannot be made because the partnership owns no property of the character required to be adjusted, or because the basis of all the property of a like character has been reduced to zero, the adjustment is made when the partnership subsequently acquires property of a like character to which an adjustment can be made.

(5) *Example*. The following example illustrates this paragraph (c):

Example. (i) A, B, and C form equal partnership PRS. A contributes $50,000 and Asset 1, capital gain property with a fair market value of $50,000 and an adjusted tax basis of $25,000. B and C each contributes $100,000. PRS uses the cash to purchase Assets 2, 3, 4, 5, and 6. Assets 4, 5, and 6 are the only assets held by the partnership which are subject to section 751. The partnership has an election in effect under section 754. After seven years, the adjusted basis and fair market value of PRS's assets are as follows:

Assets

	Adjusted Basis	Fair Market Value
Capital Gain Property:		
Asset 1	$ 25,000	$ 75,000
Asset 2	100,000	117,500
Asset 3	50,000	60,000
Ordinary Income Property:		
Asset 4	$ 40,000	$ 45,000
Asset 5	50,000	60,000
Asset 6	10,000	2,500
Total	$275,000	$360,000

(ii) *Allocation between classes*. Assume that PRS distributes Assets 3 and 5 to A in complete liquidation of A's interest in the partnership. A's basis in the partnership interest was $75,000. The partnership's basis in Assets 3 and 5 was $50,000 each. A's $75,000 basis in its partnership interest is allocated between Assets 3 and 5 under sections 732(b) and (c). A will, therefore, have a basis of $25,000 in Asset 3 (capital gain property), and a basis of $50,000 in Asset 5 (section 751 property). The distribution results in a $25,000 increase in the basis of capital gain property. There is no change in the basis of ordinary income property.

(iii) *Allocation within class*. The amount of the basis increase to capital gain property is $25,000 and must be allocated among the remaining capital gain assets in proportion to the difference between the fair market value and basis of each. The fair market value of Asset 1 exceeds its basis by $50,000. The fair market value of Asset 2 exceeds its basis by $17,500. Therefore, the basis of Asset 1 will be increased by $18,519 ($25,000, multiplied by $50,000, divided by $67,500), and the basis of Asset 2 will be increased by $6,481 ($25,000 multiplied by $17,500, divided by $67,500).

(d) *Effective date*. This section applies to transfers of partnership interests and distributions of property from a partnership that occur on or after December 15, 1999.

Par. 9. Section 1.1017-1 is amended by:

1. Revising paragraph (g)(2)(iv).

2. Adding paragraph (g)(2)(v).

The addition and revision read as follows:

§1.1017-1 Basis reductions following a discharge of indebtedness.

* * * * *

(g) * * *

(2) * * *

(iv) *Partner's share of partnership basis*—(A) *In general*. For purposes of this paragraph (g), a partner's proportionate share of the partnership's basis in depreciable property (or depreciable real property) is equal to the sum of—

(1) The partner's section 743(b) basis adjustments to items of partnership depreciable property (or depreciable real property); and

(2) The common basis depreciation deductions (but not including remedial allocations of depreciation deductions under §1.704-3(d)) that, under the terms of the partnership agreement effective for the taxable year in which the discharge of indebtedness occurs, are reasonably expected to be allocated to the partner over the property's remaining useful life. The assumptions made by a partnership in determining the reasonably expected allocation of depreciation deductions must be consistent for each partner. For example, a partnership may not treat the same depreciation deductions as being reasonably expected by more than one partner.

(B) *Effective date*. This paragraph (g)(2)(iv) applies to elections made under sections 108(b)(5) and 108(c) on or after December 15, 1999.

(v) *Treatment of basis reduction*—(A) *Basis adjustment*. The amount of the reduction to the basis of depreciable partnership property constitutes an adjustment to the basis of partnership property with respect to the partner only. No adjustment is made to the common basis of partnership property. Thus, for purposes of income, deduction, gain, loss, and distribution, the partner will have a special basis for those partnership properties the bases of which are adjusted under section 1017 and this section.

(B) *Recovery of adjustments to basis of partnership property*. Adjustments to the basis of partnership property under this section are recovered in the manner described in §1.743-1.

(C) *Effect of basis reduction*. Adjustments to the basis of partnership property under this section are treated in the same manner and have the same effect as an adjustment to the basis of partnership property under section 743(b). The following example illustrates this paragraph (g)(2)(v):

Example. (i) A, B, and C are equal partners in partnership PRS, which owns (among other things) Asset 1, an item of depreciable property with a basis of $30,000. A's basis in its partnership interest is $20,000. Under the terms of the partnership agreement, A's share of the depreciation deductions from Asset 1 over its remaining useful life will be $10,000. Under section 1017, A requests, and PRS agrees, to decrease the basis of Asset 1 with respect to A by $10,000.

(ii) In the year following the reduction of basis under section 1017, PRS amends its partnership agreement to provide that items of depreciation and loss from Asset 1 will be allocated equally between B and C. In that year, A's distributive share of the partnership's common basis depreciation deductions from Asset 1 is now $0. Under §1.743-1(j)(4)(ii)(B), the amount of the section 1017 basis adjustment that A recovers during the year is $1,000. A will report $1,000 of ordinary income because A's distributive share of the partnership's common basis depreciation deductions from Asset 1 ($0) is insufficient to offset the amount of the section 1017 basis adjustment recovered by A during the year ($1,000).

(iii) In the following year, PRS sells Asset 1 for $15,000 and recognizes a $12,000 loss. This loss is allocated equally between B and C, and A's share of the loss is $0. Upon the sale of Asset 1, A recovers its entire remaining section 1017 basis adjustment ($9,000). A will report $9,000 of ordinary income.

(D) *Effective date*. This paragraph (g)(2)(v) applies to elections made under sections 108(b)(5) and 108(c) on or after December 15, 1999.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 10. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 11. In §602.101, paragraph (b) is amended by

revising the entries for 1.732-1 and 1.743-1 in the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.732-1	1545–0099 1545–1588
* * * * *	
1.732-1	1545–0074 1545–1588
* * * *	

David A. Mader,
Acting Deputy Commissioner of Internal Revenue.

Approved November 29, 1999

Jonathan Talisman,
Acting Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on December 14, 1999, 8:45 a.m., and published in the issue of the Federal Register for December 15, 1999, 64 F.R. 69903)

Section 1361.—S Corporation Defined

26 CFR 1.1361–1: S corporation defined.

If a state law limited partnership elects under § 301.7701–3 to be classified as an association taxable as a corporation, does the entity have more than one class of stock for purposes of § 1361(b)(1)(D)? See Rev. Proc. 99–51, page 760.

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26 CFR 601.901: Missing children shown on penalty mail.

T.D. 8848

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 601

Use of Penalty Mail in the Location and Recovery of Missing Children

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Procedural rules.

SUMMARY: This rule establishes the procedures under which the IRS may use penalty mail to aid in the location and recovery of missing children. The IRS can participate in this cause as a result of the Juvenile Justice and Delinquency Prevention Act of 1974. Printing pictures and biographical data of missing children on blank pages of annual tax forms and instructions, taxpayer information publications, and other IRS products will assist the National Center for Missing and Exploited Children (National Center).

DATES: Effective Date: These regulations are effective December 13, 1999

Applicability Date: For dates of applicability of these regulations, see §601.901 (e).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Randall Hall, (202) 283-7900. Concerning the IRS' forms and publications program, Sandy Kopta, (202) 622-3726 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

On August 9, 1985, Congress enacted Public Law 99–87, 99 Stat. 290, which added a new section 3220 to title 39, United States Code. That provision authorized Federal agencies to place photographs and biographical data of missing children on penalty mail in accordance with guidelines promulgated by the Department of Justice. On December 1, 1997, Congress amended the statute to provide that the use of missing children photographs and biographical data on penalty mail would be continued until December 31, 2002.

The Office of Juvenile Justice and Delinquency Prevention (OJJDP) within the Department of Justice is directed by 39 U.S.C. 3220 (a) (1), after consultation with appropriate public and private agencies, to prescribe general guidelines under which penalty mail may be used to assist in the location and recovery of missing children. These guidelines were published on November 8, 1985 (50 FR 46622). In addition, each executive department of the Government of the United States is required by 39 U.S.C. 3220 (a) (2) to promulgate or authorize subunits to promulgate regulations under which penalty mail sent by such departments may be used in conformance with the OJJDP guidelines.

This rule is being promulgated in compliance with 39 U.S.C. 3220 (a)(2) and is in conformance with the OJJDP guidelines. The rule sets forth information on U.S. Postal Service restrictions on the placement of information, "shelf-life" restrictions on the use of missing children information, and other applicable administrative factors.

The IRS will receive photographic and biographical information on missing children through the National Center. The IRS will then give priority to the use of missing children information in mail addressed to members of the public.

Findings and Other Matters

The Commissioner has determined that notice and prior public procedure are not required for this regulation because the subject matter of the regulation pertains only to the IRS's use of penalty mail in the location and recovery of missing children. The regulation does not directly affect the rights and interests of the general public. For these reasons, the rule is to be effective on the date of publication in the Federal Register.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553 (b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. Chapter 6) does not apply. Pursuant to section 7805 (f) of the Internal Revenue Code, this statement of procedural rule will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of this statement of procedural rule is Randall Hall, Office of Chief Counsel (General Legal Services). However, other personnel from the IRS participated in its development.

* * * * *

Adoption of Amendments to the Statement of Procedural Rules

Accordingly, 26 CFR part 601 is amended as follows:

PART 601–STATEMENT OF PROCEDURAL RULES

Paragraph 1. The authority citation for part 601 is revised to read as follows:

Authority: 5 U.S.C. 301 and 552, unless otherwise noted.

Subpart I also issued under 39 U.S.C.

3220.

Par. 2. Subpart I, consisting of §601.901, is added to read as follows:

Subpart I–Use of Penalty Mail in the Location and Recovery

of Missing Children

§601.901 Missing children shown on penalty mail.

(a) *Purpose.* To support the national effort to locate and recover missing children, the Internal Revenue Service (IRS) joins other executive departments and agencies of the Government of the United States in using official mail to disseminate photographs and biographical information on hundreds of missing children.

(b) *Procedures for obtaining and disseminating data.* (1) The IRS shall publish pictures and biographical data related to missing children in domestic penalty mail containing annual tax forms and instructions, taxpayer information publications, and other IRS products directed to members of the public in the United States and its territories and possessions.

(2) Missing children information shall not be placed on the "Penalty Indicia," "OCR Read Area," "Bar Code Read Area," and "Return Address" areas of letter-size envelopes.

(3) The IRS shall accept photographic and biographical materials solely from the National Center for Missing and Exploited Children (National Center). Photographs that were reasonably current as of the time of the child's disappearance, or those which have been updated to reflect a missing child's current age through computer enhancement technique, shall be the only acceptable form of visual media or pictorial likeness used in penalty mail.

(c) *Withdrawal of data.* The shelf life of printed penalty mail is limited to 3 months for missing child cases. The IRS shall follow those guidelines whenever practicable. For products with an extended shelf life, such as those related to filing and paying taxes, the IRS will not print any pictures or biographical data relating to missing children without obtaining from the National Center a waiver of the 3-month shelf-life guideline.

(d) *Reports and contact official.* IRS shall compile and submit to OJJDP reports on its experience in implementing Public Law 99–87, 99 Stat. 290, as required by that office. The IRS contact person is: Chief, Business Publications Section (or successor office), Tax Forms and Publications Division, Technical Publications Branch, OP:FS:FP:P:3, Room 5613, Internal Revenue Service, 1111 Constitution Ave., N.W., Washington, DC 20224.

(e) *Period of applicability.* This section is applicable December 13, 1999 through December 31, 2002.

Robert E. Wenzel,
Deputy Commissioner
of Internal Revenue.

(Filed by the Office of the Federal Register on December 10, 1999, 8:45 a.m., and published in the issue of the Federal Register for December 13, 1999, 64 F.R. 69398)

Part III. Administrative, Procedural, and Miscellaneous

26 CFR 601.204: Changes in accounting periods and in methods of accounting.
(Also Part I, §§ 56, 162, 165, 166, 167, 168, 171, 174, 197, 263, 263A, 404, 446, 451, 454, 455, 461, 471, 472, 475, 481, 585, 1272, 1273, 1278, 1281, 1363; 1.165–2, 1.167(a)–11, 1.167(e)–1, 1.171–4, 1.174–1, 1.174–3, 1.174–4, 1.263(a)–2, 1.263A–1, 1.263A–3, 1.446–1, 1.446–2, 1.451–1, 1.454–1, 1.455–6, 1.461–4, 1.461–5, 1.471–1, 1.471–2, 1.471–3, 1.472–6, 1.472–8, 1.481–1, 1.481–4, 1.1272–1, 1.1273–1, 1.1273–2.)

Rev. Proc. 99–49

SECTION 1. PURPOSE

This revenue procedure provides the procedures by which a taxpayer may obtain automatic consent to change the methods of accounting described in the APPENDIX of this revenue procedure. This revenue procedure clarifies, modifies, amplifies, and supersedes Rev. Proc. 98–60, 1998–51 I.R.B. 16. It also consolidates automatic consent procedures for changes in several methods of accounting that were published subsequent to the publication of Rev. Proc. 98–60, and provides new automatic consent procedures for changes in several other methods of accounting. A taxpayer complying with all the applicable provisions of this revenue procedure has obtained the consent of the Commissioner of Internal Revenue to change its method of accounting under § 446(e) of the Internal Revenue Code and the Income Tax Regulations thereunder.

SECTION 2. BACKGROUND AND CHANGES

.01 *Change in method of accounting defined.*

(1) Section 1.446–1(e)(2)(ii)(a) of the Income Tax Regulations provides that a change in method of accounting includes a change in the overall plan of accounting for gross income or deductions, or a change in the treatment of any material item. A material item is any item that involves the proper time for the inclusion of the item in income or the taking of the item as a deduction. In determining whether a taxpayer's accounting practice for an item involves timing, generally the relevant question is whether the practice permanently changes the amount of the taxpayer's lifetime income. If the practice does not permanently affect the taxpayer's lifetime income, but does or could change the taxable year in which income is reported, it involves timing and is therefore a method of accounting. *See* Rev. Proc. 91–31, 1991–1 C.B. 566.

(2) Although a method of accounting may exist under this definition without a pattern of consistent treatment of an item, a method of accounting is not adopted in most instances without consistent treatment. The treatment of a material item in the same way in determining the gross income or deductions in two or more consecutively filed tax returns (without regard to any change in status of the method as permissible or impermissible) represents consistent treatment of that item for purposes of § 1.446–1(e)(2)(ii)(a). If a taxpayer treats an item properly in the first return that reflects the item, however, it is not necessary for the taxpayer to treat the item consistently in two or more consecutive tax returns to have adopted a method of accounting. If a taxpayer has adopted a method of accounting under these rules, the taxpayer may not change the method by amending its prior income tax return(s). *See* Rev. Rul. 90–38, 1990–1 C.B. 57.

(3) A change in the characterization of an item may also constitute a change in method of accounting if the change has the effect of shifting income from one period to another. For example, a change from treating an item as income to treating the item as a deposit is a change in method of accounting. *See* Rev. Proc. 91–31.

(4) A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability (such as errors in computation of the foreign tax credit, net operating loss, percentage depletion, or investment credit). *See* § 1.446–1(e)(2)(ii)(b).

.02 *Securing permission to make a method change.* Sections 446(e) and 1.446–1(e) state that, except as otherwise provided, a taxpayer must secure the consent of the Commissioner before changing a method of accounting for federal income tax purposes. Section 1.446–1(e)(3)(i) requires that, in order to obtain the Commissioner's consent to a method change, a taxpayer must file a Form 3115, Application for Change in Accounting Method, during the taxable year in which the taxpayer wants to make the proposed change.

.03 *Terms and conditions of a method change.* Section 1.446–1(e)(3)(ii) authorizes the Commissioner to prescribe administrative procedures setting forth the limitations, terms, and conditions deemed necessary to permit a taxpayer to obtain consent to change a method of accounting in accordance with § 446(e). The terms and conditions the Commissioner may prescribe include the year of change, whether the change is to be made with a § 481(a) adjustment or on a cut-off basis, and the § 481(a) adjustment period.

.04 *No retroactive method change.* Unless specifically authorized by the Commissioner, a taxpayer may not request, or otherwise make, a retroactive change in method of accounting, regardless of whether the change is from a permissible or an impermissible method. *See generally* Rev. Rul. 90–38.

.05 *Method change with a § 481(a) adjustment.*

(1) *Need for adjustment.* Section 481(a) requires those adjustments necessary to prevent amounts from being duplicated or omitted to be taken into account when the taxpayer's taxable income is computed under a method of accounting different from the method used to compute taxable income for the preceding taxable year. When there is a change in method of accounting to which § 481(a) is applied, income for the taxable year preceding the year of change must be determined under the method of accounting that was then employed, and income for the year of change and the following taxable years must be determined under the new method of accounting as if the new method had always been used.

Example. A taxpayer that is not required to use inventories uses the overall cash receipts and disbursements method and changes to an overall accrual method. The taxpayer has $120,000 of income earned but not yet received (accounts receivable) and $100,000 of expenses incurred but not yet paid (accounts payable) as of the end of the taxable year preceding the year of change. A positive § 481(a) adjustment of $20,000 ($120,000 accounts receivable less $100,000 accounts payable) is required as a result of the change.

(2) *Adjustment period.* Section 481(c) and §§ 1.446–1(e)(3)(ii) and 1.481–4 provide that the adjustment required by § 481(a) may be taken into account in determining taxable income in

the manner and subject to the conditions agreed to by the Commissioner and the taxpayer. Generally, in the absence of such an agreement, the § 481(a) adjustment is taken into account completely in the year of change, subject to § 481(b) which limits the amount of tax where the § 481(a) adjustment is substantial. However, under the Commissioner's authority in § 1.446–1(e)(3)(ii) to prescribe terms and conditions for changes in methods of accounting, this revenue procedure provides specific adjustment periods that are intended to achieve an appropriate balance between the goals of mitigating distortions of income that result from accounting method changes and providing appropriate incentives for voluntary compliance.

.06 *Method change using a cut-off method.* The Commissioner may determine that certain changes in methods of accounting will be made without a § 481(a) adjustment, using a "cut-off method." Under a cut-off method, only the items arising on or after the beginning of the year of change (or other operative date) are accounted for under the new method of accounting. Any items arising before the year of change (or other operative date) continue to be accounted for under the taxpayer's former method of accounting. See, for example, § 263A (which generally applies to costs incurred after December 31, 1986, for noninventory property), § 461(h) (which generally applies to amounts incurred on or after July 18, 1984), and § 1.446–3 (which applies to notional principal contracts entered into on or after December 13, 1993). Because no items are duplicated or omitted from income when a cut-off method is used to effect a change in accounting method, no § 481(a) adjustment is necessary.

.07 *Consistency and clear reflection of income.* Methods of accounting should clearly reflect income on a continuing basis, and the Internal Revenue Service exercises its discretion under §§ 446(e) and 481(c) in a manner that generally minimizes distortions of income across taxable years and on an annual basis.

.08 *Separate trades or businesses.*

(1) Sections 1.446–1(d)(1) and (2) provide that when a taxpayer has two or more separate and distinct trades or businesses, a different method of accounting may be used for each trade or business provided the method of accounting used for each trade or business clearly reflects the overall income of the taxpayer as well as that of each particular trade or business. No trade or business is separate and distinct unless a complete and separable set of books and records is kept for that trade or business.

(2) Section 1.446–1(d)(3) provides that if, by reason of maintaining different methods of accounting, there is a creation or shifting of profits or losses between the trades or businesses of the taxpayer (for example, through inventory adjustments, sales, purchases, or expenses) so that income of the taxpayer is not clearly reflected, the trades or businesses of the taxpayer are not separate and distinct.

.09 *Penalties.* Any otherwise applicable penalty for the failure of a taxpayer to change its method of accounting (for example, the accuracy-related penalty under § 6662 or the fraud penalty under § 6663) may be imposed if the taxpayer does not timely file a request to change a method of accounting. *See* § 446(f). Additionally, the taxpayer's return preparer may also be subject to the preparer penalty under § 6694. However, penalties will not be imposed when a taxpayer changes from an impermissible method of accounting to a permissible one by complying with all applicable provisions of this revenue procedure.

.10 *Change made as part of an examination.* Sections 446(b) and 1.446–1(b)(1) provide that if a taxpayer does not regularly employ a method of accounting that clearly reflects its income, the computation of taxable income must be made in a manner that, in the opinion of the Commissioner, does clearly reflect income. If a taxpayer under examination is not eligible to change a method of accounting under this revenue procedure, the change may be made by the district director. A change resulting in a positive § 481(a) adjustment will ordinarily be made in the earliest taxable year under examination with a one-year § 481(a) adjustment period.

.11 *Significant changes.* Significant changes to Rev. Proc. 98–60 include:

(1) The term "district director" is now defined in new section 3.11 to include the district director or other appropriate examining office or official. This change was made to accommodate anticipated future changes in the organizational structure of the Internal Revenue Service.

(2) Section 4.02 is modified by the addition of section 4.02(8), which provides that this revenue procedure does not apply if the taxpayer would be required to accelerate the § 481(a) adjustment in the year of change. This scope limitation does not apply to changes of accounting method under sections 2.01 and 2.02 of the APPENDIX of this revenue procedure.

(3) The additional statement required by section 6.02(5) of Rev. Proc. 98–60 has been discontinued. Elimination of this statement does not otherwise change the responsibility of a taxpayer seeking automatic consent to comply with all the applicable provisions of this revenue procedure. See sections 5.01, 6.01, 6.06 and 10.04(1) of this revenue procedure.

(4) Section 6.03(4) clarifies that the office conducting the examination gives consent to the filing of the application, rather than to the change itself. This is consistent with the current authority of such office, upon examination, to deny the change if the taxpayer fails to comply with all the applicable provisions of this revenue procedure. *See* section 6.06 of this revenue procedure.

(5) Sections 2.01 and 2.02 of the APPENDIX are modified to include certain changes in method of accounting for depreciation or amortization for purposes of computing alternative minimum taxable income and adjusted current earnings under § 56.

(6) Section 5.01 of the APPENDIX is modified to permit a taxpayer required to use an inventory method of accounting to change to an overall accrual method, provided the taxpayer uses a proper inventory method and either is a small reseller or is eligible to use the simplified resale method;

(7) Section 5.01 of the APPENDIX is modified to provide that the change does not apply to a taxpayer with two or more trades or businesses, unless the taxpayer uses or adopts the same overall accrual method for each such trade or business.

(8) Section 8.04 of the APPENDIX is modified to include changes in the method of accounting for state unemployment taxes and railroad retirement taxes.

(9) The following changes in methods of accounting have been added to the

APPENDIX of this revenue procedure:

(a) Section 1A.01 of the APPENDIX regarding the revocation of a § 171(c) election;

(b) Section 4A.01 of the APPENDIX regarding deferred compensation;

(c) Section 5A.01 of the APPENDIX regarding accrual of interest on nonperforming loans;

(d) Sections 8A.01, 8A.02, and 8A.03 of the APPENDIX regarding § 467 rental agreements;

(e) Section 10A.02 regarding elections to use the mark-to-market method of accounting under § 475(e) or (f).

(f) Section 12A.01 of the APPENDIX regarding the revocation of a § 1278(b) election.

SECTION 3. DEFINITIONS

.01 *Application.* The term "application" includes a Form 3115, or any statement that is authorized under the APPENDIX of this revenue procedure to be filed in lieu of a Form 3115, and any attachments.

.02 *Taxpayer*.

(1) *In general.* The term "taxpayer" has the same meaning as the term "person" defined in § 7701(a)(1) (rather than the meaning of the term "taxpayer" defined in § 7701(a)(14)).

