Proposed Rules

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This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

DEPARTMENT OF AGRICULTURE

Agricultural Marketing Service

7 CFR Part 981

[Docket No. FV01–981–610 Review]

California Almonds; Section 610 Review of Marketing Order

AGENCY: Agricultural Marketing Service, USDA.

ACTION: Notice of review and request for comments.

SUMMARY: This action announces that the Agricultural Marketing Service (AMS) plans to review Marketing Order 981 for almonds grown in California, under the criteria contained in section 610 of the Regulatory Flexibility Act (RFA).

DATES: Written comments on this action must be received by August 13, 2001.

ADDRESSES: Interested persons are invited to submit written comments concerning this notice of review. Comments must be sent to the Docket Clerk, Fruit and Vegetable Programs, AMS, USDA, Room 2525–S, Box 96456, Washington, DC 20090–6456; Fax: (202) 720–8938