(2) *Consolidated group*. For purposes of (a) sections 3.08(1), 3.09(1), and 4.02(1) of this revenue procedure (taxpayer under examination), (b) sections 3.09(2) and 4.02(2) of this revenue procedure (taxpayer before an appeals office), or (c) sections 3.09(3) and 4.02(3) of this revenue procedure (taxpayer before a federal court), the term "taxpayer" includes a consolidated group.

.03 *Filed.* Any form (including an application), statement, or other document required to be filed under this revenue procedure is filed on the date it is mailed to the proper address (or an address similar enough to complete delivery). If the form, statement, or other document is not mailed (or the date it is mailed cannot be reasonably determined), it is filed on the date it is delivered to the Service.

.04 *Mailed.* The date of mailing will be determined under the rules of § 7502. For example, the date of mailing is the date of the U.S. postmark or the applicable date recorded or marked by a designated private delivery service. *See* Notice 99– 41, 1999–35 I.R.B. 325.

.05 *Timely performance of acts.* The rules of § 7503 apply when the last day for the taxpayer's timely performance of any act (for example, filing an application or submitting additional information) falls on a Saturday, Sunday, or legal holiday. The performance of any act is timely if the act is performed on the next succeeding day that is not a Saturday, Sunday, or legal holiday.

.06 *Year of change*. The year of change is the taxable year for which a change in method of accounting is effective, that is, the first taxable year the new method is to be used, even if no affected items are taken into account for that year.

.07 *Section 481(a) adjustment period*. The § 481(a) adjustment period is the applicable number of taxable years for taking into account the § 481(a) adjustment required as a result of the change in method of accounting. The year of change is the first taxable year in the adjustment period and the § 481(a) adjustment is taken into account ratably over the number of taxable years in the adjustment period. The applicable adjustment periods are set forth in section 5.04 of this revenue procedure.

.08 *Under examination.*

(1) *In general.*

(a) Except as provided in section 3.08(2) of this revenue procedure, an examination of a taxpayer with respect to a federal income tax return begins on the date the taxpayer is contacted in any manner by a representative of the Service for the purpose of scheduling any type of examination of the return. An examination ends:

(i) in a case in which the Service accepts the return as filed, on the date of the "no change" letter sent to the taxpayer;

(ii) in a fully agreed case, on the earliest of the date the taxpayer executes a waiver of restrictions on assessment or acceptance of overassessment (for example, Form 870, 4549, or 4605), the date the taxpayer makes a payment of tax that equals or exceeds the proposed deficiency, or the date of the "closing" letter (for example, Letter 891 or 987) sent to the taxpayer; or

(iii) in an unagreed or a partially agreed case, on the earliest of the date the taxpayer (or its representative) is notified by Appeals that the case has been referred by the examining agent(s) to Appeals, the date the taxpayer files a petition in the Tax Court, the date on which the period for filing a petition with the Tax Court expires, or the date of the notice of claim disallowance.

(b) An examination does not end as a result of the early referral of an issue to Appeals under the provisions of Rev. Proc. 96–9, 1996–1 C.B. 575.

(c) An examination resumes on the date the taxpayer (or its representative) is notified by Appeals (or otherwise) that the case has been referred to the examining agent(s) for reconsideration.

(2) *Partnerships and S corporations subject to TEFRA.* For an entity (including a limited liability company), treated as a partnership or an S corporation for federal income tax purposes, that is subject to the TEFRA unified audit and litigation provisions for partnerships and S corporations, an examination begins on the date of the notice of the beginning of an administrative proceeding sent to the Tax Matters Partner/Tax Matters Person (TMP). An examination ends:

(a) in a case in which the Service accepts the partnership or S corporation return as filed, on the date of the "no adjustments" letter or the "no change" notice of final administrative adjustment sent to the TMP;

(b) in a fully agreed case, when all the partners, members, or shareholders execute a Form 870–P, 870-L, or 870-S; or

(c) in an unagreed or a partially agreed case, on the earliest of the date the TMP (or its representative) is notified by Appeals that the case has been referred by the examining agent(s) to Appeals, the date the TMP (or a partner, member, or shareholder) requests judicial review, or the date on which the period for requesting judicial review expires. But see section 4.02(5) of this revenue procedure for certain rules that preclude an entity from requesting a change in accounting method. Also note that S corporations are not subject to the TEFRA unified audit and litigation provisions for taxable years beginning after December 31, 1996. *See* Small Business Job Protection Act of 1996, Pub. L. No. 104–188, § 1317(a), 110 Stat. 1755, 1787 (1996).

.09 *Issue under consideration.*

(1) *Under examination.* A taxpayer's

method of accounting for an item is an issue under consideration for the taxable years under examination if the taxpayer receives written notification (for example, by examination plan, information document request (IDR), or notification of proposed adjustments or income tax examination changes) from the examining agent(s) specifically citing the treatment of the item as an issue under consideration. For example, a taxpayer's method of pooling under the dollar-value, last-in, first-out (LIFO) inventory method is an issue under consideration as a result of an examination plan that identifies LIFO pooling as a matter to be examined, but it is not an issue under consideration as a result of an examination plan that merely identifies LIFO inventories as a matter to be examined. Similarly, a taxpayer's method of determining inventoriable costs under § 263A is an issue under consideration as a result of an IDR that requests documentation supporting the costs included in inventoriable costs, but it is not an issue under consideration as a result of an IDR that requests documentation supporting the amount of cost of goods sold reported on the return. The question of whether a method of accounting is an issue under consideration may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 99–2, 1999–1 I.R.B. 73 (or any successor).

(2) *Before an appeals office*. A taxpayer's method of accounting for an item is an issue under consideration for the taxable years before an appeals office if the treatment of the item is included as an item of adjustment in the examination report referred to Appeals or is specifically identified in writing to the taxpayer by Appeals.

(3) *Before a federal court*. A taxpayer's method of accounting for an item is an issue under consideration for the taxable years before a federal court if the treatment of the item is included in the statutory notice of deficiency, the notice of claim disallowance, the notice of final administrative adjustment, the pleadings (for example, the petition, complaint, or answer) or amendments thereto, or is specifically identified in writing to the taxpayer by the counsel for the government.

.10 *Change within the LIFO inventory method.* A change within the LIFO inventory method is a change from one LIFO inventory method or sub-method to another LIFO inventory method or sub-method. A change within the LIFO inventory method does not include a change in method of accounting that could be made by a taxpayer that does not use the LIFO inventory method (for example, a method governed by § 471 or 263A).

.11 *District director*. The term "district director" includes the district director or other appropriate examining office or official.

SECTION 4. SCOPE

.01 *Applicability.* This revenue procedure applies to a taxpayer requesting the Commissioner's consent to change to a method of accounting described in the APPENDIX of this revenue procedure. This revenue procedure is the exclusive procedure for a taxpayer within its scope to obtain the Commissioner's consent.

.02 *Inapplicability.* Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, sections 4.01, 4A.01, 5.04, 8.05, 9.02, 10A.01, 12.01, and 12.02 of the APPENDIX of this revenue procedure), this revenue procedure does not apply in the following situations:

(1) *Under examination*. If, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is under examination (as provided in section 3.08 of this revenue procedure), except as provided in sections 6.03(2) (90-day window), 6.03(3) (120-day window), and 6.03(4) (examination officials consent) of this revenue procedure;

(2) *Before an appeals office*. If, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is before an appeals office with respect to any income tax issue and the method of accounting to be changed is an issue under consideration by the appeals office (as provided in section 3.09(2) of this revenue procedure);

(3) *Before a federal court*. If, on the date the taxpayer would otherwise file a copy of the application with the national office, the taxpayer is before a federal court with respect to any income tax issue and the method of accounting to be changed is an issue under consideration by the federal court (as provided in section 3.09(3) of this revenue procedure);

(4) *Consolidated group member.* A corporation that is (or was formerly) a member of a consolidated group is under examination, before an appeals office, or before a federal court (for purposes of sections 4.02(1), (2), and (3) of this revenue procedure) if the consolidated group is under examination, before an appeals office, or before a federal court for a taxable year(s) that the corporation was a member of the group;

(5) *Partnerships and S corporations*. For an entity (including a limited liability company) treated as a partnership or an S corporation for federal income tax purposes, if, on the date the entity would otherwise file a copy of the application with the national office, the entity's accounting method to be changed is an issue under consideration in an examination of a partner, member, or shareholder's federal income tax return or an issue under consideration by an appeals office or by a federal court with respect to a partner, member, or shareholder's federal income tax return;

(6) *Prior change*. If the taxpayer, within the last five taxable years (including the year of change), (a) has made a change in the same method of accounting (with or without obtaining the Commissioner's consent), or (b) has applied to change the same method of accounting without effecting the change (whether, for example, the application to change was withdrawn, not perfected, not granted, or denied);

(7) *Section 381(a) transaction*. If the taxpayer engages in a transaction to which § 381(a) applies within the proposed taxable year of change (determined without regard to any potential closing of the year under § 381(b)(1)); or

(8) *Final year of trade or business*. If the taxpayer would be required by section 5.04(3)(c) of this revenue procedure to take the entire amount of the § 481(a) adjustment into account in computing taxable income for the year of change.

.03 *Nonautomatic changes.* If a taxpayer is precluded by other than sections 4.02(1) through 4.02(5) of this revenue procedure from using this revenue procedure to make a change in method of accounting, the taxpayer requesting such a change must file a Form 3115 with the Commissioner in accordance with the requirements of § 1.446–1(e)(3)(i) and Rev. Proc. 97–27, 1997–1 C.B. 680 (or any other applicable Code, regulation, or administrative provision).

SECTION 5. TERMS AND CONDITIONS OF CHANGE

.01 *In general.* An accounting method change filed under this revenue procedure must be made pursuant to the terms and conditions provided in this revenue procedure.

.02 *Year of change.* The year of change is the taxable year designated on the application and for which the application is timely filed under section 6.02(2).

.03 *Section 481(a) adjustment.* Unless otherwise provided in this revenue procedure, a taxpayer making a change in method of accounting under this revenue procedure must take into account a § 481(a) adjustment in the manner provided in section 5.04 of this revenue procedure.

.04 *Section 481(a) adjustment period.*

(1) *In general.* Except as otherwise provided in section 5.04(3) or the APPENDIX of this revenue procedure, the § 481(a) adjustment period for positive and negative § 481(a) adjustments is four taxable years.

(2) *Short period as a separate taxable year.* If the year of change, or any taxable year during the § 481(a) adjustment period, is a short taxable year, the § 481(a) adjustment must be included in income as if that short taxable year were a full 12-month taxable year. *See* Rev. Rul. 78–165, 1978–1 C.B. 276.

Example 1. A calendar year taxpayer received permission to change an accounting method beginning with the 1999 calendar year. The § 481(a) adjustment is $30,000 and the adjustment period is four taxable years. The taxpayer subsequently receives permission to change its annual accounting period to September 30, effective for the taxable year ending September 30, 2000. The taxpayer must include $7,500 of the § 481(a) adjustment in gross income for the short period from January 1, 2000, through September 30, 2000.

Example 2. Corporation *X*, a calendar year taxpayer, received permission to change an accounting method beginning with the 1999 calendar year. The § 481(a) adjustment is $30,000 and the adjustment period is four taxable years. On July 1, 2001, Corporation *Z* acquires Corporation *X* in a transaction to which § 381(a) applies. Corporation *Z* is a calendar year taxpayer that uses the same method of accounting to which Corporation *X* changed in 1999. Corporation *X* must include $7,500 of the § 481(a) adjustment in gross income for its short period income tax return for January 1, 2001, through June 30, 2001. In addition, Corporation *Z* must include $7,500 of the § 481(a) adjustment in gross income in its income tax return for calendar year 2001.

(3) *Shortened or accelerated adjustment periods*. The § 481(a) adjustment period provided in section 5.04(1) or the APPENDIX of this revenue procedure will be shortened or accelerated in the following situations.

(a) *De minimis rule*. A taxpayer may elect to use a one-year adjustment period in lieu of the § 481(a) adjustment period otherwise provided by this revenue procedure if the entire § 481(a) adjustment is less than $25,000 (either positive or negative). A taxpayer makes an election under this *de minimis* rule by so indicating on the application. For example, for a taxpayer filing a Form 3115, the taxpayer must complete the appropriate line on the Form 3115 to elect this *de minimis* rule.

(b) *Cooperatives.* A cooperative within the meaning of § 1381(a) generally must take the entire amount of a § 481(a) adjustment into account in computing taxable income for the year of change. *See* Rev. Rul. 79–45, 1979–1 C.B. 284.

(c) *Ceasing to engage in the trade or business.*

(i) *In general.* A taxpayer that ceases to engage in a trade or business or terminates its existence must take the remaining balance of any § 481(a) adjustment relating to the trade or business into account in computing taxable income in the taxable year of the cessation or termination. Except as provided in sections 5.04(3)(c)(iv) and (v) of this revenue procedure, a taxpayer is treated as ceasing to engage in a trade or business if the operations of the trade or business cease or substantially all the assets of the trade or business are transferred to another taxpayer. For this purpose, "substantially all" has the same meaning as in section 3.01 of Rev. Proc. 77–37, 1977–2 C.B. 568.

(ii) *Examples of transactions that are treated as the cessation of a trade or business*. The following is a nonexclusive list of transactions that are treated as the cessation of a trade or business for purposes of accelerating the § 481(a) adjustment under section 5.04(3)(c) of this revenue procedure:

(A) the trade or business to which the § 481(a) adjustment relates is incorporated;

(B) the trade or business to which the § 481(a) adjustment relates is purchased by another taxpayer in a transaction to which § 1060 applies;

(C) the trade or business to which the § 481(a) adjustment relates is terminated or transferred pursuant to a taxable liquidation;

(D) a division of a corporation ceases to operate the trade or business to which the § 481(a) adjustment relates; or

(E) the assets of a trade or business to which the § 481(a) adjustment relates are contributed to a partnership.

(iii) *Conversion to or from S corporation status*. Except as provided in section 10.01 of the APPENDIX of this revenue procedure, no acceleration of a § 481(a) adjustment is required under section 5.04(3)(c) of this revenue procedure when a C corporation elects to be treated as an S corporation or an S corporation terminates its S election and is then treated as a C corporation.

(iv) *Certain transfers to which § 381(a) applies.* No acceleration of the § 481(a) adjustment is required under section 5.04(3)(c) of this revenue procedure when a taxpayer transfers substantially all the assets of the trade or business that gave rise to the § 481(a) adjustment to another taxpayer in a transfer to which § 381(a) applies and the accounting method (the change to which gave rise to the § 481(a) adjustment) is a tax attribute that is carried over and used by the acquiring corporation immediately after the transfer pursuant to § 381(c). The acquiring corporation is subject to any terms and conditions imposed on the transferor (or any predecessor of the transferor) as a result of its change in method of accounting.

(v) *Certain transfers pursuant to § 351 within a consolidated group.*

(A) *In general.* No acceleration of the § 481(a) adjustment is required under section 5.04(3)(c) of this revenue procedure when one member of an affiliated group filing a consolidated return transfers substantially all the assets of the trade or business that gave rise to the § 481(a) adjustment to another member of the same consolidated group in an exchange qualifying under § 351 and the transferee member adopts and uses the same method of accounting (the change to which gave rise to the § 481(a) adjustment) used by the transferor member. The transferor member must continue to take the § 481(a) adjustment into account pursuant to the terms and conditions set forth in this revenue procedure. The transferor member must take into account activities of the transferee member (or any successor) in determining whether acceleration of the § 481(a) adjustment is required. For example, except as provided in the following sentence, the transferor member must take any remaining § 481(a) adjustment into account in computing taxable income in the taxable year in which the transferee member ceases to engage in the trade or business to which the § 481(a) adjustment relates. The § 481(a) adjustment is not accelerated when the transferee member engages in a transaction described in section 5.04(3)(c)(iv) or 5.04(3)(c)(v)(A) of this revenue procedure.

(B) *Exception.* The provisions of section 5.04(3)(c)(v)(A) of this revenue procedure cease to apply and the transferor member must take any remaining balance of the § 481(a) adjustment into account in the taxable year immediately preceding any of the following: (1) the taxable year the transferor member ceases to be a member of the group; (2) the taxable year any transferee member owning substantially all the assets of the trade or business which gave rise to the § 481(a) adjustment ceases to be a member of the group; or (3) a separate return year of the common parent of the group. In applying the preceding sentence, the rules of paragraphs (j)(2), (j)(5), and (j)(6) of § 1.1502–13 apply, but only if the method of accounting to which the transferor member changed and to which the § 481(a) adjustment relates is adopted, carried over, or used by any transferee member acquiring the assets of the trade or business that gave rise to the § 481(a) adjustment immediately after acquisition of such assets. For example, the transferor member is not required to accelerate the § 481(a) adjustment if a transferee member ceases to be a member of a consolidated group by reason of an acquisition to which § 381(a) applies and the acquiring corporation (1) is a member of the same group as the transferor member, and (2) continues, under § 381(c)(4) and the regulations thereunder, to use the same method of accounting as that used by the transferor member with respect to the assets of the trade or business to which the § 481(a) adjustment relates.

.05 *NOL carryback limitation for taxpayer subject to criminal investigation.* Generally, no portion of any net operating loss that is attributable to a negative § 481(a) adjustment may be carried back to a taxable year prior to the year of change that is the subject of any pending or future criminal investigation or proceeding concerning (1) directly or indirectly, any issue relating to the taxpayer's federal tax liability, or (2) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability.

.06 *Change treated as initiated by the taxpayer.* For purposes of § 481, a change in method of accounting made under this revenue procedure is a change in method of accounting initiated by the taxpayer.

SECTION 6. GENERAL APPLICATION PROCEDURES

.01 *Consent.* Pursuant to § 1.446–1(e)(2)(i), the consent of the Commissioner is hereby granted to any taxpayer within the scope of this revenue procedure to change a method of accounting, provided the taxpayer complies with all the applicable provisions of this revenue procedure.

.02 *Filing requirements.*

(1) *Waiver of taxable year filing requirement.* The requirement under § 1.446–1(e)(3)(i) to file a Form 3115 within the taxable year for which the change is requested is waived for any application for a change in method of accounting filed pursuant to this revenue procedure. *See* § 1.446–1(e)(3)(ii).

(2) *Timely duplicate filing requirement.*

(a) *In general*. A taxpayer changing a method of accounting pursuant to this revenue procedure must complete and file an application in duplicate. The original must be attached to the taxpayer's timely filed (including extensions) original federal income tax return for the year of change, and a copy (with signature) of the application must be filed with the national office (see section 6.02(6) of this revenue procedure for the address) no earlier than the first day of the year of change and no later than when the original is filed with the federal income tax return for the year of change.

(b) *Limited relief for late application.*

(i) *Automatic extension.* An automatic extension of 6 months from the due date of the return for the year of change (excluding extensions) is granted to file an application, provided the taxpayer (A) timely filed (including extensions) its federal income tax return for the year of change, (B) files an amended return within the 6-month extension period in a manner that is consistent with the new method of accounting, (C) attaches the original application to the amended return, (D) files a copy of the application with the national office no later than when the original is filed with the amended return, and (E) writes at the top of the application "FILED PURSUANT TO § 301.9100–2."

(ii) *Other extensions.* A taxpayer that fails to file the application for the year of change as provided in section 6.02(2)(a) or 6.02(2)(b)(i) of this revenue procedure will not be granted an extension of time to file under § 301.9100 of the Procedure and Administration Regulations, except in unusual and compelling circumstances. *See* § 301.9100–3(c)(2).

(3) *Label.*

(a) In order to assist in processing an application under this revenue procedure, the section of the APPENDIX of this revenue procedure describing the specific change in method of accounting should be included in the application. For example, a phrase such as "Section 1.01 of the APPENDIX of Rev. Proc. 99–49" should be included on the appropriate line on the Form 3115.

(b) If a taxpayer is authorized under the APPENDIX of this revenue procedure to file a statement in lieu of a Form 3115, the taxpayer must include the taxpayer's name and employer identification number (or social security number in the case of an individual) at the top of the first page of the statement underneath any other required label.

(4) *Signature requirements.* The application must be signed by, or on behalf of, the taxpayer requesting the change by an individual with authority to bind the taxpayer in such matters. For example, an

officer must sign on behalf of a corporation, a general partner on behalf of a state law partnership, a member-manager on behalf of a limited liability company, a trustee on behalf of a trust, or an individual taxpayer on behalf of a sole proprietorship. If the taxpayer is a member of a consolidated group, an application submitted on behalf of the taxpayer must be signed by a duly authorized officer of the common parent. See the signature requirements set forth in the General Instructions attached to a current Form 3115 regarding those who are to sign. If an agent is authorized to represent the taxpayer before the Service, receive the original or a copy of the correspondence concerning the application, or perform any other act(s) regarding the application filed on behalf of the taxpayer, a power of attorney reflecting such authorization(s) must be attached to the application. A taxpayer's representative without a power of attorney to represent the taxpayer as indicated in this section will not be given any information regarding the application.

(5) *Where to file copy.*

(a) For a taxpayer other than an exempt organization, the copy of the application must be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A (Automatic Rulings Branch), P.O. Box 7604, Benjamin Franklin Station, Washington, D.C. 20044 (or, in the case of a designated private delivery service: Commissioner of Internal Revenue, Attention: CC:DOM:IT&A (Automatic Rulings Branch), 1111 Constitution Avenue, NW, Washington, D.C. 20224).

(b) For an exempt organization, the copy of the application must be addressed to the Commissioner, Tax Exempt and Government Entities, Attention: TEGE:EO, P.O. Box 120, Benjamin Franklin Station, Washington, D.C. 20044 (or, in the case of a designated private delivery service: Commissioner, Tax Exempt and Government Entities, Attention: TEGE:EO, 1111 Constitution Avenue, NW, Washington, D.C. 20224).

(c) The copy of the application may also be hand delivered:

(i) To the drop box at the 12th Street entrance of 1111 Constitution Avenue, NW, Washington, D.C. No receipt will be given at the drop box. For a taxpayer other than an exempt organization, the copy of the application must be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A (Automatic Rulings Branch), 1111 Constitution Avenue, NW, Washington, D.C. 20224. For an exempt organization, the copy of the application must be addressed to the Commissioner, Tax Exempt and Government Entities, Attention: TEGE:EO, 1111 Constitution Avenue, NW, Washington, D.C. 20224; or

(ii) Between the hours of 8:15 a.m. and 5:00 p.m., to the courier's desk at the main entrance of 1111 Constitution Avenue, NW, Washington, D.C. A receipt will be given at the courier's desk. For a taxpayer other than an exempt organization, the copy of the application must be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A (Automatic Rulings Branch), 1111 Constitution Avenue, NW, Washington, D.C. 20224. For an exempt organization, the copy of the application must be addressed to the Commissioner, Tax Exempt and Government Entities, Attention: TEGE:EO, 1111 Constitution Avenue, NW, Washington, D.C. 20224

(6) *No user fee.* A user fee is not required for an application filed under this revenue procedure, and, except as provided in section 6.02(6)(c)(ii) of this revenue procedure, the receipt of an application filed under this revenue procedure will not be acknowledged.

(7) *Single application for certain consolidated groups.* A parent corporation may file a single application to change an identical method of accounting on behalf of more than one member of a consolidated group. To qualify, the taxpayers in the consolidated group must be members of the same affiliated group under § 1504(a) that join in the filing of a consolidated tax return, and they must be changing from the identical present method of accounting to the identical proposed method of accounting. All aspects of the change in method of accounting, including the present and proposed methods, the underlying facts, and the authority for the change, must be identical, except for the § 481(a) adjustment. *See* section 15.07(3) of Rev. Proc. 99– 1, 1999–1 I.R.B. 6, 53 (or any successor), for the information required to be submitted with the application.

.03 *Taxpayer under examination.*

(1) *In general.* Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, sections 4.01, 4A.01, 5.04, 8.05, 9.02, 10A.01, 12.01, and 12.02 of the APPENDIX of this revenue procedure), a taxpayer that is under examination may file an application to change a method of accounting under section 6 of this revenue procedure only if the taxpayer is within the provisions of section 6.03(2) (90-day window), 6.03(3) (120-day window), or 6.03(4) (district director consent) of this revenue procedure. A taxpayer that files an application beyond the time periods provided in the 90-day and 120-day windows is not eligible for the automatic extension of time and will not be granted an extension of time to file under § 301.9100, except in unusual and compelling circumstances.

(2) *90-day window period.*

(a) A taxpayer may file a copy of the application with the national office to change a method of accounting under this revenue procedure during the first 90-days of any taxable year (the "90-day window") if the taxpayer has been under examination for at least 12 consecutive months as of the first day of the taxable year. This 90-day window is not available if the method of accounting the taxpayer is changing is an issue under consideration at the time the copy of the application is filed or an issue the examining agent(s) has placed in suspense at the time the copy of the application is filed.

(b) A taxpayer changing a method of accounting under this 90-day window must provide a copy of the application to the examining agent(s) at the same time it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s). The taxpayer must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration or an issue placed in suspense by the examining agent(s).

(3) *120-day window period.*

(a) A taxpayer may file a copy of the application with the national office to change a method of accounting under this revenue procedure during the 120-day period following the date an examination ends (the "120-day window"), regardless of whether a subsequent examination has commenced. This 120-day window is not available if the method of accounting the taxpayer is changing is an issue under consideration at the time a copy of the application is filed or an issue the examining agent(s) has placed in suspense at the time the copy of the application is filed.

(b) A taxpayer changing a method of accounting under this 120-day window must provide a copy of the application to the examining agent(s) for any examination that is in process at the same time it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s). The taxpayer must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration or an issue placed in suspense by the examining agent(s).

(4) *Consent of district director.*

(a) A taxpayer under examination may change its method of accounting under this revenue procedure if the district director consents to the filing of the application. The district director will consent to the filing of the application unless, in the opinion of the district director, the method of accounting to be changed would ordinarily be included as an item of adjustment in the year(s) for which the taxpayer is under examination. For example, the district director will consent to the filing of an application to change from a clearly permissible method of accounting, or from an impermissible method of accounting where the impermissible method was adopted subsequent to the years under examination. The question of whether the method of accounting from which the taxpayer is changing is permissible or was adopted subsequent to the years under examination may be referred to the national office as a request for technical advice under the provisions of Rev. Proc. 99–2 (or any successor).

(b) A taxpayer changing a method of accounting under this revenue procedure with the consent of the district director must attach to the application a statement from the district director consenting to the filing of the application. The taxpayer must provide a copy of the application to the district director at the same time it files a copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s).

.04 *Taxpayer before an appeals office.* Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, sections 4.01, 4A.01, 5.04, 8.05, 9.02, 10A.01, 12.01, and 12.02 of the APPENDIX of this revenue procedure), a taxpayer that is before an appeals office must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration by the appeals office. The taxpayer must provide a copy of the application to the appeals officer at the same time it files a copy of the application with the national office. The application must contain the name and telephone number of the appeals officer.

.05 *Taxpayer before a federal court.* Except as otherwise provided in the APPENDIX of this revenue procedure (see, for example, sections 4.01, 4A.01, 5.04, 8.05, 9.02, 10A.01, 12.01, and 12.02 of the APPENDIX of this revenue procedure), a taxpayer that is before a federal court must attach to the application a separate statement signed by the taxpayer certifying that, to the best of the taxpayer's knowledge, the same method of accounting is not an issue under consideration by the federal court. The taxpayer must provide a copy of the application to the counsel for the government at the same time it files a copy of the application with the national office. The application must contain the name and telephone number of the counsel for the government.

.06 *Compliance with provisions.* If a taxpayer to which this revenue procedure applies changes to a method of accounting without complying with all the applicable provisions of this revenue procedure (for example, the taxpayer changes to a method of accounting that varies from the applicable accounting method described in this revenue procedure or the taxpayer is outside the scope of this revenue procedure), the taxpayer has initiated a change in method of accounting without obtaining the consent of the Commissioner as required by § 446(e). Upon examination, a taxpayer that has initiated an unauthorized change in method of accounting may be denied the change. Alternatively, such a taxpayer may be required to effect the change in an earlier or later taxable year and may be denied the benefit of spreading the § 481(a) adjustment over the number of taxable years otherwise prescribed by this revenue procedure.

SECTION 7. AUDIT PROTECTION FOR TAXABLE YEARS PRIOR TO YEAR OF CHANGE

.01 *In general.* Except as provided in section 7.02 or the APPENDIX of this revenue procedure, when a taxpayer timely files a copy of the application with the national office in compliance with all the applicable provisions of this revenue procedure, the Service will not require the taxpayer to change its method of accounting for the same item for a taxable year prior to the year of change.

.02 *Exceptions.*

(1) *Change not made or made improperly.* The Service may change a taxpayer's method of accounting for prior taxable years if (a) the taxpayer fails to implement the change, (b) the taxpayer implements the change but does not comply with all the applicable provisions of this revenue procedure, or (c) the method of accounting is changed or modified because there has been a misstatement or omission of material facts (*see* section 8.02(2) of this revenue procedure).

(2) *Change in sub-method.* The Service may change a taxpayer's method of accounting for prior taxable years if the taxpayer is changing a sub-method of accounting within the method. For example, an examining agent may propose to terminate the taxpayer's use of the LIFO inventory method during a prior taxable year even though the taxpayer changes its method of valuing increments in the current year.

(3) *Prior year Service-initiated change.* The Service may make adjustments to the taxpayer's returns for the same item for taxable years prior to the requested year of change to reflect a prior year Service-initiated change.

(4) *Criminal investigation.* The Service may change a taxpayer's method of accounting for the same item for taxable years prior to the year of change if there is

any pending or future criminal investigation or proceeding concerning (a) directly or indirectly, any issue relating to the taxpayer's federal tax liability for any taxable year prior to the year of change, or (b) the possibility of false or fraudulent statements made by the taxpayer with respect to any issue relating to its federal tax liability for any taxable year prior to the year of change.

SECTION 8. EFFECT OF CONSENT

.01 *In general.* A taxpayer that changes to a method of accounting pursuant to this revenue procedure may be required to change or modify that method of accounting for the following reasons:

(1) the enactment of legislation;

(2) a decision of the United States Supreme Court;

(3) the issuance of temporary or final regulations;

(4) the issuance of a revenue ruling, revenue procedure, notice, or other statement published in the Internal Revenue Bulletin;

(5) the issuance of written notice to the taxpayer that the change in method of accounting was not in compliance with all the applicable provisions of this revenue procedure or is not in accord with the current views of the Service; or

(6) a change in the material facts on which the consent was based.

.02 *Retroactive change or modification.* Except in rare or unusual circumstances, if a taxpayer that changes its method of accounting under this revenue procedure is subsequently required under section 8.01 of this revenue procedure to change or modify that method of accounting, the required change or modification will not be applied retroactively, provided that:

(1) the taxpayer complied with all the applicable provisions of this revenue procedure;

(2) there has been no misstatement or omission of material facts;

(3) there has been no change in the material facts on which the consent was based;

(4) there has been no change in the applicable law; and

(5) the taxpayer to whom consent was granted acted in good faith in relying on the consent, and applying the change or modification retroactively would be to the taxpayer's detriment.

SECTION 9. REVIEW BY DISTRICT DIRECTOR

.01 *In general.* The district director must apply a change in method of accounting made in compliance with all the applicable provisions of this revenue procedure in determining the taxpayer's liability, unless the district director recommends that the change in method of accounting should be modified or revoked. (See section 6.06 of this revenue procedure if a change in method of accounting is made without complying with all the applicable provisions of this revenue procedure.) The district director will ascertain if the change in method of accounting was made in compliance with all the applicable provisions of this revenue procedure, including whether:

(1) the representations on which the change was based reflect an accurate statement of the material facts;

(2) the amount of the § 481(a) adjustment was properly determined;

(3) the change in method of accounting was implemented in compliance with all the applicable provisions of this revenue procedure.

The district director will also ascertain whether:

(4) there has been any change in the material facts on which the change was based during the period the method of accounting was used; and

(5) there has been any change in the applicable law during the period the method of accounting was used.

.02 *National office consideration.* If the district director recommends that a change in method of accounting (other than the § 481(a) adjustment) made in compliance with all the applicable provisions of this revenue procedure should be modified or revoked, the district director will forward the matter to the national office for consideration before any further action is taken. Such a referral to the national office will be treated as a request for technical advice, and the provisions of Rev. Proc. 99–2 (or any successor) will be followed.

SECTION 10. REVIEW BY NATIONAL OFFICE

.01 *In general.* Any application filed under this revenue procedure may be reviewed by the national office. If the application is reviewed by the national office, the procedures in sections 10.02 through 10.04 of this revenue procedure apply.

.02 *Incomplete application — 30 day rule.* If the Service reviews an application and determines that the application is not properly completed in accordance with the instructions of the Form 3115 or the provisions of this revenue procedure, or if supplemental information is needed, the Service will notify the taxpayer. The notification will specify the information that needs to be provided, and the taxpayer will be permitted 30 days from the date of the notification to furnish the necessary information. The Service reserves the right to impose shorter reply periods if subsequent requests for additional information are made. An extension of the 30-day period to furnish information, not to exceed 30 days, may be granted to a taxpayer. A request for an extension of the 30-day period must be made in writing and submitted within the initial 30-day period. If the extension request is denied, there is no right of appeal. Ordinarily, if the taxpayer fails to provide the additional information on a timely basis, the application does not qualify for the automatic consent procedures of this revenue procedure.

.03 *Conference in the national office.* If the national office tentatively determines that the taxpayer has changed its method of accounting without complying with all the applicable provisions of this revenue procedure (for example, the taxpayer changed to a method of accounting that varies from the applicable accounting method described in this revenue procedure or the taxpayer is outside the scope of this revenue procedure), the national office will notify the taxpayer of its tentative adverse determination and will offer the taxpayer a conference of right, if the taxpayer has requested a conference. For conference procedures for taxpayers other than exempt organizations, see section 11 of Rev. Proc. 99–1 (or any successor). For conference procedures for exempt organizations, see section 12 of Rev. Proc. 99–4, 1999–1 I.R.B. 115 (or any successor).

.04 *National office determination.*

(1) *Consent not granted.* Except as provided in section 10.04(2) of this revenue procedure, if the national office determines that a taxpayer has changed its method of accounting without complying with all the applicable provisions of this revenue procedure, the national office will notify the taxpayer that consent to make the change in method of accounting is not granted. See section 6.06 of this revenue procedure.

(2) *Application changed.* If the national office determines that a taxpayer has changed its method of accounting without complying with all the applicable provisions of this revenue procedure, the national office, in its discretion, may allow the taxpayer (a) to make appropriate adjustments to conform its change in method of accounting to the applicable provisions of this revenue procedure, and (b) to make conforming amendments to any federal income tax returns filed for the year of change and subsequent taxable years. Any application changed under section 10.04(2) of this revenue procedure is subject to review by the district director as provided in section 9 of this revenue procedure.

SECTION 11. APPLICABILITY OF REV. PROCS. 99–1 AND 99–4

Rev. Procs. 99–1 and 99–4 (or any successors) are applicable to applications filed under this revenue procedure, unless specifically excluded or overridden by other published guidance (including the special procedures in this document).

SECTION 12. INQUIRIES

Inquiries regarding this revenue procedure may be addressed to the Commissioner of Internal Revenue, Attention: CC:DOM:IT&A, 1111 Constitution Avenue, NW, Washington, D.C. 20224.

SECTION 13. EFFECTIVE DATE

.01 *In general.* Except as provided in sections 13.02 and 13.03 of this revenue procedure, this revenue procedure is effective for taxable years ending on or after December 27, 1999. The Service will return any application that is filed on or after December 27, 1999 if the application is filed with the national office pursuant to the Code, regulations, or administrative guidance other than this revenue procedure and the change in method of accounting is within the scope of this revenue procedure.

.02 *Transition rules.* If a taxpayer filed an application or ruling request with the national office to make a change in method of accounting authorized by this revenue procedure, and the application or ruling request is pending with the national office on December 27, 1999, the taxpayer may make the change under this revenue procedure. However, the national office will process the application or ruling request in accordance with the authority under which it was filed, unless prior to the later of February 1, 2000, or the issuance of the letter ruling granting or denying consent to the change, the taxpayer notifies the national office that it wants to make the change under this revenue procedure. If the taxpayer timely notifies the national office that it wants to make the method change under this revenue procedure, the national office will require the taxpayer to make appropriate modifications to the application or ruling request to comply with the applicable provisions of this revenue procedure. In addition, any user fee that was submitted with the application or ruling request will be returned to the taxpayer.

.03 *Special rules.*

(1) *Change in method of accounting to comply with § 404(a)(11).* For a change in method of accounting described in section 4A.01 of the APPENDIX of this revenue procedure, this revenue procedure is effective for the taxpayer's first taxable year ending after July 22, 1998.

(2) *Changes in methods of accounting for § 467 rental agreements.* For changes in methods of accounting described in sections 8A.01, 8A.02, and 8A.03 of the APPENDIX of this revenue procedure, this revenue procedure is effective for applications filed after December 27, 1999 for the taxpayer's first taxable year ending after May 18, 1999.

(3) *Change in method of accounting to discontinue the mark-to-market method of accounting.* For a change in method of accounting described in section 10A.01 of the APPENDIX of this revenue procedure, this revenue procedure is effective for the taxpayer's first taxable year ending after July 22, 1998.

(4) *Change in method of accounting for a pool of debt instruments.* For a change in method of accounting described in section 12.02 of the APPENDIX of this revenue procedure, this revenue procedure is effective for the taxpayer's first taxable year beginning after August 5, 1997.

SECTION 14. EFFECT ON OTHER DOCUMENTS

.01 Rev. Proc. 98–60, is clarified, modified, amplified, and superseded.

.02 Section 7 of Rev. Proc. 92–67, 1992–2 C.B. 429, is modified and, as modified, is superseded. The remainder of Rev. Proc. 92–67 remains in effect as originally published.

.03 Section 6 of Rev. Proc. 99–17, 1999–7 I.R.B. 52, is superseded. The remainder of Rev. Proc. 99–17 remains in effect as originally published.

SECTION 15. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545–1551.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid OMB control number.

The collections of information in this revenue procedure are in sections 6, 10, and sections 1A, 2, 3, 5, 6, 7, 10, 10A, 12, and 12A of the APPENDIX. This information is necessary and will be used to determine whether the taxpayer properly changed to a permitted method of accounting. The collections of information are required for the taxpayer to obtain consent to change its method of accounting. The likely respondents are the following: individuals, farms, business or other for-profit institutions, nonprofit institutions, and small businesses or organizations.

The estimated total annual reporting and/or recordkeeping burden is 15,739 hours.

The estimated annual burden per respondent/recordkeeper varies from $^1/_6$

hour to $8^1/_2$ hours, depending on individual circumstances, with an estimated average of $1^1/_2$ hours. The estimated number of respondents is 13,650. The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is Grant D. Anderson of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure, contact Mr. Anderson on (202) 622-4970 (not a toll-free call). For further information regarding the APPENDIX of this revenue procedure contact the following individuals: (1) for changes in methods of accounting under sections 1A.01 and 12A.01 of the APPENDIX of this revenue procedure, Christina Morrison of the Office of Assistant Chief Counsel (Financial Institutions and Products) on (202) 622-3960 (not a toll-free call); (2) for changes in methods of accounting under sections 2.01 and 2.02 of the APPENDIX of this revenue procedure, Peter Friedman of the Office of Assistant Chief Counsel (Passthroughs and Special Industries) on (202) 622-3110 (not a toll-free call); (3) for changes in methods of accounting under section 2A.01 of the APPENDIX of this revenue procedure, Leslie H. Finlow of the Office of Assistant Chief Counsel (Passthroughs and Special Industries) on (202) 622-3120 (not a toll free call);(4)for changes in methods of accounting under section 4A.01 of the APPENDIX of this revenue procedure, Norm Paul of the Office of Associate Chief Counsel (Employee Benefits and Exempt Organizations); (5) for changes in methods of accounting under sections 5.04, 6, 12, and 13 of the APPENDIX of this revenue procedure, William Blanchard of the Office of Assistant Chief Counsel (Financial Institutions and Products) on (202) 622-3950 (not a toll-free call); (6) for changes in methods of accounting under section 5A.01 of the APPENDIX of this revenue procedure, Timothy Sebastian of the Office of Assistant Chief Counsel (Financial Institutions and Products) on (202) 622-3920 (not a toll-free call); (7) for changes in methods of accounting under section 10A.01 of the APPENDIX of this revenue procedure, Pamela Lew of the Office of Assistant Chief Counsel (Financial Institutions and Products) on (202) 622-3950 (not a toll-free call); (8) for changes in methods of accounting under section 10A.02 of the APPENDIX of this revenue procedure, JoLynn Ricks of the Office of Assistant Chief Counsel (Financial Institutions and Products) on (202) 622-3920 (not a toll-free call); (9) for changes in methods of accounting under section 11 of the APPENDIX of this revenue procedure, Craig R. Wojay of the Office of Assistant Chief Counsel (Financial Institutions and Products) on (202) 622-3920 (not a toll-free call); and (10) for all other sections, Mr. Anderson on (202) 622-4970 (not a toll-free call).

APPENDIX
CHANGES IN METHODS OF ACCOUNTING TO WHICH THIS REVENUE PROCEDURE APPLIES

SECTION 1. TRADE OR BUSINESS EXPENSES (§ 162)

.01 *Advances made by a lawyer on behalf of clients — Description of change and scope*. This change applies to a lawyer handling cases on a contingent fee basis that advances money to pay for costs of litigation or for other expenses on behalf of clients and that wants to change the method of accounting for such advances from treating them as deductible business expenses to treating them as loans. *See Boccardo v. United States*, 12 Cl. Ct. 184 (1987); *Canelo v. Commissioner*, 53 T.C. 217 (1969), *aff'd per curiam*, 447 F.2d 484 (9th Cir. 1971).

.02 *Year 2000 costs — Description of change and scope.* This change applies to a taxpayer that wants to change its method of accounting for Year 2000 costs (as defined in Rev. Proc. 97–50, 1997–2 C.B. 525) to conform to the method described in section 3 of Rev. Proc. 97–50. Section 3 of Rev. Proc. 97–50 provides that Year 2000 costs fall within the purview of Rev. Proc. 69–21, 1969–2 C.B. 303, and that the Service will not disturb a taxpayer's treatment of its Year 2000 costs as deductible expenses or capital expenditures if the taxpayer treats these costs in accordance with Rev. Proc. 69–21.

SECTION 1A. AMORTIZABLE BOND PREMIUM (§ 171)

.01 *Revocation of § 171(c) election.*

(1) *Description of change and scope.* This change applies to a taxpayer that wants to change its method of accounting for amortizable bond premium by revoking its § 171(c) election. Under § 171(c), a taxpayer that holds certain taxable bonds may elect to amortize any bond premium on the bonds in accordance with regulations prescribed by the Secretary. Sections 1.171–1 through 1.171–5 provide rules relating to the amortization of bond premium by a taxpayer. Section 1.171–4 provides the procedures to make a § 171(c) election to amortize bond premium.

(2) *Revocation of election.* The revocation of a § 171(c) election applies to all taxable bonds that are held by the taxpayer on the first day of the first taxable year for which the revocation is effective (year of change), and to all taxable bonds that are subsequently acquired by the taxpayer.

(3) *Manner of making the change.* This change is made using a cut-off method and applies only to taxable bonds held during or after the year of change. Consequently, for taxable bonds held at the beginning of the year of change, the taxpayer may not amortize any remaining bond premium on the bonds. Because cut-off treatment is prescribed for this change, the basis of any bond, adjusted for amounts previously amortized during the period of the election, is not affected by the revocation.

(4) *Additional requirements.* On a statement attached to the application, the taxpayer must provide:

(a) the reason(s) for revoking the election; and

(b) a description of the method by which, and the date on which, the taxpayer made the § 171(c) election that is proposed to be revoked.

(5) *Audit protection.* A taxpayer receives audit protection under section 7 of

this revenue procedure in connection with this change. However, the audit protection applicable to this change does not preclude the Commissioner from examining the method used by the taxpayer to determine the amount of amortizable bond premium under § 171(b) for a taxable year prior to the year of change.

.02 *Reserved.*

SECTION 2. DEPRECIATION OR AMORTIZATION (§ 56(a)(1), 56(g)(4)(A), 167, 168, OR 197, OR FORMER § 168)

.01 *Impermissible to permissible method of accounting for depreciation or amortization.*

(1) *Description of change.*

(a) This change applies to a taxpayer that wants to change from an impermissible method of accounting for depreciation or amortization (depreciation) under which the taxpayer did not claim the depreciation allowable, to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable.

(b) A change from a taxpayer's impermissible method of accounting for depreciation under which the taxpayer did not claim the depreciation allowable to a permissible method of accounting for depreciation under which the taxpayer will claim the depreciation allowable is a change in method of accounting for which the consent of the Commissioner is required. Sections 1.167(e)–1(a) and 1.446–1(e)(2)(ii)(b). This method change, however, does not include any correction of mathematical or posting errors. Section 1.446–1(e)(2)(ii)(b).

(2) *Scope.*

(a) *Applicability.* This change applies to any taxpayer that has used an impermissible method of accounting for depreciation in at least the two taxable years immediately preceding the year of change, and is changing that accounting method to a permissible method of accounting for depreciation, for any item of property:

(i) for which, under the taxpayer's impermissible method of accounting, the taxpayer has not taken into account any depreciation allowance or has taken into account some depreciation but less than or more than the depreciation allowable (claimed less than or more than the depreciation allowable);

(ii) for which depreciation is determined under-§ 56(a)(1), 56(g)(4)(A), 167, 168, 197, or 168 prior to its amendment in 1986 (former § 168); and

(iii) that is owned by the taxpayer at the beginning of the year of change.

(b) *Certain scope limitations inapplicable.* The scope limitations in section 4.02(8) of this revenue procedure are not applicable to this change.

(c) *Inapplicability.* This change does not apply to:

(i) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(ii) any taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 2.01 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(iii) any intangible property subject to § 56(g)(4)(A) or 167, except for property subject to § 167(f) (regarding certain property excluded from § 197);

(iv) any property subject to § 167(g) (regarding property depreciated under the income forecast method);

(v) any § 1250 property that a taxpayer is reclassifying to an asset class of Rev. Proc. 87–56, 1987–2 C.B. 674, or Rev. Proc. 83–35, 1983–1 C.B. 745, as appropriate, that does not explicitly include § 1250 property (for example, asset class 57.0, Distributive Trades and Services);

(vi) any property for which a taxpayer is revoking a timely valid election, or making a late election, under § 167, 168, former § 168, or § 13261(g)(2) or (3) of the Revenue Reconciliation Act of 1993 (1993 Act), 1993–3 C.B. 1, 128 (relating to amortizable § 197 intangibles). A taxpayer may request consent to revoke or make the election by submitting a request for a letter ruling under Rev. Proc. 99–1, 1999–1 I.R.B. 6 (or any successor);

(vii) any property subject to § 56(g)(4)(A) or 167 (other than § 167(f), regarding certain property excluded from § 197), for which a taxpayer is changing only the estimated useful life of the property. A change in the estimated useful life of property for which depreciation is determined under § 56(g)(4)(A) or 167 (other than § 167(f)) must be made prospectively (*see*, for example, § 1.167(b)–2(c)). (In contrast, section 2.01 of this APPENDIX generally applies to a change in the recovery period of property for which depreciation is determined under § 56(a)(1), 56(g)(4)(A), 168 or former § 168);

(viii) any depreciable property that changes use but continues to be owned by the same taxpayer (*see*, for example, § 168(i)(5));

(ix) any property for which depreciation is determined in accordance with § 1.167(a)–11 (regarding the Class Life Asset Depreciation Range System (ADR));

(x) any change in method of accounting involving a change from deducting the cost or other basis of any property as an expense to capitalizing and depreciating the cost or other basis;

(xi) any change in method of accounting involving a change from one permissible method of accounting for the property to another permissible method of accounting for the property. For example:

(A) a change from the straight-line method of depreciation to the income forecast method of depreciation for videocassettes. *See* Rev. Rul. 89–62, 1989–1 C.B. 78; or

(B) a change from charging the depreciation reserve with costs of removal and crediting the depreciation reserve with salvage proceeds to deducting costs of removal as an expense (provided the costs of removal are not required to be capitalized under any provision of the Code, such as, § 263(a)) and including salvage proceeds in taxable income (see section 2.02 of this APPENDIX for making this change for property for which depreciation is determined under § 167);

(xii) any change in method of accounting involving both a change from treating the cost or other basis of the property as nondepreciable property to treating the cost or other basis of the property as depreciable property and the adoption of a method of accounting for depreciation requiring an election under § 167, 168, former § 168, or § 13261(g)(2) or (3) of the 1993 Act (for example, a change in the treatment of the space consumed in landfills placed in service in 1990 from nondepreciable to depreciable property (assuming section 2.01(2)(c)(xiii) of the APPENDIX does not apply) and the making of an election under § 168(f)(1) to depreciate this property under the unit-of-production method of depreciation under § 167);

(xiii) any change in method of accounting for an item of income or deduction other than depreciation, even if a taxpayer's present method of accounting may have resulted in the taxpayer claiming less than or more than the depreciation allowable. For example, a change in method of accounting involving:

(A) a change in inventory costs (for example, when property is reclassified from inventory property to depreciable property, or vice versa) (but see section 3.02 of this APPENDIX for making a change from inventory property to depreciable property for unrecoverable line pack gas or unrecoverable cushion gas); or

(B) a change in the character of a transaction from sale to lease, or vice versa (but see section 2.03 of this APPENDIX for making this change); or

(xiv) a change from determining depreciation under § 168 to determining depreciation under former § 168 for any property subject to the transition rules in § 203(b) or 204(a) of the Tax Reform Act of 1986, 1986–3 (Vol. 1) C.B. 1, 60–80.

(3) *Additional requirements.* A taxpayer also must comply with the following:

(a) *Permissible depreciation method.* A taxpayer must change to a permissible method of accounting for depreciation for the item of property. This method is the same method that determines the depreciation allowable for the item of property (as provided in section 2.01(6) of this APPENDIX).

(b) *Statements required.* A taxpayer must provide the following statements, if applicable, and attach them to the completed application:

(i) a detailed description of the former and new methods of accounting. A general description of these methods of accounting is unacceptable (for example, MACRS to MACRS or erroneous method to proper method);

(ii) to the extent not provided elsewhere on the application, a statement describing the taxpayer's business or income-producing activities. Also, if the taxpayer has more than one business or income-producing activity, a statement describing the taxpayer's business or income-producing activity in which the item of property at issue is primarily used by the taxpayer;

(iii) to the extent not provided elsewhere on the application, a statement of the facts and law supporting the new method of accounting, new classification of the item of property, and new asset class in, as appropriate, Rev. Proc. 87–56 or Rev. Proc. 83–35. If the taxpayer is the owner and lessor of the item of property at issue, the statement of the facts and law supporting the new asset class also must describe the business or income-producing activity in which that item of property is primarily used by the lessee;

(iv) to the extent not provided elsewhere on the application, a statement identifying the year in which the item of property was placed in service;

(v) if the item of property is depreciated under former § 168, a statement identifying the asset class in Rev. Proc. 83–35 that applies under the taxpayer's former and new methods of accounting (if none, state and explain);

(vi) if any item of property is public utility property within the meaning of § 168(i)(10) or former § 167(l)(3)(A), as applicable, a statement providing that the taxpayer agrees to the following additional terms and conditions:

(A) a normalization method of accounting (within the meaning of former § 167(l)(3)(G), former § 168(e)(3)(B), or § 168(i)(9), as applicable) will be used for the public utility property subject to the application;

(B) as of the beginning of the year of change, the taxpayer will adjust its deferred tax reserve account or similar reserve account in the taxpayer's regulatory books of account by the amount of the deferral of federal income tax liability associated with the § 481(a) adjustment applicable to the public utility property subject to the application; and

(C) within 30 calendar days of filing the federal income tax return for the year of change, the taxpayer will provide a copy of the completed application to any regulatory body having jurisdiction over the public utility property subject to the application;

(vii) if the taxpayer is changing the classification of an item of § 1250 property placed in service after August 19, 1996, to a retail motor fuels outlet under § 168(e)(3)(E)(iii), a statement containing the following representation: "For purposes of § 168(e)(3)(E)(iii) of the Internal Revenue Code, the taxpayer represents that (A) 50 percent or more of the gross revenue generated from the item of § 1250 property is from the sale of petroleum products (not including gross revenue from related services, such as the labor cost of oil changes and gross revenue from the sale of nonpetroleum products such as tires and oil filters), (B) 50 percent or more of the floor space in the item of property is devoted to the sale of petroleum products (not including floor space devoted to related services, such as oil changes and floor space devoted to nonpetroleum products such as tires and oil filters), or (C) the item of § 1250 property is 1,400 square feet or less."; and

(viii) if the taxpayer is changing the classification of an item of property from § 1250 property to § 1245 property under § 168 or former § 168, a statement of the facts and law supporting the new § 1245 property classification, and a statement containing the following representation: "Each item of property that is the subject of the application filed under section 2.01 of the APPENDIX of Rev. Proc. 99–49 for the year of change beginning *[Insert the date]*, and that is reclassified from *[Insert, as appropriate: nonresidential real property, residential rental property, 19-year real property, 18-year real property, or 15-year real property]* to an asset class of *[Insert, as appropriate, either: Rev. Proc. 87–56, 1987–2 C.B. 674, or Rev. Proc. 83–35, 1983–1 C.B. 745]* that does not explicitly include § 1250 property, is § 1245 property for depreciation purposes."

(4) *Section 481(a) adjustment.* Because the adjusted basis of the property is changed as a result of a method change made under section 2.01 of this APPENDIX (*see* section 2.01(5) of this APPENDIX), items are duplicated or omitted. Accordingly, this change is made with a § 481(a) adjustment. This adjustment may result in either a negative § 481(a) adjustment (a decrease in taxable income) or a positive § 481(a) adjustment (an increase

in taxable income) and may be a different amount for regular tax, alternative minimum tax, and adjusted current earnings purposes. This § 481(a) adjustment equals the difference between the total amount of depreciation taken into account in computing taxable income for the property under the taxpayer's former method of accounting, and the total amount of depreciation allowable for the property under the taxpayer's new method of accounting (as determined under section 2.01(6) of this APPENDIX), for open and closed years prior to the year of change. However, the amount of the § 481(a) adjustment must be adjusted to account for the proper amount of the depreciation allowable that is required to be capitalized under any provision of the Code (for example, § 263A) at the beginning of the year of change.

(5) *Basis adjustment.* As of the beginning of the year of change, the basis of depreciable property to which section 2.01 of this APPENDIX applies must reflect the reductions required by § 1016(a)(2) for the depreciation allowable for the property (as determined under section 2.01(6) of this APPENDIX).

(6) *Meaning of depreciation allowable.*

(a) *In general.* Section 2.01(6) of this APPENDIX provides the amount of the depreciation allowable, determined under § 56(a)(1), 56(g)(4)(A), 167, 168, 197, or former § 168. This amount, however, may be limited by other provisions of the Code (for example, § 280F).

(b) *Section 56(a)(1) property.* The depreciation allowable for any taxable year for property for which depreciation is determined under § 56(a)(1) is determined by using the depreciation method, recovery period, and convention provided for under § 56(a)(1) that applies for the property's placed-in-service date.

(c) *Section 56(g)(4)(A) property.* The depreciation allowable for any taxable year for property for which depreciation is determined under § 56(g)(4)(A) is determined by using the depreciation method, recovery period or useful life, as applicable, and convention provided for under § 56(g)(4)(A) that applies for the property's placed-in-service date.

(d) *Section 167 property.* Generally, for any taxable year, the depreciation allowable for property for which depreciation is determined under § 167, is determined either:

(i) under the depreciation method adopted by a taxpayer for the property; or

(ii) if that depreciation method does not result in a reasonable allowance for depreciation or a taxpayer has not adopted a depreciation method for the property, under the straight-line depreciation method.

For determining the estimated useful life and salvage value of the property, see §§ 1.167(a)–1(b) and (c), respectively. The depreciation allowable for any taxable year for property subject to § 167(f) (regarding certain property excluded from § 197) is determined by using the depreciation method and useful life prescribed in § 167(f).

(e) *Section 168 property*. The depreciation allowable for any taxable year for property for which depreciation is determined under § 168, is determined by using either:

(i) the general depreciation system in § 168(a); or

(ii) the alternative depreciation system in § 168(g) if the property is required to be depreciated under the alternative depreciation system pursuant to § 168(g)(1) or other provisions of the Code (for example, property described in § 263A(e)(2)(A) or 280F(b)(1)). Property required to be depreciated under the alternative depreciation system pursuant to § 168(g)(1) includes property in a class (as set out in § 168(e)) for which the taxpayer made a timely election under § 168(g)(7).

(f) *Section 197 property*. The depreciation allowable for any taxable year for an amortizable § 197 intangible (including any property for which a timely election under § 13261(g)(2) of the 1993 Act was made) is determined by using the straight-line method over a 15-year period.

(g) *Former § 168 property*. The depreciation allowable for any taxable year for property subject to former § 168 is determined by using either:

(i) the accelerated method of cost recovery applicable to the property (for example, for 5-year property, the recovery method under former § 168(b)(1)); or

(ii) the straight-line method applicable to the property if the property is required to be depreciated under the straight-line method (for example, property described in former § 168(f)(12) or former § 280F(b)(2)) or if the taxpayer elected to determine the depreciation allowance under the optional straight-line percentage (for example, the straight-line method in former § 168(b)(3)).

.02 *Permissible to permissible method of accounting for depreciation.*

(1) *Description of change*. This change applies to a taxpayer that wants to change from a permissible method of accounting for depreciation under § 56(g)(4)(A)(iv) or 167 to another permissible method of accounting for depreciation under § 56(g)(4)(A)(iv) or 167. Pursuant to §§ 1.167(a)–7(a) and (c), a taxpayer may account for depreciable property either by treating each individual asset as an account or by combining two or more assets in a single account and, for each account, depreciation allowances are computed separately.

(2) *Scope*.

(a) *Applicability.* This change applies to any taxpayer wanting to make a change in method of accounting for depreciation specified in section 2.02(3) of this APPENDIX for the property in an account:

(i) for which the present and proposed methods of accounting for depreciation specified in section 2.02(3) of this APPENDIX are permissible methods for the property under § 56(g)(4)(A) or 167; and

(ii) that is owned by the taxpayer at the beginning of the year of change.

(b) *Certain scope limitations inapplicable.* The scope limitations in section 4.02(8) of this revenue procedure are not applicable to this change.

(c) *Inapplicability.* This change does not apply to:

(i) any taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 2.02 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(ii) any property to which § 1016(a)(3) (regarding property held by a tax-exempt organization) applies;

(iii) any intangible property;

(iv) any property described in § 167(f) (regarding certain property excluded from § 197);

(v) any property subject to § 167(g) (regarding property depreciated under the income forecast method);

(vi) any property for which depreciation is determined under § 56(a)(1), 56(g)(4)(A)(i), (ii), (iii), or (v), 168 or § 168 prior to its amendment in 1986 (former § 168);

(vii) any property that the taxpayer elected under § 168(f)(1) or former § 168(e)(2) to exclude from the application of, respectively, § 168 or former § 168;

(viii) any property for which depreciation is determined in accordance with § 1.167(a)–11 (regarding the Class Life Asset Depreciation Range System (ADR)); or

(ix) any depreciable property for which the taxpayer is changing the depreciation method pursuant to § 1.167(e)–1(b) (change from declining-balance method to straight-line method), § 1.167(e)–1(c) (certain changes for § 1245 property), or § 1.167(e)–1(d) (certain changes for § 1250 property). These changes must be made prospectively and are not permitted under the cited regulations for property for which the depreciation is determined under § 168 or former § 168.

(3) *Changes covered.* Section 2.02 of this APPENDIX only applies to the following changes in methods of accounting for depreciation:

(a) a change from the straight-line method to the sum-of-the-years-digits method, the sinking fund method, the unit-of-production method, or the declining-balance method using any proper percentage of the straight-line rate;

(b) a change from the declining-balance method using any percentage of the straight-line rate to the sum-of-the-years-digits method, the sinking fund method, or the declining-balance method using a different proper percentage of the straight-line rate;

(c) a change from the sum-of-the-years-digits method to the sinking fund method, the declining-balance method using any proper percentage of the straight-line rate, or the straight-line method;

(d) a change from the unit-of-production method to the straight-line method;

(e) a change from the sinking fund method to the straight-line method, the unit-of-production method, the sum-of-the-years-digits method, or the declining-balance method using any proper percentage of the straight-line rate;

(f) a change in the interest factor used in connection with a compound interest method or sinking fund method;

(g) a change in averaging convention as set forth in § 1.167(a)–10(b). However, as specifically provided in § 1.167(a)–10(b), in any taxable year in which an averaging convention substantially distorts the depreciation allowance for the taxable year, it may not be used (*see* Rev. Rul. 73–202, 1973–1 C.B. 81);

(h) a change from charging the depreciation reserve with costs of removal and crediting the depreciation reserve with salvage proceeds to deducting costs of removal as an expense and including salvage proceeds in taxable income as set forth in § 1.167(a)–8(e)(2). *See* Rev. Rul. 74–455, 1974–2 C.B. 63. This change, however, may be made under this revenue procedure only if:

(i) the change is applied to all items in the account for which the change is being made; and

(ii) the removal costs are not required to be capitalized under any provision of the Code (for example, § 263(a), 263A, or 280B);

(i) a change from crediting the depreciation reserve with the salvage proceeds realized on normal retirement sales to computing and recognizing gains and losses on such sales (see Rev. Rul. 70–165, 1970–1 C.B. 43);

(j) a change from crediting ordinary income (including the combination method of crediting the lesser of estimated salvage value or actual salvage proceeds to the depreciation reserve, with any excess of salvage proceeds over estimated salvage value credited to ordinary income) with the salvage proceeds realized on normal retirement sales, to computing and recognizing gains and losses on such sales (*see* Rev. Rul. 70–166, 1970–1 C.B. 44); or

(k) a change from item accounting for specific assets to multiple asset accounting for the same assets, or vice versa.

(4) *Additional requirements.* A taxpayer also must comply with the following:

(a) *Basis for depreciation.* At the beginning of the year of change, the basis for depreciation of property to which this change applies is the adjusted basis of the property as provided in § 1011 at the end of the taxable year immediately preceding the year of change (determined under the taxpayer's present method of accounting for depreciation). If applicable under the taxpayer's proposed method of accounting for depreciation, this adjusted basis is reduced by the estimated salvage value of the property (for example, a change to the straight-line method).

(b) *Rate of depreciation.* The rate of depreciation for property changed to:

(i) the straight-line or sum-of-the-years-digits method of depreciation must be based on the remaining useful life of the property as of the beginning of the year of change; or

(ii) the declining-balance method of depreciation must be based on the useful life of the property measured from the placed-in-service date, and not the expected remaining life from the date the change becomes effective.

(c) *Regulatory requirements.* For changes in method of depreciation to the sum-of-the-years-digits or declining-balance method, the property must meet the requirements of § 1.167(b)–0 or 1.167(c)–1, as appropriate.

(d) *Public utility property.* If any item of property is public utility property within the meaning of former § 167(l)(3)(A), the taxpayer must attach to the application a statement providing that the taxpayer agrees to the following additional terms and conditions:

(i) a normalization method of accounting within the meaning of former § 167(l)(3)(G) will be used for the public utility property subject to the application; and

(ii) within 30 calendar days of filing the federal income tax return for the year of change, the taxpayer will provide a copy of the completed application to any regulatory body having jurisdiction over the public utility property subject to the application.

(5) *Section 481(a) adjustment.* Because the adjusted basis of the property is not changed as a result of a method change made under section 2.02 of this APPENDIX, no items are being duplicated or omitted. Accordingly, the §

481(a) adjustment is zero.

.03 *Sale or lease transactions.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to a taxpayer that wants to change its method of accounting from:

(i) improperly treating property as sold by the taxpayer to properly treating property as leased by the taxpayer;

(ii) improperly treating property as leased by the taxpayer to properly treating property as sold by the taxpayer;

(iii) improperly treating property as purchased by the taxpayer to properly treating property as leased by the taxpayer; and

(iv) improperly treating property as leased by the taxpayer to properly treating property as purchased by the taxpayer.

(b) *Inapplicability.* This change does not apply to:

(i) a rent-to-own dealer that wants to change its method of accounting for rent-to-own contracts described in section 3 of Rev. Proc. 95–38, 1995–2 C.B. 397; or

(ii) a taxpayer that holds assets for sale or lease, if any asset so held is not the subject of a sale or lease transaction as of the beginning of the year of change.

(2) *Manner of making the change.*

(a) The change in method of accounting under section 2.03 of this APPENDIX is made using a cut-off method and applies to transactions entered into on or after the beginning of the year of change. *See* section 2.06 of this revenue procedure.

(b) If a taxpayer wants to change its method of accounting for existing sale or lease transactions, the taxpayer must file an application with the Commissioner in accordance with the requirements of § 1.446–1(e)(3)(i) and Rev. Proc. 97–27. A change involving existing sale or lease transactions will require a § 481(a) adjustment. Consent to change a method of accounting for an existing sale or lease transaction is granted only in unusual and compelling circumstances.

(3) *No audit protection.* A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

SECTION 2A. RESEARCH AND EXPERIMENTAL EXPENDITURES (§ 174)

.01 *Changes to a different method or different amortization period.*

(1) *Description of change.*

(a) This change applies to a taxpayer that wants to change the treatment of expenditures that qualify as research and experimental expenditures under § 174.

(b) Section 174 and the regulations thereunder provide the specific rules for changing a method of accounting under § 174 for research and experimental expenditures. Under § 174, a taxpayer may treat research and experimental expenditures that are paid or incurred by the taxpayer during the taxable year in connection with the taxpayer's trade or business as expenses under § 174(a) or as deferred expenses amortizable ratably over a period of not less than 60 months under § 174(b). Pursuant to § 1.174–1, research and experimental expenditures that are not treated as expenses or deferred expenses under § 174 must be treated as capital expenditures. Further, § 1.174–1 provides that the expenditures to which § 174 applies may relate either to a general research program or to a particular project.

(c) If a taxpayer has not treated research and experimental expenditures as expenses under § 174(a), §§ 174(a)(2)(B) and 1.174–3(b)(2) provide that the taxpayer may, with consent, adopt the expense method at any time.

(d) If a taxpayer has treated research and experimental expenditures as expenses under § 174(a), §§ 174(a)(3) and 1.174–3(b)(3) provide that the taxpayer may, with consent, change to a different method of treating research and experimental expenditures.

(e) If a taxpayer has treated research and experimental expenditures as deferred expenses under § 174(b), §§ 174(b)(2) and 1.174–4(b)(2) provide that the taxpayer may, with consent, change to a different method of treating research or experimental expenditures or to a different period of amortization for deferred expenses.

(2) *Scope.*

(a) *Applicability*. This change applies to any taxpayer that is changing:

(i) from treating research and experimental expenditures for a particular project or projects as expenses under § 174(a) to treating such expenditures as deferred expenses under § 174(b), or vice versa;

(ii) to a different period of amortization for research and experimental expenditures for a particular project or projects that are being treated as deferred expenses under § 174(b); or

(iii) from treating research and experimental expenditures for a particular project or projects as expenses under § 174(a) or deferred expenses under § 174(b) to treating such expenditures as a capital expenditure under § 263(a), or vice versa.

(b) *Scope limitations clarified.* The scope limitation under section 4.02(6) of this revenue procedure is applied on a project by project basis.

(c) *Inapplicability.* This change does not apply to:

(i) a portion of the research and experimental expenditures paid or incurred for a particular project during the year of change or in subsequent taxable years (that is, the change must apply to all of such expenditures; *see* §§ 1.174–3(a) and 1.174–4(a)(5));

(ii) a change in the treatment of computer software costs under Rev. Proc. 69–21, 1969–2 C.B. 303; or

(iii) a change in the treatment of Year 2000 costs under Rev. Proc. 97–50, 1997–2 C.B. 525 (but see section 1.02 of this APPENDIX for making this change).

(3) *Manner of making the change.*

(a) This change is made using a cut-off method and applies to all research and experimental expenditures paid or incurred for a particular project or projects during the year of change and in subsequent taxable years. *See* section 2.06 of this revenue procedure and §§ 174(b)(2), 1.174–3(a), 1.174–3(b)(2), and 1.174–4(a)(5).

(b) The requirement under §§ 1.174–3(b)(2), 1.174–3(b)(3), and 1.174–4(b)(2) to file an application no later than the end of the first taxable year in which the different method or different amortization period is to be used is waived for this change. However, see section 6 of this revenue procedure for filing requirements applicable under this revenue procedure.

(c) The consent granted under this revenue procedure satisfies the consent required under §§ 174(a)(2)(B), 174(a)(3), 174(b)(2), 1.174–3(b)(2), 1.174–3(b)(3), and 1.174–4(b)(2).

(4) *Additional requirement.* A taxpayer must attach to the application a written statement providing:

(a) the information required in § 1.174–3(b)(2) if the taxpayer is changing to treating research and experimental expenditures as expenses under § 174(a);

(b) the information required in § 1.174–3(b)(3) if the taxpayer is changing from treating research and experimental expenditures as expenses under § 174(a); or

(c) the information required in § 1.174–4(b)(2) if the taxpayer is changing from treating research and experimental expenditures as deferred expenses method under § 174(b) or is changing to a different period of amortization for research and experimental expenditures being treated as deferred expenses under § 174(b).

(5) *No audit protection.* A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 *Reserved.*

SECTION 3. CAPITAL EXPENDITURES (§ 263)

.01 *Package design costs.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to a taxpayer that wants to change its method of accounting for package design costs that are within the scope of Rev. Proc. 97–35, 1997–2 C.B. 448, to one of the three alternative methods of accounting for package design costs described in section 5 of Rev. Proc. 97–35. The three alternative methods of accounting for package design costs described are: (1) the capitalization method, (2) the design-by-design capitalization and 60-month amortization method, and (3) the pool-of-cost capitalization and 48-month amortization method.

(b) *Inapplicability.* This change does not apply to a taxpayer that wants to change to the capitalization method for costs of developing (or modifying) any package design that has an ascertainable useful life.

(2) *Additional requirements.* If a taxpayer is changing its method of accounting for package design costs to the capitalization method or the design-by-design capitalization and 60-month amortization method, the taxpayer must attach a statement to its timely filed application. The statement must provide a description of each package design, the date on which each was placed in service, and the cost basis of each (as determined under sections 5.01(2) or 5.02(2) of Rev. Proc. 97–35).

.02 *Line pack gas; cushion gas.*

(1) *Description of change and scope.* This change applies to a taxpayer that wants to change its method of accounting for line pack gas or cushion gas to a method consistent with the holding in Rev. Rul. 97–54, 1997–2 C.B. 23. Rev. Rul. 97–54 holds that the cost of line pack gas or cushion gas is a capital expenditure under § 263, the cost of recoverable line pack gas or recoverable cushion gas is not depreciable, and the cost of unrecoverable line pack gas or unrecoverable cushion gas is depreciable under §§ 167 and 168.

(2) *Additional requirements.* A taxpayer that changes its method of accounting for unrecoverable line pack gas or unrecoverable cushion gas under section 3.02 of this APPENDIX must change to a permissible method of accounting for depreciation for the cost of that gas.

SECTION 4. UNIFORM CAPITALIZATION (§ 263A)

.01 *Certain uniform capitalization (UNICAP) methods used by small resellers, formerly small resellers, and reseller-producers.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to:

(i) a small reseller of personal property changing from a permissible UNICAP method to a permissible non-UNICAP inventory capitalization method in any taxable year that it qualifies as a small reseller;

(ii) a formerly small reseller changing from a permissible non-UNICAP inventory capitalization method to a permissible UNICAP method in the first taxable year that it does not qualify as a small reseller;

(iii) a reseller-producer changing from a permissible UNICAP method for both its production and resale activities to a permissible simplified resale method described in § 1.263A–3(d)(3) in any taxable year that it qualifies to use a simplified resale method for both its production and resale activities under § 1.263A–3(a)(4) (resellers with de minimis production activities); or

(iv) a reseller-producer changing from a permissible simplified resale method described in § 1.263A–3(d)(3) for both its production and resale activities to a permissible UNICAP method for both its production and resale activities in the first taxable year that it does not qualify to use a simplified resale method for both its production and resale activities under § 1.263A–3(a)(4).

(b) *Scope limitations inapplicable.* A taxpayer that wants to make this change is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(c) *Inapplicability.* This change does not apply to a taxpayer making a historic absorption ratio election under § 1.263A–2(b)(4) or 1.263A–3(d)(4).

(2) *Definitions.*

(a) "Reseller" means a taxpayer that acquires real or personal property described in § 1221(1) for resale.

(b) "Small reseller" means a reseller whose average annual gross receipts for the three immediately preceding taxable years (or fewer, if the taxpayer has not been in existence during the three preceding taxable years) do not exceed $10,000,000. *See* § 263A(b)(2)(B).

(c) "Formerly small reseller" means a reseller that no longer qualifies as a small reseller.

(d) "Producer" means a taxpayer that produces real or tangible personal property.

(e) "Reseller-producer" means a taxpayer that is both a producer and a reseller.

(f) "Permissible UNICAP

method" means a method of capitalizing costs that is permissible under § 263A.

(g) "Permissible non-UNICAP inventory capitalization method" means a method of capitalizing inventory costs that is permissible under § 471.

(3) *Section 481(a) adjustment.* Beginning with the year of change, a taxpayer changing its method of accounting for costs pursuant to section 4.01 of this APPENDIX generally must take any applicable § 481(a) adjustment into account ratably over the same number of taxable years, not to exceed four, that the taxpayer used its former method of accounting. See section 5.04(3) of this revenue procedure for exceptions to this general rule.

(4) *No audit protection.* A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

(5) *Example*. The following example illustrates the principles of section 4.01 of this APPENDIX for small resellers and formerly small resellers.

Assume X, a corporate reseller of personal property, incorporated January 2, 1991, adopted a taxable year ending December 31. X determines that its average annual gross receipts for the three taxable years (or fewer, if applicable) immediately preceding taxable years 1991 through 2000 are as shown in the table below:

AVERAGE Annual Gross

Current Receipts for the Three Taxable Years

Taxable Years Immediately Preceding the

Current Taxable Year	Year
1991	$ 0
1992	5,000,000
1993	6,000,000
1994	7,000,000
1995	11,000,000
1996	11,000,000
1997	9,000,000
1998	8,000,000
1999	11,000,000
2000	12,000,000

Furthermore, X, which adopted the dollar-value LIFO inventory method, has the following LIFO inventory balances determined without considering the effects of the UNICAP method:

	Beginning	Ending
1995	$1,000,000	$1,100,000
1996	1,100,000	1,200,000
1997	1,200,000	1,300,000
1998	1,300,000	1,400,000
1999	1,400,000	1,500,000
2000	1,500,000	1,600,000

X was required by § 263A to change to the UNICAP method for 1995 because its average annual gross receipts for the three taxable years immediately preceding 1995 were $11,000,000, which exceeded the $10,000,000 ceiling permitted by the small reseller exception. Assume that X was required to capitalize $80,000 of "additional § 263A costs" to the cost of its 1995 beginning inventory because of this change in inventory method. In addition, X was required to include one-fourth of the § 481(a) adjustment when computing taxable income for each of the four taxable years beginning with 1995. Thus, X was required to include a $20,000 positive § 481(a) adjustment in its 1995 taxable income.

X elected to use the simplified resale method without a historic absorption ratio election under § 1.263A–3(d)(3) for determining the amount of additional § 263A costs to be capitalized to each LIFO layer. Assume that X was required to add $10,000 of additional § 263A costs to the cost of its 1995 ending inventory because of the $100,000 increment for 1995.

X's 1995 Ending Inventory:

Beginning Inventory (Without UNICAP costs) $1,000,000
1995 Increment 100,000
Additional § 263A Costs in Beginning Inventory 80,000
Additional § 263A Costs in 1995 Increment 10,000
Total 1995 Ending Inventory $1,190,000

X's Unamortized 1995 § 481(a) adjustment:

1995 § 481(a) Adjustment $80,000
Amount Included in 1995 Taxable Income . . . .<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/95 . . . .$60,000

Because X failed to satisfy the small reseller exception for 1996, X was required to continue using the UNICAP method for its inventory costs. Furthermore, X was required to include $20,000 of the unamortized 1995 positive § 481(a) adjustment in 1996 taxable income. Assume that X was required to add $10,000 of additional § 263A costs to the cost of its 1996 ending inventory because of the $100,000 increment for 1996.

X's 1996 Ending Inventory:

Beginning Inventory (With UNICAP costs) $1,190,000
1996 Increment 100,000

Additional § 263A Costs in 1996 Increment 10,000
Total 1996 Ending Inventory $1,300,000

X's Unamortized 1995 § 481(a) Adjustment:

Unamortized 1995 § 481(a) Adjustment—12/31/95 . . . . . $60,000

Amount Included in 1996 Taxable Income . . . .<20,000>

Unamortized 1995 § 481(a) Adjustment—12/31/96 . . . .$40,000

Because X satisfies the small reseller exception for 1997, X may change voluntarily from the UNICAP method to a permissible non-UNICAP inventory capitalization method under section 4.01 of this APPENDIX. To reflect the removal of the additional § 263A costs from the cost of its 1997 beginning inventory, X must compute a corresponding § 481(a) adjustment, which is a negative $100,000 ($1,200,000 - $1,300,000). Because X used the UNICAP method for only two years (that is, 1995 and 1996), X must include one-half of the § 481(a) adjustment when computing taxable income for each of the two taxable years beginning with 1997. Thus, X must include a $50,000 negative § 481(a) adjustment in 1997 taxable income. In addition, X must include $20,000 of the unamortized 1995 § 481(a) adjustment in 1997 taxable income.

X's 1997 Ending Inventory:

Beginning Inventory (With UNICAP costs) $1,300,000
1997 Increment 100,000
1997 § 481(a) Adjustment <Negative> . . . .<100,000>
Total 1997 Ending Inventory $1,300,000

X's Unamortized 1995 § 481(a) Adjustment:

Unamortized 1995 § 481(a) Adjustment—12/31/96	$40,000
Amount Included in 1997 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/97	$20,000

X's Unamortized 1997 § 481(a) Adjustment:

1997 § 481(a) Adjustment <Negative>	$<100,000>
Amount Included in 1997 Taxable Income	50,000
Unamortized 1997 § 481(a) Adjustment—12/31/97	$< 50,000>

X also satisfies the small reseller exception for 1998 and, therefore, is not required to return to the UNICAP method for 1998. X, however, must include $20,000 of the unamortized 1995 positive § 481(a) adjustment and $50,000 of the unamortized 1997 negative § 481(a) adjustment in 1998 taxable income.

X's 1998 Ending Inventory:

Beginning Inventory (Without UNICAP costs)	$1,300,000
1998 Increment	100,000
Total 1998 Ending Inventory	$1,400,000

X's Unamortized 1995 § 481(a) Adjustment:

Unamortized 1995 § 481(a) Adjustment—12/31/97	$20,000
Amount Included in 1998 Taxable Income	<20,000>
Unamortized 1995 § 481(a) Adjustment—12/31/98	$ 0

X's Unamortized 1997 § 481(a) Adjustment:

Unamortized 1997 § 481(a) Adjustment—12/31/97	$<50,000>
Amount Included in 1998 Taxable Income	50,000
Unamortized 1997 § 481(a) Adjustment—12/31/98	$ 0

In 1999, X fails to satisfy the small reseller exception and, therefore, must return to the UNICAP method as provided under section 4.01 of this APPENDIX. X changes to the simplified resale method without a historic absorption ratio election under § 1.263A–3(d)(3). Assume that X must capitalize $120,000 of additional § 263A costs to the cost of its 1999 beginning inventory because of this change in inventory method. In addition, X must determine the appropriate adjustment period for the corresponding positive § 481(a) adjustment. Because X used its former inventory method for two taxable years before 1999 (that is, 1997 and 1998), X must include one-half of the § 481(a) adjustment when computing taxable income for each of the two taxable years beginning with 1999. Thus, X must include a $60,000 positive § 481(a) adjustment in its 1999 taxable income. Assume that X must add $10,000 of additional § 263A costs to the cost of its 1999 ending inventory because of the $100,000 increment for 1999.

X's 1999 Ending Inventory:

Beginning Inventory (Without UNICAP costs)	$1,400,000
1999 Increment	100,000
Additional § 263A costs in Beginning Inventory	120,000
Additional § 263A costs in 1999 Increment	10,000
Total 1999 Ending Inventory	$1,630,000

X's Unamortized 1999 § 481(a) adjustment:

1999 § 481(a) Adjustment	$120,000
Amount Included in 1999 Taxable Income	< 60,000>
Unamortized 1999 § 481(a) Adjustment—12/31/99	$ 60,000

Because X fails to satisfy the small reseller exception for 2000, X must continue using the UNICAP method for its inventory costs. Furthermore, X is required to include $60,000 of the unamortized 1999 positive § 481(a) adjustment in 2000 taxable income. Assume that X is required to add $10,000 of additional § 263A costs to the cost of its 2000 ending inventory because of the $100,000 increment for 2000.

X's 2000 Ending Inventory:

Beginning Inventory (With UNICAP costs)	$1,630,000
2000 Incremen	100,000
Additional § 263A Costs in 2000 Increment	10,000
Total 2000 Ending Inventory	$1,740,000

X's Unamortized 1999 § 481(a) Adjustment:

Unamortized 1999 § 481(a) Adjustment—12/31/99	$60,000
Amount Included in 2000 Taxable Income	<60,000>
Unamortized 1999 § 481(a) Adjustment—12/31/00	$ 0

.02 *Reserved.*

SECTION 4A. DEFERRED COMPENSATION (§ 404)

.01 *Change to comply with § 404(a)(11).*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to a taxpayer that must change its method of accounting for its first taxable year ending after July 22, 1998, to comply with § 404(a)(11). Section 404(a)(11) provides that, for purposes of determining under § 404 whether compensation of an employee is deferred compensation and when deferred compensation is paid, no amount is treated as received by the employee, or paid, until it is actually received by the employee. Section 404(a)(11) overturns the decision in *Schmidt Baking Co. v. Commissioner*, 107 T.C. 271 (1996), in which the court held that a § 83(a) income inclusion event upon securitization of vacation and severance pay benefits with a letter of credit constitutes receipt of those benefits by employees for purposes of determining whether an employer's deduction for the benefits is subject to § 404. *See* Notice 99–16, 1999–13 I.R.B. 10 (March 29, 1999).

(b) *Scope limitations inapplicable.* A taxpayer that must make this change is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(2) *Section 481(a) adjustment period.* A taxpayer must take the § 481(a) adjustment into account ratably over three taxable years.

(3) *No audit protection.* A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 *Reserved.*

SECTION 5. METHODS OF ACCOUNTING (§ 446)

.01 *Cash or hybrid method to accrual method.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to:

(i) a taxpayer that wants to change to an overall accrual method, or to an overall accrual method in conjunction with the recurring item exception under § 461(h)(3), from the cash receipts and disbursements method (cash method), or from a hybrid method (the use of a combination of accounting methods under which an item or items of income or expense are reported on the cash method and another item or other items of income or expense are reported on an accrual method); or

(ii) a taxpayer that is required to change to an overall accrual method under § 448, but is ineligible to make the change under § 1.448–1(h)(2) (relating to the "first § 448 year").

(b) *Inapplicability.* This change does not apply to:

(i) a financial institution described in § 581 or 591;

(ii) a farmer;

(iii) a cooperative organization described in § 501(c)(12), 521, or 1381;

(iv) an individual taxpayer, except for activities conducted as a sole proprietorship;

(v) a taxpayer required to use an inventory method of accounting, unless:

(A) the taxpayer is using or adopts a proper inventory method under § 471 and the regulations thereunder, the taxpayer is a small reseller within the meaning of § 1.263A–3(a), and, if the taxpayer has production activities, the taxpayer's production activities qualify under the de minimis presumption of § 1.263A–3(a)(2)(iii); or

(B) the taxpayer is using or adopts a proper inventory method under § 471 and the regulations thereunder, the taxpayer is a reseller eligible to use the simplified resale method under § 1.263A–3(d), and the taxpayer adopts a proper method under that section for the year of change;

(vi) a taxpayer required to use a long-term contract method in accordance with § 460, if the taxpayer is not in compliance with that section and any related administrative guidance;

(vii) a taxpayer required or wanting to use a special method of accounting, unless the taxpayer is permitted to change automatically to the special method under this revenue procedure. A special method of accounting is a method that deviates from the normal tax accounting rules, such as the method of accounting for advance payments pursuant to either Rev. Proc. 71–21, 1971–2 C.B. 549, or § 1.451–5, the installment method of accounting under § 453, or a long-term contract method, such as the percentage of completion method or the completed contract method;

(viii) a taxpayer required to change to an overall accrual method under § 448 and eligible to make the change under § 1.448–1(h)(2). *See* § 1.448–1(h)(2), which provides an automatic consent procedure for a taxpayer changing for the first taxable year that it is subject to § 448. *See also* § 1.448–1(h)(1), which provides that § 1.448–1(h) does not apply to a change required under any Code section (or regulations thereunder) other than § 448 (for example, a taxpayer with inventories); or

(ix) a taxpayer engaged in two or more trades or businesses, unless the taxpayer uses or adopts the same overall accrual method for each such trade or business.

(2) *Section 481(a) adjustment.*

(a) *In general.* The § 481(a) adjustment takes into account the accounts receivable, accounts payable, inventory, and any other item determined to be necessary in order to prevent items from being duplicated or omitted. The § 481(a) adjustment does not include any item of income accrued but not received that was worthless or partially worthless (within the meaning of § 166(a)) on the last day of the year preceding the year of change.

(b) *Recurring item exception.* As part of the change to an overall accrual method, a taxpayer may adopt the recurring item exception for the year of change if the taxpayer is eligible and follows the procedures of § 1.461–5(d). If the taxpayer is eligible and wants to adopt this method as specified in § 461(h)(3), the amount of the § 481(a) adjustment must be modified to account for the amount of any additional deduction.

(3) *Change to a special method of accounting.* If a taxpayer that wants to change to an accrual method in conjunction with a change to a special method of accounting is not permitted to make the change under this revenue procedure, the taxpayer may request to make both changes only by filing one application under the provisions of Rev. Proc. 97–27, 1997–1 C.B. 680. Only one user fee will be required for these changes.

.02 *Multi-year service warranty contracts.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to an eligible accrual method manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods that wants to change to the service warranty income method described in section 5 of Rev. Proc. 97–38, 1997–2 C.B. 479. Under the service warranty income method, a qualifying taxpayer may, in certain specified and limited circumstances, include a portion of an advance payment related to the sale of a multi-year service warranty contract in gross income generally over the life of the service warranty obligation.

(b) *Inapplicability.* This change does not apply to a taxpayer outside the scope of Rev. Proc. 97–38.

(2) *Manner of making the change.*

(a) This change is made using a cut-off method, under which the taxpayer begins the use of the service warranty income method for all qualified advance payment amounts received in the year of change and thereafter. *See* section 2.06 of this revenue procedure.

(b) In accordance with § 1.446–1(e)(3)(ii), the requirement of § 1.446–1(e)(3)(i) to file an application on Form 3115 is waived and a statement in lieu of the Form 3115 is authorized for this change. The statement must be identified at the top as follows: "**CHANGE TO THE SERVICE WARRANTY IN-**

COME METHOD UNDER SECTION 5.02 OF THE APPENDIX OF REV. PROC. 99–49." The statement must set forth the information required under section 6.03 of Rev. Proc. 97–38, except that the statement under section 6.03(2) (that the taxpayer agrees to all of the terms and conditions of the revenue procedure) also should refer to Rev. Proc. 99–49.

(c) A taxpayer changing to the service warranty income method of accounting under section 5.02 of this APPENDIX must satisfy the annual reporting requirement set forth in section 6.04 of Rev. Proc. 97–38.

.03 *Multi-year insurance policies for multi-year service warranty contracts — Description of change and scope*.

(1) *Applicability.* This change applies to a manufacturer, wholesaler, or retailer of motor vehicles or other durable consumer goods that wants to change its method of accounting for insurance costs paid or incurred to insure its risks under multi-year service warranty contracts to the method described in section 5.03(3) of this APPENDIX. Multi-year service warranty contracts to which this change applies include only those separately priced contracts sold by a manufacturer, wholesaler, or retailer also selling the motor vehicles or other durable consumer goods (to the ultimate customer or to an intermediary) underlying the contracts. The classification of goods as "durable consumer goods" for purposes of this change depends on the common usage of the goods, rather than the purchaser's actual intended use of the goods.

(2) *Inapplicability.* This change does not apply to a taxpayer that covers its risks under its multi-year service warranty contracts through arrangements not constituting insurance.

(3) *Description of method*. If a taxpayer purchases a multi-year service warranty insurance policy (in connection with its sale of multi-year service warranty contracts to customers) by paying a lump-sum premium in advance, the taxpayer must capitalize the amount paid or incurred and may only obtain deductions for that amount by prorating (or amortizing) it over the life of the insurance policy (whether the cash method or an accrual method of accounting is used to account for service warranty transactions).

.04 *Interest accruals on short-term consumer loans — Rule of 78s method.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to a taxpayer that wants to change its method of accounting from the Rule of 78s method to the constant yield method for stated interest (including stated interest that is original issue discount) on short-term consumer loans described in Rev. Proc. 83–40, 1983–1 C.B. 774, which was obsoleted by Rev. Proc. 97–37, 1997–2 C.B. 455.

(b) *Scope limitations inapplicable*. A taxpayer that wants to make this change for its first or second taxable year beginning on or after January 1, 1998, is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(2) *Background.*

(a) A short-term consumer loan is described in Rev. Proc. 83–40, provided:

(i) the loan is a self-amortizing loan that requires level payments, at regular intervals at least annually, over a period not in excess of five years (with no balloon payment at the end of the loan term); and

(ii) the loan agreement between the borrower and the lender provides that interest is earned, or upon the prepayment of the loan interest is treated as earned, in accordance with the Rule of 78s method.

(b) In general, the Rule of 78s method allocates interest over the term of a loan based, in part, on the sum of the periods' digits for the term of the loan. See Rev. Rul. 83–84, 1983–1 C.B. 97, for a description of the Rule of 78s method.

(c) In general, the constant yield method allocates interest and original issue discount over the term of a loan based on a constant yield. See § 1.1272–1(c) for a description of the constant yield method. The Rule of 78s method generally front-loads interest as compared to the constant yield method.

(d) Rev. Proc. 83–40 was obsoleted because, under §§ 1.446–2 and 1.1272–1 (which were effective for debt instruments issued on or after April 4, 1994), taxpayers generally must account for stated interest and original issue discount on a debt instrument (loan) by using a constant yield method. As a result, the Rule of 78s method is no longer an acceptable method of accounting for federal income tax purposes.

(e) Notwithstanding §§ 1.446–2 and 1.1272–1, as a matter of administrative convenience, the Service will allow a taxpayer to use the Rule of 78s method for stated interest on short-term consumer loans described in Rev. Proc. 83–40 if the loans were issued prior to the first day of the taxpayer's first taxable year that begins on or after January 1, 1999.

(3) *Manner of making the change.*

(a) This change is made using a cut-off method and applies only to loans issued on or after the first day of the year of change. *See* section 2.06 of this revenue procedure.

(b) The taxpayer must maintain books and records sufficient to satisfy the district director that loans issued before the year of change and loans issued on or after the first day of the year of change have been adequately accounted for separately.

SECTION 5A. TAXABLE YEAR OF INCLUSION (§ 451)

.01 *Accrual of interest on nonperforming loans.*

(1) *Description of change and scope.*

(a) This change applies to an accrual method taxpayer that is a bank as defined in § 581 (or whose primary business is making or managing loans) and wants to change its method of accounting to comply with §§ 451 and 1.451–1(a) for qualified stated interest (as defined in § 1.1273–1(c)) on nonperforming loans.

(b) Section 1.451–1(a) requires income to be accrued when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. A taxpayer may not stop accruing qualified stated interest on a nonperforming loan for federal income tax purposes merely because payments on the loan are overdue by a certain length of time, such as 90 days, even if a federal, state, or other regulatory authority having jurisdiction over the taxpayer permits or requires that the overdue interest not be accrued for regulatory purposes.

(c) Under §§ 451 and 1.451–1(a), a taxpayer must continue accruing qualified stated interest on any nonperforming loan until either (i) the loan is worthless under § 166 and charged off as a bad debt, or (ii) the interest is determined to be uncollectible. In order for interest to be determined uncollectible, the taxpayer must substantiate, taking into account all the facts and circumstances, that it has no reasonable expectation of payment of the interest. This substantiation requirement is applied on a loan by loan basis.

(d) A taxpayer that changes its method of accounting under section 5A.01 of this APPENDIX must do so for all of its loans.

(2) *Section 481(a) adjustment.* In general, the § 481(a) adjustment for a method change under section 5A.01 of this APPENDIX represents the amount of qualified stated interest, on the taxpayer's nonperforming loans outstanding as of the beginning of the year of change, that should have been accrued under §§ 451 and 1.451–1(a) and was not accrued. Interest for which the taxpayer, as of the beginning of the year of change, has no reasonable expectation of payment is not taken into account in determining the amount of the § 481(a) adjustment.

.02 *Reserved.*

SECTION 6. OBLIGATIONS ISSUED AT DISCOUNT (§ 454)

.01 *Series E or EE U.S. savings bonds.*

(1) *Description of change and scope.* This change applies to a cash method taxpayer that wants to change its method of accounting for interest income on Series E or EE U.S. savings bonds. However, this change only applies to a taxpayer that has previously made an election under § 454 to report as interest income the increase in redemption price on a bond occurring in a taxable year, and that now wants to report this income in the taxable year in which the bond is redeemed, disposed of, or finally matures, whichever is earliest.

(2) *Manner of making the change.*

(a) This change is made using a cut-off method and is effective for any increase in redemption price occurring after the beginning of the year of change for all Series E and EE U.S. savings bonds held by the taxpayer on or after the beginning of the year of change. *See* section 2.06 of this revenue procedure.

(b) In accordance with § 1.446–1(e)(3)(ii), the requirement of § 1.446–1(e)(3)(i) to file an application on Form 3115 is waived and a statement in lieu of the Form 3115 is authorized for this change. The statement must be identified at the top as follows: "**CHANGE IN METHOD OF ACCOUNTING UNDER SECTION 6.01 OF THE APPENDIX OF REV. PROC. 99–49.**" The statement must set forth:

(i) the Series E or EE U.S. savings bonds for which this change in accounting method is requested;

(ii) an agreement to report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest; and

(iii) an agreement to report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of any interest income previously reported in prior taxable years.

.02 *Reserved.*

SECTION 7. PREPAID SUBSCRIPTION INCOME (§ 455)

.01 *Prepaid subscription income.*

(1) *Description of change and scope.* This change applies to an accrual method taxpayer that wants to change its method of accounting for prepaid subscription income to the method described in § 455 and the regulations thereunder, including an eligible taxpayer that wants to make the "within 12 months" election under § 1.455–2.

(2) *Manner of making the change.*

(a) This change is made using a cut-off method and does not apply to any prepaid subscription income received before the first taxable year to which the change applies. Any prepaid subscription income arising prior to the year of change is accounted for under the taxpayer's former method of accounting. *See* section 2.06 of this revenue procedure.

(b) In accordance with § 1.446–1(e)(3)(ii), the requirement of § 1.446–1(e)(3)(i) to file an application on Form 3115 is waived and a statement in lieu of the Form 3115 is authorized for this change. The statement must be identified at the top as follows: "**CHANGE IN METHOD OF ACCOUNTING FOR PREPAID SUBSCRIPTION INCOME UNDER SECTION 7.01 OF THE APPENDIX OF REV. PROC. 99–49.**" The statement must set forth the information required under § 1.455–6(b).

(c) The consent granted under this revenue procedure satisfies the consent required under §§ 455(c)(3) and 1.455–6(b).

.02 *Reserved.*

SECTION 8. TAXABLE YEAR OF DEDUCTION (§ 461)

.01 *Timing of incurring liabilities for employee compensation.*

(1) *Description of change and scope.*

(a) *Applicability.* This change applies to an accrual method taxpayer that wants to change its method of accounting to treat bonuses or self-insured medical benefits as follows:

(i) *Bonuses.* If the obligation to pay a bonus becomes fixed and certain by the end of the taxable year (*see* Rev. Rul. 61–127, 1961–2 C.B. 36), and the bonus is otherwise deductible, but the bonus is paid after the 15th day of the third calendar month after the end of that taxable year, to treat the bonus as deductible in the taxable year of the employer in which or with which ends the taxable year of the employee in which the bonus is includible in the gross income of the employee; or

(ii) *Self-insured medical benefits.* If the obligation to pay an employee's medical expenses is neither insured nor paid from a welfare benefit fund within the meaning of § 419(e), to treat the liability as incurred in the taxable year in which the employee files the claim with the employer. *See United States v. General Dynamics Corp.*, 481 U.S. 239 (1987), 1987–2 C.B. 134.

(b) *Inapplicability.* This change does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.01 of this APPENDIX, if the taxpayer is not capitalizing the costs as required.

(2) *Amounts taken into account.* Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, direct labor costs must be included in inventory costs and may be recovered through cost of goods sold. *See* § 1.263A–1(e)(2)(i)(B). A taxpayer may not rely on the provisions of section 8.01 of this APPENDIX to take a current year deduction.

.02 *Timing of incurring liabilities for real property taxes.*

(1) *Description of change*. An accrual method taxpayer generally incurs a liability in the taxable year that all the events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. *See* § 1.446–1(c)(1)(ii). Under § 1.461–4(g)(6), if the liability of the taxpayer is to pay a tax, economic performance occurs as the tax is paid to the government authority that imposed the tax.

(2) *Scope*.

(a) *Applicability*. This change applies to an accrual method taxpayer that wants to change its method of accounting to:

(i) treat a liability for real property taxes (for which the all events test of § 461(h)(4) is otherwise met) as incurred in the taxable year in which the taxes are paid, under §§ 461 and 1.461–4(g)(6);

(ii) account for real property taxes under the recurring item exception to the economic performance rules under §§ 461(h)(3) and 1.461–5(b)(1); or

(iii) revoke an election under § 461(c) (ratable accrual election).

(b) *Inapplicability*. This change does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.02 of this APPENDIX, if the taxpayer is not capitalizing the costs as required.

(3) *Amounts taken into account.* Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, certain real property taxes must be included in inventory costs and may be recovered through cost of goods sold. *See* § 1.263A–1(e)(3)(ii)(L). A taxpayer may not rely on the provisions of section 8.02 of this APPENDIX to take a current year deduction.

.03 *Timing of incurring liabilities under a workers' compensation act, tort, breach of contract, or violation of law.*

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to an accrual method taxpayer that wants to change its method of accounting for self-insured liabilities (including any amounts not covered by insurance, such as a "deductible" amount under an insurance policy) arising under any workers' compensation act or out of any tort, breach of contract, or violation of law, to treating the liability for the workers' compensation, tort, breach of contract, or violation of law as being incurred in the taxable year in which all the events have occurred which establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and payment is made to the person to which the liability is owed. *See* §§ 461 and 1.461–4(g)(2).

(b) *Inapplicability*. This change does not apply:

(i) to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.03 of this APPENDIX, if the taxpayer is not capitalizing the costs as required;

(ii) if payment is made to a third party rather than to the person to which the liability is owed. *See* § 1.461–4(g)(1); or

(iii) if payment is made by a third party.

(2) *Amounts taken into account*. Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, certain employee benefit costs (including workers' compensation) must be included in inventory costs and may be recovered through costs of goods sold. *See* § 1.263A– 1(e)(3)(ii)(D). A taxpayer may not rely on the provisions of section 8.03 of this APPENDIX to take a current year deduction.

.04 *Timing of incurring liabilities for payroll taxes*.

(1) *Applicability*. This change applies to:

(a) an accrual method employer that wants to change its method of accounting for

(i) FICA and FUTA taxes to a method consistent with the holding in Rev. Rul. 96–51, 1996–2 C.B. 36 (Rev. Rul. 96–51 holds that, under the all events test of § 461, an accrual method employer may deduct in Year 1 its otherwise deductible FICA and FUTA taxes imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, if the requirements of the recurring item exception are met); and

(ii) state unemployment taxes and, in the event the taxpayer is an employer within the meaning of the Railroad Retirement Tax Act (*see* § 3231(a)), railroad retirement taxes to a method under which the taxpayer may deduct in Year 1 its otherwise deductible state unemployment taxes and railroad retirement taxes (if applicable) imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, if the requirements of the recurring item exception are met (including the requirement that, as of the end of the taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy, *see* § 1.461–5(b)); or

(b) an accrual method employer that utilizes a method of accounting for FICA and FUTA taxes that is consistent with the holding in Rev. Rul. 96–51, 1996–2 C.B. 36 and wishes to change its method of accounting for state unemployment taxes and, in the event the employer is an employer within the meaning of the Railroad Retirement Tax Act (*see* § 3231(a)), railroad retirement taxes to a method under which the taxpayer may deduct in Year 1 its otherwise deductible state unemployment taxes and railroad retirement taxes (if applicable)imposed with respect to year-end wages properly accrued in Year 1, but paid in Year 2, if the requirements of the recurring item exception are met (including the requirement that, as of the end of the taxable year, all events have occurred that establish the fact of the liability and the amount of the liability can be determined with reasonable accuracy, *see* § 1.461–5(b)).

(2) *Inapplicability*. This change does not apply to a taxpayer that is subject to § 263A and that is required to capitalize the costs with respect to which the taxpayer wants to change its method of accounting under section 8.04 of this APPENDIX, if the taxpayer is not capitalizing the costs as required.

(3) *Recurring item exception*. A taxpayer that previously has not changed to or adopted the recurring item exception for FICA, FUTA, state unemployment taxes and railroad retirement taxes (if applicable) must change to the recurring item exception method for FICA, FUTA, state unemployment taxes and railroad retirement taxes (if applicable) as specified in § 461(h)(3) as part of this change.

(4) *Amounts taken into account*. Applicable provisions of the Code, regulations, and other published guidance prescribe the manner in which a liability that has been incurred is taken into account. For example, for a taxpayer with inventories, certain taxes must be included in inventory costs and may be recovered through cost of goods sold. *See* § 1.263A–1(e)(3)(ii)(L). A taxpayer may not rely on the provisions of section 8.04 of this APPENDIX to take a current year deduction.

.05 *Cooperative advertising*.

(1) *Description of change and scope.* This change applies to a taxpayer that wants to change its method of accounting for cooperative advertising costs to a method consistent with the holding in Rev. Rul. 98–39, 1998–33 I.R.B. 4. Rev. Rul. 98–39 generally provides that, under the all events test of § 461, an accrual method manufacturer's liability to pay a retailer for cooperative advertising services is incurred in the year in which the services are performed, provided the manufacturer is able to reasonably estimate this liability, and even though the retailer does not submit the required claim form until the following year.

(2) *Scope limitations inapplicable.* A taxpayer that wants to make this change for its first or second taxable year ending on or after August 17, 1998, is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

SECTION 8A. CERTAIN PAYMENTS FOR THE USE OF PROPERTY OR SERVICES (§ 467)

.01 *Change to constant rental accrual method.*

(1) *Description of change*. This change applies to a taxpayer that wants to change to the constant rental accrual method, as described in § 1.467–3, for all of its section 467 rental agreements described in § 1.467–8(b). *See* § 1.467–8.

(2) *Requirements*. Taxpayers changing their method of accounting in accordance with this change must do so for all of their section 467 rental agreements described in § 1.467–8(b). This change must be made for the taxpayer's first taxable year ending after May 18, 1999.

(3) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure are not applicable to this change. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

.02 *Change to comply with §§ 1.467–1 through 1.467–7.*

(1) *Description of change*. This change applies to a taxpayer that wants to change its method of accounting for rental agreements described in § 1.467–9(a)(2) to comply with §§ 1.467–1 through 1.467–7. *See* § 1.467–9(e)(1).

(2) *Requirements.* This change must be made for the taxpayer's first taxable year ending after May 18, 1999.

(3) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure are not applicable to this change. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(4) *Manner of making the change*. This change is made using a cut-off method and applies only to rental agreements described in § 1.467–9(a)(2). *See* section 2.06 of this revenue procedure. For purposes of this paragraph (4), a rental agreement is entered into on its agreement date (within the meaning of § 1.467–1(h)(1) and, if applicable, § 1.467–1(f)(1)(i)).

.03 *Change to comply with regulation project IA–292–84.*

(1) *Description of the change.* This change applies to a taxpayer that wants to change its method of accounting for any rental agreement described in § 1.467–9(c) to comply with the provisions of regulation project IA–292–84 (1996–2 C.B. 462).

(2) *Requirements*. This change must be made for the taxpayer's first taxable year ending after May 18, 1999.

(3) *Scope limitations inapplicable*. The scope limitations in section 4.02 of this revenue procedure are not applicable to this change. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

SECTION 9. INVENTORIES (§ 471)

.01 *Cash discounts — Description of change and scope.* This change applies to a taxpayer that wants to change its method of accounting for cash discounts (discounts granted for timely payment) when they approximate a fair interest rate, from a method of consistently including the price of the goods before discount in the cost of the goods and including in gross income any discounts taken (the "gross invoice method"), to a method of reducing the cost of the goods by the cash discounts and deducting as an expense any discounts not taken (the "net invoice method"), or vice versa. *See* Rev. Rul. 73–65, 1973–1 C.B. 216.

.02 *Estimating inventory "shrinkage"*.

(1) *Description of change and scope.* This change applies to a taxpayer that wants to change to a method of accounting for estimating inventory shrinkage in computing ending inventory, using:

(a) the "retail safe harbor method" described in section 4 of Rev. Proc. 98–29, 1998–15 I.R.B. 22; or

(b) a method other than the retail safe harbor method, provided (i) the taxpayer's present method of accounting does not estimate inventory shrinkage, and (ii) the taxpayer's new method of accounting (that estimates inventory shrinkage) clearly reflects income under § 446(b).

(2) *Scope limitations inapplicable.* A taxpayer that wants to make this change is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(3) *Additional requirements*. If the taxpayer wants to change to a method of accounting for inventory shrinkage other than the retail safe harbor method, the taxpayer must attach to the application a statement setting forth a detailed description of all aspects of the new method of estimating inventory shrinkage (including, for LIFO taxpayers, the method of determining inventory shrinkage for, or allocating inventory shrinkage to, each LIFO pool).

(4) *Audit protection*. A taxpayer, whose present method of accounting estimates inventory shrinkage, does not receive audit protection under section 7 of this revenue procedure in connection with a change to the retail safe harbor method if, on the date the taxpayer files a copy of the Form 3115 with the national office, the taxpayer's present method of estimating inventory shrinkage is an issue under consideration within the meaning of section 3.09 of this revenue procedure.

(5) *Future change*. A taxpayer that changes to the retail safe harbor method described in this revenue procedure will not be precluded, solely by reason of such change, from changing to another safe harbor method for estimating inventory shrinkage in computing ending inventory in the first year that such other safe harbor method is available.

SECTION 10. LAST-IN, FIRST-OUT (LIFO) INVENTORIES (§ 472)

.01 *Change from the LIFO inventory method.*

(1) *Description of change and scope.*

(a) *In general*. This change applies to any taxpayer that wants to:

(i) change from the LIFO inventory method for all its LIFO inventory; and

(ii) change to the permitted method as determined in section 10.01(1)(b) of this APPENDIX.

(b) *Method to be used*.

(i) *Determining method to be used*. The inventory method to be used by a taxpayer is determined as follows:

(A) If the taxpayer has inventoriable goods not included in its LIFO inventory computations (non-LIFO inventory) and, for all the taxpayer's non-LIFO inventory, the taxpayer uses an inventory method that is a permitted method, then the taxpayer must use that same inventory method for its entire inventory.

(B) If the LIFO inventory method is used by the taxpayer with respect to all its inventoriable goods, then the taxpayer must use the same inventory method it used prior to the adoption of the LIFO inventory method, if that prior method is a permitted method.

(C) If the taxpayer has only LIFO inventory and the method used by the taxpayer prior to the adoption of the LIFO inventory method is not a permitted method, then the taxpayer must use a permitted method.

(D) If the taxpayer did not use an inventory method prior to the adoption of the LIFO inventory method and has no inventoriable goods other than its LIFO inventory, then the taxpayer must use a permitted method.

(ii) *Permitted method defined.* For purposes of section 10.01 of this APPENDIX, a permitted method is a method under which:

(A) the identification method is either the first-in, first-out (FIFO) inventory method or the specific identification inventory method; and

(B) the valuation method is cost; cost or market, whichever is lower; market (but only if the taxpayer is a dealer in securities, as defined in § 1.471–5); the "farm price method" or the "unit-livestock-price method" (but only if the taxpayer is a farmer permitted to use such methods); or the retail method, reduced to either approximate cost or approximate cost or market, whichever is lower (but only if the taxpayer is a retail merchant).

(iii) *Method not to be used*. The average cost method (sometimes also referred to as "the rolling average method") described in Rev. Rul. 71–234, 1971–1 C.B. 148, is not a permitted method.

(iv) *Determining permitted method.* Whether an inventory method is a permitted method is determined by the taxpayer's method of inventory identification and valuation, and not by which types and amounts of costs are capitalized under the taxpayer's method of computing inventory cost. *See* § 263A and the regulations thereunder, which govern the types and amounts of costs required to be included in inventory cost for taxpayers subject to those provisions.

(2) *Limitation on LIFO election*. The taxpayer may not re-elect the LIFO inventory method for a period of at least five taxable years beginning with the year of change, unless based on a showing of unusual and compelling circumstances, consent is specifically granted by the Commissioner to change the method of accounting at an earlier time. A taxpayer that wants to re-elect the LIFO inventory method within a period of five taxable years (beginning with the year of change) must file a Form 3115 in accordance with

Rev. Proc. 97–27, 1997–1 C.B. 680. A taxpayer that wants to re-elect the LIFO inventory method after a period of five taxable years (beginning with the year of change) is not required to file a Form 3115 in accordance with Rev. Proc. 97–27, but must file a Form 970, Application to Use LIFO Inventory Method, in accordance with § 1.472–3.

(3) *Effect of subchapter S election by corporation*.

(a) *S election effective for year of LIFO discontinuance*. If a C corporation elects to be treated as an S corporation for the taxable year in which it discontinues use of the LIFO inventory method, § 1363(d) requires an increase in the taxpayer's gross income for the LIFO recapture amount (as defined in § 1363(d)(3)) for the taxable year preceding the year of change (the taxpayer's last taxable year as a C corporation), and a corresponding adjustment to the basis of the taxpayer's inventory as of the end of the taxable year preceding the year of change. Any increase in income tax as a result of the inclusion of the LIFO recapture amount is payable in four equal installments, beginning with the taxpayer's last taxable year as a C corporation as provided in § 1363(d)(2). Any corresponding basis adjustment is taken into account in computing the § 481(a) adjustment (if any) that results upon the discontinuance of the LIFO method by the corporation.

(b) *S election effective for a year after LIFO discontinuance.* If a C corporation elects to be treated as an S corporation for a taxable year after the taxable year in which it discontinued use of the LIFO inventory method, the remaining balance of any positive § 481(a) adjustment must be included in its gross income in its last taxable year as a C corporation. If this inclusion results in an increase in tax for its last taxable year as a C corporation, this increase in tax is payable in four equal installments, beginning with the taxpayer's last taxable year as a C corporation as provided in § 1363(d)(2), unless the taxpayer is required to take the remaining balance of the § 481(a) adjustment into account in the last taxable year as a C corporation under another acceleration provision in section 5.02(3)(c) of this revenue procedure.

(4) *Additional requirements.* The taxpayer must complete the following statements and attach them to the application:

(a) "The new method of identifying inventory goods is the [insert method; that is, specific identification; FIFO; retail; etc.] method."

(b) "The new method of valuing inventory goods is [insert method; that is, cost; cost or market, whichever is lower; etc.]."

(c) "The new method conforms to the requirements of section 10.01(1)(b)(i) [insert either (A), (B), (C), or (D)] of the APPENDIX of Rev. Proc. 99–49 because [explain in detail how the new method conforms to the specific subdivision]."

.02 *Determining the cost of used vehicles purchased or taken as a trade-in.*

(1) *Description of change and scope*. This change applies to a LIFO taxpayer that wants to:

(a) determine the cost of used vehicles acquired by trade-in using the average wholesale price listed by an official used car guide on the date of the trade-in. *See* Rev. Rul. 67–107, 1967–1 C.B. 115. The official used car guide selected must be consistently used;

(b) determine the cost of used vehicles purchased for cash using the actual purchase price of the vehicle; or

(c) reconstruct the beginning-of-the-year cost of used vehicles purchased for cash using values computed by national auto auction companies based on vehicles purchased for cash. The national auto auction company selected must be consistently used.

(2) *Manner of making the change*. This change is made using a cut-off method and applies to used vehicles acquired during the year of change and all subsequent years. *See* section 2.06 of this revenue procedure.

.03 *Alternative LIFO inventory method for retail automobile dealers.*

(1) *Description of change and scope*.

(a) *Applicability.* This change applies to a taxpayer engaged in the trade or business of retail sales of new automobiles or new light-duty trucks ("automobile dealer") that wants to change to the "Alternative LIFO Method" described in section 4 of Rev. Proc. 97–36, 1997–2 C.B. 450, for its LIFO inventories of new automobiles and new light-duty trucks. Light-duty trucks are trucks with a gross vehicle weight of 14,000 pounds or less, which also are referred to as class 1, 2, or 3 trucks.

(b) *Inapplicability.* This change does not apply to an automobile dealer that uses the inventory price index computation (IPIC) method for goods other than new automobiles, new light-duty trucks, parts and accessories, used automobiles, and used trucks.

(2) *Manner of making the change*.

(a) *Cut-off method.* This change is made using a cut-off method. *See* section 2.06 of this revenue procedure and section 5.03(6) of Rev. Proc. 97–36.

(b) *IPIC method changes*. An automobile dealer that uses the IPIC method also must change from the IPIC method under section 10.03 of this APPENDIX to another acceptable method for its goods other than new automobiles and new light-duty trucks. For parts and accessories, the automobile dealer must change to the dollar-value, index method, with all parts and accessories within each separate trade or business in a separate LIFO pool. For used vehicles, the automobile dealer must change to the dollar-value, link-chain method, with all used automobiles within each separate trade or business in one LIFO pool and all used trucks within each separate trade or business in another separate LIFO pool.

(c) *Additional requirements*. An automobile dealer also must comply with the following:

(i) the conditions in section 5.03 of Rev. Proc. 97–36; and

(ii) for an automobile dealer changing from the IPIC method, the automobile dealer also must attach to the application a schedule setting forth the classes of goods for which the automobile dealer has elected to use the LIFO method and the accounting method changes being made under section 10.03 of this APPENDIX for each class of goods.

.04 *Inventory price index computation (IPIC) method under the LIFO inventory method*.

(1) *Description of change and scope*.

(a) This change applies to an eligible taxpayer that wants to change its LIFO inventory method to use the IPIC method for its entire LIFO inventory in accordance with all the provisions of § 1.472–8(e)(3) and Rev. Proc. 84–57, 1984–2 C. B. 496. The taxpayer must:

(i) in the case of the CPI Detailed Report, select an index from Table 3 (Consumer Price Index for All Urban Consumers (CPI-U): U.S. city average, detailed expenditure categories); and

(ii) in the case of the Producer Price Indexes, select an index from Table 6 (Producer price indexes and percent changes for commodity groupings and individual items).

(b) A taxpayer using the IPIC method must apply the inventory price index to its ending inventory valued at current-year cost, under the taxpayer's method of determining current-year cost. *See* § 1.472–8(e)(2)(ii). Furthermore, there must be a nexus between the taxpayer's method of determining current-year costs and the month to be used in selecting indexes. *See* § 1.472–8(e)(3)(iii)(C) and Rev. Rul. 89–29, 1989–1 C.B. 168. For example, if a taxpayer determines current-year cost by reference to the actual cost of goods purchased or produced during the taxable year in the order of acquisition (earliest acquisitions cost), then the inventory price index must be applied to the earliest acquisitions cost of ending inventory. In computing the inventory price index, such a taxpayer must select indexes from a month toward the beginning of its taxable year.

(c) A taxpayer may not change its method of pooling as part of a change made under section 10.04 of this APPENDIX, except to a method specifically authorized by § 1.472–8(e)(3)(iv) or section 3.04(1)(b) of Rev. Proc. 84–57. These special pooling rules do not apply to goods manufactured by the taxpayer. *See* § 1.472–8(b) for principles for establishing pools of manufacturers and processors.

(d) A taxpayer may change its method of determining current-year cost as part of a change made under section 10.04 of this APPENDIX by also following the provisions of section 10.05 of this APPENDIX. These changes may be made using a single application, provided the application is labeled as being filed under both sections 10.04 and 10.05 of this APPENDIX. *See* section 6.02(3) of this revenue procedure.

(2) *Manner of making the change*. This change is made using a cut-off method. *See* section 2.06 of this revenue procedure.

(3) *Bargain purchase.* If the taxpayer has previously improperly accounted for a bulk bargain purchase, the taxpayer must, as part of this change, first change its method of accounting to comply with *Hamilton Industries, Inc. v. Commissioner*, 97 T.C. 120 (1991), and compute a § 481(a) adjustment for that part of the change. *See* Announcement 91–173, 1991–47 I.R.B. 29. Upon examination, if a taxpayer has properly changed under section 10.04 of this APPENDIX except for complying with section 10.04(3) of this APPENDIX, an examining agent may not deny the taxpayer the change. However, the taxpayer does not receive audit protection under section 7 of this revenue procedure with respect to the improper method of accounting for the bargain purchase. Accordingly, the examining agent may make any necessary adjustments in any open year to effect compliance with *Hamilton Industries, Inc*.

.05 *Determining current-year cost under the LIFO inventory method*.

(1) *Description of change and scope*. This change applies to a LIFO taxpayer that wants to change to a method of determining current year cost:

(a) by reference to the actual cost of the goods most recently purchased or produced;

(b) by reference to the actual cost of the goods purchased or produced during the taxable year in the order of acquisition; or

(c) by application of an average unit cost equal to the aggregate actual cost of all the goods purchased or produced throughout the taxable year divided by the total number of units so purchased or produced. *See* § 1.472–8(e)(2)(ii).

(2) *Manner of making the change*. This change is made using a cut-off method. *See* section 2.06 of this revenue procedure.

SECTION 10A. MARK-TO-MARKET ACCOUNTING METHOD FOR DEALERS IN SECURITIES (§ 475)

.01 *Discontinuing the mark-to-market method of accounting for nonfinancial customer paper.*

(1) *Description of change and scope.*

(a) *Applicability*. This change applies to:

(i) a taxpayer that must discontinue the use of the mark-to-market method of accounting for nonfinancial customer paper to comply with § 475(c)(4), enacted by § 7003 of the IRS Restructuring and Reform Act of 1998, Pub. L. No. 105–206, 112 Stat. 833 (July 22, 1998), provided the change is made for the taxpayer's first taxable year ending after July 22, 1998. The taxpayer must change to a method other than the lower of cost or market method; and

(ii) a taxpayer that was a dealer in securities solely because of its dealings in nonfinancial customer paper, that, in conjunction with the change under section 10A.01(1)(a)(i) of this APPENDIX, wants to discontinue the use of the mark-to-market method of accounting for all securities (including nonfinancial customer paper).

(b) *Scope limitations inapplicable.* A taxpayer that wants to make this change is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(2) *Additional Requirements.*

(a) On a statement attached to the application, the taxpayer must describe all items that were marked to market and that will no longer be marked to market.

(b) When complying with section 6.02(3) of this revenue procedure, the taxpayer should indicate whether the taxpayer is changing under section 10A.01(1)(a)(i) or sections 10A.01(1)(a)(i) and (ii) of this APPENDIX.

(3) *No audit protection*. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 *Commodities dealers, securities traders, and commodities traders electing to use the mark-to-market method of accounting under § 475(e) or (f).*

(1) *Description of change*. This change applies to certain taxpayers that have elected to use the mark-to-market method of accounting under § 475(e) or (f). Under § 475(e) and (f) and Rev. Proc. 99–17, 1999–7 I.R.B. 52, if a taxpayer makes an election under § 475(e) or (f),

then beginning with the first taxable year for which the election is effective (election year), mark to market is the only permissible method of accounting for securities or commodities subject to the election. Thus, if the electing taxpayer's method of accounting for its taxable year immediately preceding the election year is inconsistent with § 475, the taxpayer is required to change its method of accounting to comply with the election. A taxpayer that makes a § 475(e) or (f) election but fails to change its method of accounting to comply with that election is using an impermissible method. *See* section 4 of Rev. Proc. 99–17.

(2) *Scope*

(a) *Applicability*. This change applies to a taxpayer if all of the following conditions are satisfied:

(i) The taxpayer is a commodities dealer, securities trader, or commodities trader that has made a valid election under § 475(e) or (f) (*see* section 5.02 or 5.03(1) of Rev. Proc. 99–17) and that is required to change its method of accounting to comply with the election;

(ii) The method of accounting to which the taxpayer changes is in accordance with its election under § 475(e) or (f);and

(iii) The year of change is the election year.

(b) *Scope limitations inapplicable*. A taxpayer making this change is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

SECTION 11. BANK RESERVES FOR BAD DEBTS (§ 585)

.01 *Changing from the § 585 reserve method to the § 166 specific charge-off method.*

(1) *Description of change and scope.*

(a) *Applicability*. This change applies to a bank (as defined in § 581, including a bank for which a qualified subchapter S subsidiary (QSSS) election is filed) that wants to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method.

(b) *Certain scope limitations inapplicable.* A bank that changed from the § 593 reserve method under § 593(g) to the § 585 reserve method will not be prohibited under section 4.02(6) of this revenue procedure from changing its method of accounting for bad debts under section 11.01 of this APPENDIX solely because of the § 593(g) change. A bank for which a QSSS election is filed will not be prohibited under section 4.02(7) of this revenue procedure from changing its method of accounting for bad debts under section 11.01 of this APPENDIX solely because of the deemed liquidation of the bank arising from a QSSS election.

(c) *Inapplicability.* This change does not apply to a large bank as defined in § 585(c)(2).

(2) *Section 481(a) adjustment*. Generally, the amount of the § 481(a) adjustment for a change in method of accounting under section 11.01 of this APPENDIX is the amount of the bank's reserve for bad debts as of the close of the taxable year immediately before the year of change. However, the amount of the § 481(a) adjustment does not include the amount of a bank's pre-1988 reserves (as described in § 593(g)(2)(A)(ii), without taking into account § 593(g)(2)(B)) if the bank changed in a prior year from the § 593 reserve method to the § 585 reserve method and § 593(g) applied to that change. The deemed liquidation of a bank occurring solely because its parent makes a QSSS election does not accelerate the § 481(a) adjustment. In accordance with section 5.04(3)(c) of this revenue procedure, a bank that ceases to be a bank under § 581 must accelerate its § 481(a) adjustment.

(3) *Change from § 585 required when electing S corporation status*. A bank electing S corporation status (or a bank for which a QSSS election is filed) cannot use the § 585 reserve method. The filing by a bank of a Form 2553 (Election by a Small Business Corporation) or the filing by a bank's parent of a QSSS election with respect to the bank will constitute an agreement by the bank to change its method of accounting for bad debts from the § 585 reserve method to the § 166 specific charge-off method effective as of the taxable year for which the S corporation election or QSSS election is effective (year of change) in accordance with all of the applicable provisions of this revenue procedure (including section 6 of this revenue procedure, which requires filing a Form 3115 in duplicate). The § 481(a) adjustment is recognized built-in gain under § 1374. *See* § 1.1374–4(d).

.02 *Reserved.*

SECTION 12. ORIGINAL ISSUE DISCOUNT (§§ 1272; 1273)

.01 *De minimis original issue discount (OID).*

(1) *Description of change and scope.*

(a) *Applicability*. This change applies to a taxpayer that wants to change to the principal-reduction method of accounting described in section 5 of Rev. Proc. 97–39, 1997–2 C.B. 485. The principal-reduction method of accounting is an aggregate method of accounting for de minimis OID (discount) on certain loans originated by the taxpayer.

(b) *Scope limitations inapplicable*. A taxpayer that wants to make this change is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(c) *Description*. The principal-reduction method of accounting is a permissible method for use by taxpayers to account for discount on one or more categories of loans described in section 4.02 or 4.03 of Rev. Proc. 97–39. If the principal-reduction method is used to account for any loans in a category of loans, the method must be used for the entire category of loans. The principal-reduction method applies only to loans described in section 3 of Rev. Proc. 97–39.

(2) *Manner of making the change*.

(a) This change is made using a cut-off method and applies only to loans described in section 3 of Rev. Proc. 97–39 that were acquired on or after the first day of the year of change. *See* section 2.06 of this revenue procedure.

(b) The taxpayer must maintain books and records sufficient to satisfy the district director that old and new loans have been adequately segregated.

(3) *Additional requirements*. On a statement attached to the application, the taxpayer must:

(a) identify the categories of loans to which the new method will apply; and

(b) describe any "additional categories" permitted under section 4.03 of Rev. Proc. 97–39.

(4) *No audit protection*. A taxpayer does not receive audit protection under section 7 of this revenue procedure in connection with this change.

.02 *Pool of debt instruments*.

(1) *Description of change and scope*.

(a) *Applicability*. This change applies to a taxpayer that must change its method of accounting for a pool of debt instruments to comply with § 1272(a)(6) (as required by § 1004 of the Taxpayer Relief Act of 1997, Pub. L. No. 105–34, 111 Stat. 788, 911), provided the change is for the taxpayer's first taxable year beginning after August 5, 1997.

(b) *Scope limitations inapplicable.* A taxpayer that must make this change is not subject to the scope limitations in section 4.02 of this revenue procedure. However, if the taxpayer is under examination, before an appeals office, or before a federal court, the taxpayer must provide a copy of the application to the examining agent(s), appeals officer, or counsel for the government, as appropriate, at the same time that it files the copy of the application with the national office. The application must contain the name(s) and telephone number(s) of the examining agent(s), appeals officer, or counsel for the government, as appropriate.

(c) *Description.*

(i) Under § 1272, the holder of a debt instrument with original issue discount (OID) must include in income the sum of the daily portions of the OID for each day during the taxable year on which the holder held the instrument. Section 1272(a)(6) provides special rules to determine the daily portions of OID for certain debt instruments subject to prepayments. Under these rules, the daily portions of OID are determined, in part, by taking into account an assumption regarding the prepayment of principal on the debt instruments.

(ii) Section 1004 of the Taxpayer Relief Act of 1997, which is effective for taxable years beginning after August 5, 1997, extended the rules in § 1272(a)(6) to any pool of debt instruments the yield on which may be affected by reason of prepayments. In particular, § 1272(a)(6) now applies to a pool of credit card receivables subject to a grace period provision (under which, for example, a credit card issuer does not charge interest for a billing cycle if the credit card obligor pays off its account balance by a specified date, even though the balance is not due on that date). *See* H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 522 (1997). (A credit card receivable subject to a grace period provision has OID because none of the stated interest on the receivable is qualified stated interest under § 1.1273–1(c)).

(iii) The holder of a pool of credit card receivables subject to a grace period provision must accrue OID on the pool based on a reasonable assumption regarding the timing of the payments by the obligors of the receivables in the pool. Under §1272(a)(6), it is not reasonable for a holder to assume that all of the obligors will pay their balances by the specified grace period date and, based on this assumption, defer the inclusion of OID until the end of the grace period. If the payments in the pool occur soon after year end and before the holder files its tax return for the taxable year that includes such year end, the holder may accrue OID based on its actual experience rather than based upon a reasonable assumption. If the holder does not accrue OID based on its actual experience, the holder must make an adjustment to its income for the following taxable year to account for any difference between its accrual based on a reasonable assumption and its actual experience.

(2) *Additional requirements.* On a statement attached to the application, the taxpayer must provide a detailed description of the pool(s) of debt instruments and the proposed method (including the prepayment assumption used for each pool).

SECTION 12A. MARKET DISCOUNT BONDS (§ 1278)

.01 *Revocation of § 1278(b) election*.

(1) *Description of change and scope*. This change applies to a taxpayer that wants to change its method of accounting for market discount bonds by revoking its § 1278(b) election. Under § 1278(b), a taxpayer may elect a method of accounting under which market discount is currently included in gross income for the taxable years to which the discount is attributable. See Rev. Proc. 92–67, 1992–2 C.B. 429, for the procedures to make a § 1278(b) election (including a deemed § 1278(b) election). The procedures for revoking a § 1278(b) election were formerly provided in section 7 of Rev. Proc. 92–67.

(2) *Revocation of election.* The revocation of a § 1278(b) election applies to all market discount bonds that are held by the taxpayer on the first day of the first taxable year for which the revocation is effective (year of change), and to all market discount bonds that are subsequently acquired by the taxpayer. If a § 1278(b) election is revoked, then, for purposes of § 1276(a), accrued market discount with respect to any bond previously subject to the election means accrued market discount as defined in § 1276(b) less any market discount included in income while the bond was subject to the § 1278(b) election.

(3) *Manner of making the change.* This change is made using a cut-off method and applies only to market discount accruing on or after the first day of the year of change. Market discount accruing on a bond prior to the year of change was currently included in income and market discount accruing on the bond on and after the first day of the year of change is included in income generally upon disposition of the bond. See § 1276(a). Because cut-off treatment is prescribed for this change, the basis of any bond, adjusted for amounts previously included in income during the period of the election, is not affected by the revocation.

(4) *Additional requirements*. On a statement attached to the application, the taxpayer must provide:

(a) the reason(s) for revoking the § 1278(b) election (or deemed § 1278(b) election);

(b) a description of the method by which, and the date on which, the taxpayer made the § 1278(b) election (or deemed § 1278(b) election) that is being revoked; and

(c) a statement that, after the revocation, the taxpayer will not make a constant interest rate election for any bond that has been subject to the § 1278(b) election (or deemed § 1278(b) election) being revoked and for which a constant interest rate election was not effective in the year of acquisition.

(5) *Audit protection.* A taxpayer receives audit protection under section 7 of this revenue procedure in connection with this change. However, the audit protection applicable to this change does not preclude the Commissioner from examining the method used by the taxpayer to determine the amount of accrued market discount under § 1276(b) for a taxable year prior to the year of change.

.02 *Reserved.*

SECTION 13. SHORT-TERM OBLIGATIONS (§ 1281)

.01 *Interest income on short-term obligations.*

(1) *Description of change and scope.*

(a) This change applies to a taxpayer that wants to change its method of accounting to comply with § 1281 for interest income on short-term obligations.

(b) Under § 1281, a holder of certain short-term obligations, including a bank as defined in § 581, must include in gross income any accrued interest income on such obligations, regardless of the holder's overall method of accounting. Section 1281 applies to all types of interest income, including acquisition discount, original issue discount (OID), and stated interest. *See* S. Rep. No. 99–313, 99th Cong., 2d Sess. 903 (1986), 1986–3 (Vol. 3) C.B. 903.

(c) Section 1283(a)(1) generally defines a short-term obligation as any bond, debenture, note, certificate, or other evidence of indebtedness that matures in one year or less from its issue date. A short-term loan, including a short-term loan made in the ordinary course of the taxpayer's business, is a short-term obligation.

(d) Under §§ 1281(a) and 1283(c), a holder of a short-term obligation subject to § 1281 must include in gross income an amount equal to the sum of the daily portions of the acquisition discount or OID, whichever is applicable, on the obligation for each day during the taxable year that the obligation is held by the holder. See § 1283(b), as modified by § 1283(c), to determine the daily portions of acquisition discount or OID. In addition, § 1281(a) requires the holder to include in gross income any stated interest that is payable on the short-term obligation (other than stated interest taken into account to determine the amount of the acquisition discount or OID) as it accrues.

(2) *Section 481(a) adjustment period.* A taxpayer must take the entire § 481(a) adjustment into account in computing taxable income for the year of change.

.02 *Stated interest on short-term loans of cash method banks in the Eighth Circuit.*

(1) *Description of change and scope.*

(a) This change applies to a cash method bank in the Eighth Circuit that wants to change its method of accounting from accruing stated interest on short-term loans made in the ordinary course of business to using the cash method for that interest.

(b) In *Security Bank Minnesota v. Commissioner*, 994 F.2d 432 (8th Cir. 1993), *aff'g* 98 T.C. 33 (1992), the U.S. Circuit Court of Appeals for the Eighth Circuit held that § 1281 does not require a cash method bank to include in gross income stated interest on short-term loans made in the ordinary course of business as that interest accrues. The Service disagrees with the interpretation of § 1281 in *Security Bank Minnesota* and intends to pursue this issue in other circuits. In light of *Security Bank Minnesota*, however, cash method banks in the Eighth Circuit will be granted permission to change to the cash method of accounting for stated interest on short-term loans made in the ordinary course of business. If this change was made on or before November 6, 1995, the Service will not seek to deny cash method banks in the Eighth Circuit the use of the cash method on the ground that there was an unauthorized change in method of accounting.

(2) *Section 481(a) adjustment period.* A taxpayer must take the entire § 481(a) adjustment into account in computing taxable income for the year of change.

(3) *No ruling protection.* If the Service is later successful in further litigation on this issue in other circuits, or there is a change in law, then cash method banks in the Eighth Circuit may be required to use an accrual method of accounting for any taxable year not barred by the statute of limitations.

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26 CFR 601.602: Tax forms and instructions. (Also Part I, §§ 138, 220, 408, 408A, 529, 530, 1441, 1442, 1443, 3402, 3405, 3406, 6011, 6041, 6041A, 6042, 6043, 6044, 6045, 6047, 6049, 6050A, 6050B, 6050D, 6050E, 6050H, 6050J, 6050N, 6050P, 6050Q, 6050R, 6050S; 1.408–7, 1.408A–7, 1.1461–1, 1.1461–2, 31.3402(q)–1, 31.3404(r)–1, 31.3405(c)–1, 35.3405–1, 31.3406(a)–1, 31.3406(g)–2, 35a.3406–2, 1.6011–1, 1.6011–3, 1.6041–1, 7.6041–1, 1.6041A–1, 1.6042–2, 1.6044–2, 1.6045–1, 1.6045–2, 1.6045–4, 1.6049–4, 1.6050A–1, 1.6050E–1, 1.6050H–1, 1.6050J–1T, 1.6050N–1, and 1.6050P–1.)

Rev. Proc. 99–50

SECTION 1. PURPOSE

This revenue procedure permits combined information reporting by a successor business entity (*i.e.*, a corporation, partnership, or sole proprietorship) in certain situations following a merger or an acquisition and supersedes Rev. Proc. 90–57, 1990–2 C.B. 641 and Rev. Rul. 69–556, 1969–2 C.B. 242. This revenue procedure explains both the procedure otherwise required under the regulations (the "standard procedure") and an elective procedure (the "alternative procedure") for preparing and filing certain Forms 1042–S, all forms in the series 1098, 1099, and 5498, and Forms W-2G, in certain situations involving a successor business entity and a predecessor business entity (*i.e.*, a corporation, partnership, or sole proprietorship) when the successor acquires substantially all of the property (1) used in the trade or business of the predecessor (including certain situations when one or more corporations are absorbed by another corporation pursuant to a merger agreement), or (2) used in a separate unit of a trade or business of the predecessor.

SECTION 2. BACKGROUND

.01 *General Requirement of Return or*

Statement. Section 6011(a) of the Internal Revenue Code provides that, when required by regulations, any person made liable for any tax imposed by the Code, or for the collection of the tax, must make a return or statement according to the forms and regulations prescribed by the Secretary.

.02 *Certain Payments Reported on Forms 1042-S*. Payments under the Code sections described in this paragraph are reported on Forms 1042-S. Section 1441(a) generally provides that persons having the control, receipt, custody, disposal, or payment of items of gross income specified in § 1441(b) from sources within the United States of any nonresident alien individual or foreign partnership must deduct and withhold a tax equal to either 30 percent or 14 percent of those amounts. Section 1442 provides that, in the case of certain foreign corporations, a tax equal to 30 percent shall be deducted and withheld in the same manner and on the same items of income as provided in § 1441. Section 1443(a) provides that, in the case of certain foreign tax-exempt organizations, a tax equal to 30 percent of the amount of the unrelated business taxable income shall be deducted and withheld in the same manner as provided in § 1441. Section 1443(b) provides that, in the case of certain foreign tax-exempt organizations, a tax on gross investment income derived from sources within the United States equal to 4 percent of such amount shall be deducted and withheld in the same manner as provided in § 1441(a) or § 1442(a). Persons required to deduct and withhold taxes under § 1441, 1442, or 1443 generally must file Forms 1042-S reporting aggregate amounts for the calendar year, as provided in the Income Tax Regulations under § 1461.

.03 *Payments Reported on Forms 1098*. Payments and receipts under the following Code sections are reported on forms in the series 1098: §§ 6050H (returns relating to mortgage interest received in trade or business from individuals); and 6050S (returns relating to higher education tuition and related expenses).

.04 *Payments Reported on Forms 1099*. (1) *In general*. Payments under the following Code sections are reported on forms in the series 1099: §§ 220(h) (medical savings accounts); 408(i) (individual retirement arrangements); 529(d) (qualified state tuition programs); 530(h) (education individual retirement accounts); 6041 (information at source); 6041A (returns regarding payments of remuneration for services and direct sales); 6042 (returns regarding payments of dividends and corporate earnings and profits); 6043 (liquidating, etc., transactions); 6044 (returns regarding payments of patronage dividends); 6045 (returns of brokers); 6047 (information relating to certain trusts and annuity plans); 6049 (returns regarding payments of interest); 6050A (reporting requirements of certain fishing boat operators); 6050B (returns relating to unemployment compensation); 6050D (returns relating to energy grants and financing); 6050E (state and local income tax refunds); 6050J (returns relating to foreclosures and abandonments of security); 6050N (returns regarding payments of royalties); 6050P (returns relating to the cancellation of indebtedness by certain entities); 6050Q (certain long-term care benefits); and 6050R (returns relating to certain purchases of fish).

(2) *Persons Made Liable for Backup Withholding*. Section 3406 provides that payors of reportable payments (as defined in § 3406(b)) must, in certain circumstances, deduct and withhold a tax equal to 31 percent of the payment ("backup withholding"). Under § 3406(b), reportable payments generally are payments required to be shown on a return under §§ 6041 (relating to certain information at source), 6041A(a) (relating to payments of remuneration for services), 6042(a) (relating to payments of dividends), 6044 (relating to patronage dividends), 6045 (relating to returns of brokers), 6049(a) (relating to payments of interest), 6050A (relating to reporting requirements of certain fishing boat operators), and 6050N (relating to payments of royalties).

(3) *Persons Made Liable for Withholding on Pensions, Annuities, and Other Deferred Income*. Section 3405 provides that payors of pensions, annuities and certain other deferred income must, in certain circumstances, deduct and withhold a tax: (1) on periodic payments as defined in § 3405(e)(2), an amount that would be required to be withheld from such payment if such payment were a payment of wages; (2) on nonperiodic distributions as defined in § 3405(e)(3), 10 percent of the distribution; and (3) on eligible rollover distributions as defined in § 3405(c)(3), 20 percent of the distribution. Generally, the persons required to deduct and withhold taxes under § 3405 must file Forms 1099 reporting payments and distributions, as provided under § 35.3405–1 of the Temporary Employment Tax Regulations and § 31.3405(c)–1 of the Employment Tax Regulations.

.05 *Contributions Reported on Forms 5498*. Contributions under the following Code sections are reported on forms in the series 5498: §§ 138 (medicare+choice MSA); 220 (medical savings accounts); 408(a) (individual retirement account); 408(b) (individual retirement annuity); 408(k) (simplified employee pension); 408(p) (simple retirement account); 408A (Roth IRA); and 530 (education individual retirement account).

.06 *Payments Reported on Forms W-2G*. (1) *In general*. Section 7.6041–1 of the Temporary Income Tax Regulations provides that payments of winnings of $1,200 or more from a bingo game or slot machine play, and payments of winnings of $1,500 or more from a keno game, are reportable on Forms W-2G. Section 31.3406(g)–2(d) generally provides that under § 3406 a reportable gambling winning is any gambling winning subject to information reporting under § 6041. In addition, a gambling winning (other than a winning from bingo, keno, or slot machines) is a reportable gambling winning only if the amount paid with respect to the wager is $600 or more and if the proceeds are at least 300 times as large as the amount wagered.

(2) *Extension of Withholding to Certain Gambling Winnings*. Section 3402(q) provides that every person making a payment of winnings that are subject to withholding (defined in §§ 3402(q)(3) and 31.3402(q)–1) shall deduct and withhold a tax in an amount equal to 28 percent of such payment.

SECTION 3. SCOPE

This revenue procedure applies only when all of the following conditions are met:

(1) One business entity (*i.e.*, a corporation, partnership, or sole proprietorship) (the "successor") acquires from another business entity (the "predecessor") substantially all the property (a) used in the trade or business of the predecessor (including when two or more corporations are parties to a merger agreement under which the surviving corporation becomes the owner of all the assets and assumes all the liabilities of the absorbed corporation(s)), or (b) used in a separate unit of a trade or business of the predecessor;

(2) During the pre-acquisition portion of the "acquisition year" (the calendar year in which the acquisition occurs), the predecessor is required to file information returns as a result of making or receiving payments, or withholding or collecting taxes, as provided under the appropriate sections of the Code and regulations set forth above;

(3) During the post-acquisition portion of the acquisition year, the predecessor (for an acquisition described in section 3(1)(a)) or the separate unit of the predecessor (for an acquisition described in section 3(1)(b)) does not make or receive any such payments and does not withhold or collect any such tax;

(4) The requirements of section 5 of this revenue procedure are met; and

(5) The Internal Revenue Service instructions or publications relating to Forms 1042–S, a specific form in the series 1098, 1099, or 5498, or Forms W-2G do not prohibit use of the alternative procedure described in section 5.

SECTION 4. STANDARD PROCEDURE

Each person that makes or receives payments, or withholds or collects taxes, that are reportable on Forms 1042-S, forms in the series 1098, 1099, and 5498, or Forms W-2G, is responsible for information reporting of those transactions. Thus, unless the alternative procedure of section 5 of this revenue procedure is used, both the predecessor and the successor must file certain Forms 1042-S, forms in the series 1098, 1099, and 5498, or Forms W-2G for reportable transactions occurring in the acquisition year.

SECTION 5. ALTERNATIVE PROCEDURE

.01 The predecessor and the successor must agree that the successor assumes the predecessor's entire information reporting obligations for those Forms 1042-S (as described in section 2.02 of this revenue procedure), forms in the series 1098, 1099, and 5498, and Forms W-2G to which their agreement applies. The predecessor is relieved of its information reporting obligations for reportable transactions occurring in the acquisition year only if and to the extent that their agreement meets, and the successor satisfies, each of the requirements of section 5 of this revenue procedure.

.02 The predecessor and successor must agree upon the specific Forms 1042-S, forms in the series 1098, 1099, and 5498, and Forms W-2G to which this alternative procedure applies. The predecessor and successor may agree to (a) use the alternative procedure for all Forms 1042-S, forms in the series 1098, 1099, or 5498, or Forms W-2G; or (b) limit the use of the alternative procedure to (1) specific Forms 1042-S, forms in the series 1098, 1099, or 5498, or Forms W-2G; or (2) specific reporting entities (*i.e.*, any unit, branch or location within a particular business entity that files its own separate information returns). For example, if the only compatible computer or record keeping systems of a predecessor and successor are their dividends paid ledgers, they may use the alternative procedure for Forms 1099-DIV, and use the standard procedure for Forms 1042-S and all other forms in the series 1098 or 1099. Similarly, if the only compatible computer or record keeping systems of a predecessor and successor are in their branches located in the Midwest, they may use the alternative procedure with respect to the records maintained at those locations, and use the standard procedure with respect to the records maintained at all other locations. The sharing between the predecessor and successor of taxpayer identification numbers and other information obtained under § 3406 for information reporting and backup withholding purposes, for the sole purpose of complying with this revenue procedure, does not violate the confidentiality rules contained in § 3406(f).

.03 On each "appropriate form" (*i.e.*, each form to which the agreement in section 5 of this revenue procedure applies), the successor must combine (1) the payments made or received on account of a person by the predecessor in the pre-acquisition portion of the acquisition year with (2) the payments made or received on account of that person by the successor in that year, if any, and must report the aggregate amount(s) on account of that person for that year. In the case of amounts that are required or permitted to be reported transactionally (for example, broker sales of stock that are required to be reported on Forms 1099-B, Proceeds From Broker and Barter Exchange Transactions) the successor must report each transaction of the predecessor and each of its transactions on each appropriate form. The successor may include with the form additional information explaining to the recipient the combined reporting by the predecessor and successor.

.04 On each appropriate form, the successor must also combine the amount of any tax withheld under §§ 1441, 1442, 1443, 3402(q), 3402(r), 3405, and 3406(a) for a person by the predecessor in the pre-acquisition portion of the acquisition year with the amount withheld under such sections for that person by the successor in that year and, on the appropriate form(s), must report the aggregate amount for the year.

.05 The successor must file a statement with the Internal Revenue Service indicating that the appropriate forms are being filed on a combined basis in accordance with the provisions of this revenue procedure. This statement is needed to assist the Service in processing the forms filed under the alternative procedure. If tax has been withheld by the predecessor pursuant to §§ 3402(q), 3402(r), 3405, and 3406(a) during the acquisition year and reported by the predecessor on Form 945, Annual Return of Withheld Federal Income Tax, the total of the withholding amounts shown on the successor's Forms 1099 and W-2G for that year will exceed the total of the withholding amounts shown on the successor's Form 945. Therefore, the statement that must be filed with the Service must reflect the amount of any tax that has been withheld by the predecessor and by the successor for each type of form (for example, Forms 1099-R or Forms 1099-MISC). Likewise, if any tax has been withheld under §§ 1441 and 1442 during the acquisition year and reported on Form 1042, Annual Withholding Tax Return for U.S. Source Income of Foreign Persons, the total of the withholding amounts shown on the successor's Forms 1042-S for that year will exceed the total of the withholding amounts shown on the successor's Form 1042. Therefore, the statement that must be filed with the Service must reflect the amount of tax that has been withheld by the predecessor and successor for Form 1042-S.

.06 The statement required by section 5.05 of this revenue procedure must include the name, address, telephone number, and Employer Identification Numbers of both the successor and predecessor, and the name and telephone number of the person responsible for preparing this statement.

.07 The statement for Forms 1042-S must be **attached** to the Form 1042 and mailed to the address for filing the Form 1042 (appearing in the instructions to the form) on or before the date the Form 1042 is due.

.08 The statement for forms in the series 1098, 1099 and 5498, and Forms W-2G must be **filed separately** from such forms and Form 945. Unless directed otherwise by the instructions to the forms, the statement for forms in the series 1098, 1099, and 5498, and Forms W-2G must be mailed to the following address on or before the date those forms are due:

Internal Revenue Service
Martinsburg Computing Center
230 Murall Drive
Attention: Chief, Information Returns Branch
Mail Stop 360
Kearneysville, WV 25430

SECTION 6. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 90–57, 1990–2 C.B. 641, and Rev. Rul. 69–556, 1969–2 C.B. 242, are modified and, as modified, are superseded.

SECTION 7. EFFECTIVE DATE

This revenue procedure is effective for Forms 1042-S, forms in the series 1098, 1099, and 5498, and Forms W-2G filed after December 31, 1999. In addition, if a successor filed forms on or before December 31, 1999, in the circumstances described in section 3 of this revenue procedure, the predecessor's filing obligations are deemed to have been satisfied with respect to amounts shown on those forms if the predecessor and successor have substantially complied with all the requirements of section 5 of this revenue procedure (except for the statement requirement of section 5.05).

SECTION 8. PAPERWORK REDUCTION ACT

The collections of information contained in this revenue procedure have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (44 U.S.C. 3507) under control number 1545-1667. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number.

The collection of information is contained in section 5 of this revenue procedure which requires the filing of a statement that the alternative procedure has been elected. This information is required to aid the Service in processing Forms 1042-S, forms in the series 1098, 1099, and 5498, and Forms W-2G filed by successors who use the alternative procedure, reconcile discrepancies between the amounts reported on Forms 945 and Forms 1099 and W-2G filed by both predecessors and successors who use the alternative procedure, and reconcile discrepancies between the amounts reported on Forms 1042-S and Forms 1042 filed by predecessors and successors who use the alternative procedure. The likely respondents are business or other for-profit institutions.

The estimated average annual burden to prepare the statement is 5 minutes. The estimated number of respondents that will elect to use the alternate procedure is 6,000 and the estimated total annual reporting burden is 500 hours.

The estimated annual frequency of responses is on occasion.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

DRAFTING INFORMATION

The principal author of this revenue procedure is A. Katharine Jacob Kiss of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this revenue procedure contact Ms. Kiss on (202) 622-4920 (not a toll-free call).

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26 CFR 601.201: Rulings and determination letters.
(Also Part I, section 1361)

Rev. Proc. 99–51

SECTION 1. PURPOSE

This revenue procedure amplifies Rev. Proc. 99–3, 1999–1 I.R.B. 103, which sets forth areas of the Internal Revenue Code under the jurisdiction of the Associate Chief Counsel (Domestic) in which the Internal Revenue Service will not issue advance rulings or determination letters.

SECTION 2. BACKGROUND

Section 301.7701–3 of the Procedure and Administrative Regulations allows an eligible entity to elect to be classified as an association taxable as a corporation for federal tax purposes. Under § 301.7701–3(a), an eligible entity is a business entity not classified as a corporation under § 301.7701–2(b)(1), (3), (4), (5), (6), (7), or (8). A state law partnership is an eligible entity. Consequently, a state law limited partnership may elect to be classified as an association taxable as a corporation for federal tax purposes.

Section 1362(a) of the Internal Revenue Code allows an eligible corporation to elect to be taxable as an S corporation. For a corporation to be eligible to elect under § 1362(a), the corporation must be a small business corporation. Section 1361(b)(1)(D) requires that a small business corporation have no more than a single class of stock. A general partnership interest includes rights and obligations not included in a limited partnership interest. If these obligations and rights result in general and limited partnership interests in a limited partnership having non-pro rata distribution rights, such interests are different classes of stock for purposes of § 1361(b)(1)(D).

Given the factual difficulties involved in determining whether the differences between the rights and obligations of general and limited partnership interests give rise to a second class of stock, the issue of whether a state law limited partnership complies with the single class of stock requirement is under extensive study. Accordingly, advanced rulings will not be provided on the issue until the Service resolves it through publication of a revenue ruling, revenue procedure, regulations, or otherwise.

SECTION 3. PROCEDURE

Rev Proc. 99–3 is amplified by adding the following to section 5.01:

Section 1361. — Definition of a Small Business Corporation. — Whether a state law limited partnership electing under § 301.7701–3 to be classified as an association taxable as a corporation has more than one class of stock for purposes of § 1361(b)(1)(D). The Service will treat any request for a ruling on whether a state law limited partnership is eligible to elect S corporation status as a request for a ruling on whether the partnership complies with § 1361(b)(1)(D).

SECTION 4. EFFECTIVE DATE

This revenue procedure applies to all ruling requests, including any pending in the National Office and any submitted after the date of this publication.

SECTION 5. EFFECT ON OTHER DOCUMENTS

Rev. Proc. 99–3 is amplified.

SECTION 6. DRAFTING INFORMATION

The principal author of this revenue procedure is Richard Castanon of the Office of Assistant Chief Counsel (Passthroughs and Special Industries). For further information regarding this revenue procedure contact Richard Castanon at 202-622-3070 (not a toll free call).

Tax Avoidance Using Distributions of Encumbered Property

Notice 99–59

The Internal Revenue Service and Treasury Department have become aware of certain types of transactions, as described below, that are being marketed to taxpayers for the purpose of generating tax losses. This notice is being issued to alert taxpayers and their representatives that the purported losses arising from such transactions are not properly allowable for federal income tax purposes.

The transactions are cast in a variety of forms. In one typical arrangement, taxpayers act through a partnership to contribute cash to a foreign corporation, which has been formed for the purpose of carrying out the transaction, in exchange for the common stock of that corporation. Another party contributes additional capital to the corporation in exchange for the preferred stock of that corporation. The foreign corporation then acquires additional capital by borrowing from a bank and grants the bank a security interest in securities acquired by the foreign corporation that have a value equal to the amount of the borrowing. Thereafter, the foreign corporation makes a distribution of the encumbered securities to the partnership that holds its common stock. The effect of the distribution, combined with fees and other transaction costs incurred at the corporate level, is to reduce the remaining value of the foreign corporation's common stock to zero or a minimal amount. Although the distributed securities are encumbered by the bank debt (and the taxpayers or their partnership may be secondarily liable for the debt as guarantors), the foreign corporation has sufficient other assets to repay the debt, and it is the understanding of all parties that the foreign corporation will repay the debt with such other assets.

For example, if the taxpayers' partnership had contributed $100x for the common stock of the foreign corporation, the partnership might receive a distribution of securities with a fair market value of approximately $100x, and that distribution would have the economic effect of reducing the remaining value of the foreign corporation's common stock to zero. Nonetheless, because the distribution to the partnership is subject to the bank debt, the parties take the position, pursuant to § 301(b)(2) of the Internal Revenue Code, that the amount of the distribution is zero for purposes of § 301. On that theory, no part of the distribution is treated either as a dividend or as a reduction of stock basis under § 301(c).

The partnership is treated as having subsequently disposed of the stock of the foreign corporation, giving rise to a tax loss equal to the excess of the partnership's original basis in the stock ($100x in the example) over the fair market value of the common stock after the distribution of securities (zero). The deemed disposition of the stock may be based upon an election under § 301.7701–3(c) of the regulations to change the federal income tax classification of the foreign corporation from a corporation to a partnership, giving rise to a deemed liquidation of the foreign corporation, or by treating the partnership as a trader in securities which elects under § 475(f) to treat the securities that it holds, including the stock of the foreign corporation, as having been sold for their fair market value on the last business day of the taxable year.

Thereafter, typically in a later taxable year, the bank debt is repaid out of other assets held by the foreign corporation. Although the parties previously treated the debt as reducing the amount of the earlier distribution from the foreign corporation, promoters advise taxpayers to take the position that the foreign corporation's repayment of the debt is not treated as a distribution on its common stock.

A loss is allowable as a deduction for federal income tax purposes only if it is bona fide and reflects actual economic consequences. An artificial loss lacking economic substance is not allowable. See *ACM Partnership v. Commissioner,* 157 F.3d 231, 252 (3d Cir. 1998), *cert. denied*, 119 S. Ct. 1251 (1999) ("Tax losses such as these . . . which do not correspond to any actual economic losses, do not constitute the type of 'bona fide' losses that are deductible under the Internal Revenue Code and regulations."); *Scully v. United States*, 840 F.2d 478, 486 (7th Cir. 1988) (to be deductible, a loss must be a "genuine economic loss"); *Shoenberg v. Com-*

missioner, 77 F.2d 446, 448 (8th Cir. 1935) (to be deductible, a loss must be "actual and real"); § 1.165–1(b) ("Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.").

In the view of the Service and the Treasury Department, the arrangement described above (or any similar arrangement) does not produce an allowable loss. Through a series of contrived steps, taxpayers claim tax losses for capital outlays that they have in fact recovered. Such artificial losses are not allowable for federal income tax purposes.

The purported tax benefits from these transactions may also be subject to challenge under other provisions of the Code and regulations, including but not limited to §§ 269, 301, 331, 446, 475, 482, 752, and 1001 of the Code.

Additionally, the Service may impose penalties on participants in these transactions or, as applicable, on persons who participate in the promotion or reporting of these transactions, including the accuracy-related penalty under § 6662, the return preparer penalty under § 6694, the promoter penalty under § 6700, and the aiding and abetting penalty under § 6701.

The principal author of this notice is Ken Cohen of the Office of Assistant Chief Counsel (Corporate). For further information regarding this notice, contact Mr. Cohen on (202) 622-7790 (not a toll-free call).

Information Reporting – Royalty Payments

Notice 99–60

Section 6050N(a)(1) requires that every person who makes payments of royalties (or similar amounts) aggregating $10 or more to any other person during the calendar year shall make a return according to the forms or regulations prescribed by the Secretary, setting forth the aggregate amount of such payments and the name and address of the person to whom paid. Section 6050N(a)(2) imposes this requirement on every person who receives payments of royalties (or similar amounts) as a nominee and who makes payments aggregating $10 or more during any calendar year to any other person with respect to the royalties (or similar amounts) so received.

However, the reporting requirement of § 6050N does not apply to payments of royalties that are not subject to income tax because the royalties are derived directly by a noncompetent Indian from allotted and restricted land under the General Allotment Act, 25 U.S.C. §§ 331–358, or from land held under acts or treaties containing an exception provision similar to the General Allotment Act. *See* Rev. Rul. 67–284, 1967–2 C.B. 55, *modified on another issue by* Rev. Rul. 74–13, 1974–1 C.B. 14, and *amplified on another issue by* Rev. Rul. 94–16, 1994–1 C.B. 19.

The principal author of this notice is Eric Lucas of the Office of Assistant Chief Counsel (Income Tax and Accounting). For further information regarding this notice contact Mr. Lucas at (202) 622-4920 (not a toll-free call).

Weighted Average Interest Rate Update

Notice 99-61

Notice 88-73 provides guidelines for determining the weighted average interest rate and the resulting permissible range of interest rates used to calculate current liability for the purpose of the full funding limitation of § 412(c)(7) of the Internal Revenue Code as amended by the Omnibus Budget Reconciliation Act of 1987 and as further amended by the Uruguay Round Agreements Act, Pub. L. 103-465 (GATT).

The average yield on the 30-year Treasury Constant Maturities for November 1999 is 6.15 percent.

The following rates were determined for the plan years beginning in the month shown below.

Month	Year	Weighted Average	90% to 105% Permissible Range	90% to 110% Permissible Range
December	1999	6.00	5.40 to 6.30	5.40 to 6.60

Drafting Information

The principal author of Notice 99–61 is Todd Newman of Employee Plans, Tax Exempt and Government Entities Division. For further information regarding this notice, call the Employee Plans Actuarial hotline, (202) 622-6076 between 2:30 and 3:30 p.m. Eastern time (not a toll-free number). Mr. Newman's number is (202) 622-8458 (also not a toll-free number).

Part IV. Items of General Interest

Foundations Status of Certain Organizations

Announcement 99–115

The following organizations have failed to establish or have been unable to maintain their status as public charities or as operating foundations. Accordingly, grantors and contributors may not, after this date, rely on previous rulings or designations in the Cumulative List of Organizations (Publication 78), or on the presumption arising from the filing of notices under section 508(b) of the Code. This listing does *not* indicate that the organizations have lost their status as organizations described in section 501(c)(3), eligible to receive deductible contributions.

Former Public Charities. The following organizations (which have been treated as organizations that are not private foundations described in section 509(a) of the Code) are now classified as private foundations:

A & M Nutrition, Incorporated, Winnsboro, LA
Assist, Inc., Buffalo, NY
Children & Youth 2000, c/o Wolin & Rosen, Chicago, IL
Colorado Collective for Medical Decisions, Inc., Denver, CO
Friends of the Environment, Sacramento, CA
Glenville Community Festival Foundation, Cleveland, OH
Impact For Change Ministries International, Inc. Waldorf, MD
Jersey Shore Public Relations & Advertising Charitable Scholarship Trust, Princeton, NJ
Lewis IDA Community Development Corp, Lowville, NY
Lo Society Branch of Wisconsin Inc, Oshkosh, WI
MPA Foundation, New York, NY
Neighborhood Network Inc., Uniontown, PA
SGV Property Management, Los Angeles, CA
Vision Research Foundation Inc., Phoenix, AZ
Voters Organized to Educate, Compton, CA
West Tennessee Young Farmers & Homemakers Leadership Development, Columbia, TN
White Collar Crime, Inc., Roseland, NJ
Working With Women Transporting Service, Inc., Los Angeles, CA

If an organization listed above submits information that warrants the renewal of its classification as a public charity or as a private operating foundation, the Internal Revenue Service will issue a ruling or determination letter with the revised classification as to foundation status. Grantors and contributors may thereafter rely upon such ruling or determination letter as provided in section 1.509(a)–7 of the Income Tax Regulations. It is not the practice of the Service to announce such revised classification of foundation status in the Internal Revenue Bulletin.

Actions on Decisions; Correction

Announcement 99–116

This document corrects the Actions on Decisions published in 1999–35 I.R.B. 314. All 7 footnotes describing the "Acquiescence" or "Nonacquiesence" in each decision included the words "in result only," which were erroneous. The court cases are listed below, followed by the footnotes with the correct text.

The Commisioner ACQUIESCES in the following decisions:

Internal Revenue Service v. Waldschmidt (In re Bradley),[1]
(M.D. Tenn 1999)

Estate of Mellinger v. Commisioner,[2]
112 T.C. 4 (1999)

Hospital Corp. of America and Subsidiaries v. Commissioner,[3]
109 T.C. 21 (1997)

Boyd Gaming Corporation v. Commissioner,[4]
F.3d (9th Cir. 1999)

The Commissioner NONACQUIESCES in the following decisions:

Vulcan Materials Company and Subsidiaries v. Commissioner,[5]
96 T.C. 410 (1991)

St. Jude Medical, Inc. v. Commissioner,[6]
34 F.3d 1394 (8th Cir. 1994)

Hospital Corp. of America and Subsidiaries v. Commissioner,[7]
109 T.C. 21 (1997)

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[1]Acquiescence relating to whether gain on the sale of the debtor's residence is excluded from gross income of the bankruptcy estate to the extent provided by I.R.C. §121 and in accord with section 1398.

[2]Acquiescence relating to whether, for estate tax valuation purposes, a minority interest in a closely held corporation held in a Qualified Terminable Interest Property (QTIP) trust, which is includible in the gross estate under I.R.C. §2044, is aggregated with a minority interest in the same corporation that is includible in a decedent's gross estate under other provisions of the Code.

[3]Acquiescence relating to whether the tests developed under the investment tax credit (ITC) prior to the 1981 adoption of the cost recovery system are applicable in determining a structural component for the purposes of Accelerated Cost Recovery System (ACRS) and Modified Accelerated Cost Recovery System (MACRS).

[4]Acquiescence relating to whether a meal furnished by the taxpayer/employer on its business premises to an employee is furnished for "the convenience of the employer" within the meaning of that phrase in section 119 of the Internal Revenue Code.

[5]Nonacquiescence relating to whether the term "accumulated profits" as used in the denominator of the section 902 deemed paid credit fraction before the Tax Reform Act of 1986 means all of a foreign corporation's accumulated profits for the taxable year. This revised action on decision clarifies the Service's position on this issue in cases appealable to the 11th Circuit.

[6]Nonacquiescence relating to whether section 1.861–8(e)(3) of the Income Tax Regulations is invalid as applied to DISC combined taxable income (CTI) calculations.

[7]Nonacquiescence relating to whether certain items treated as tangible personal property and depreciated over a 5-year recovery period were in fact structural components of the buildings to which they relate which must be depreciated over the same recovery period as the buildings, pursuant to I.R.C. §168.

Social Security Contribution and Benefit Base for 2000

Under authority contained in the Social Security Act ("the Act"), the Commissioner, Social Security Administration, has determined and announced (64 F.R. 57506, dated October 25, 1999) that the contribution and benefit base for remuneration paid in 1999, and self-employment income earned in taxable years beginning in 2000 is $76,200.

“Old-Law” Contribution and Benefit Base

General

The “old-law” contribution and benefit base for 2000 is $56,700. This is the base that would have been effective under the Act without the enactment of the 1977 amendments. The base is computed under section 230(b) of the Act as it read prior to the 1977 amendments.

The “old-law” contribution and benefit base is used by:

(a) The Railroad Retirement program to determine certain tax liabilities and tier II benefits payable under that program to supplement the tier I payments which correspond to basic Social Security benefits,

(b) The Pension Benefit Guaranty Corporation to determine the maximum amount of pension guaranteed under the Employee Retirement Income Security Act (as stated in section 230(d) of the Social Security Act),

(c) Social Security to determine a year of coverage in computing the special minimum benefit, as described earlier, and

(d) Social Security to determine a year of coverage (acquired whenever earnings equal or exceed 25 percent of the “old-law” base for this purpose only) in computing benefits for persons who are also eligible to receive pensions based on employment not covered under section 210 of the Act.

Domestic Employee Coverage Threshold

General

Section 2 of the “Social Security Domestic Employment Reform Act of 1994” (Pub. L. 103-387) increased the threshold for coverage of a domestic employee’s wages paid per employer from $50 per calendar quarter to $1,000 per annum in calendar year 1994. The statute held the coverage threshold at the $1,000 level for 1995 and then increased the threshold in $100 increments for years after 1995. Section 3121(x) of the Internal Revenue Code provides the formula for increasing the threshold.

Computation

Under the formula, the domestic employee coverage threshold amount for 2000 shall be equal to the 1995 amount of $1,000 multiplied by the ratio of the national average wage index for 1998 to that for 1993. If the amount so determined is not a multiple of $100, it shall be rounded to the next lower multiple of $100.

Domestic Employee Coverage Threshold Amount

The ratio of the national average wage index for 1998, $28,861.44, compared to that for 1993, $23,132.67, is 1.2476485. Multiplying the 1995 domestic employee coverage threshold amount of $1,000 by the ratio of 1.2476485 produces the amount of $1,247.65, which must then be rounded to $1,200. Accordingly, the domestic employee coverage threshold amount is determined to be $1,200 for 2000.

(Filed by the Office of the Federal Register on October 22, 1999, 8:45 a.m., and published in the issue of the Federal Register for October 25, 1999, 64 F.R. 57506)

Definition of Terms

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in law or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in the new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C.—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contribution Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign Corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statements of Procedral Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

Numerical Finding List[1]

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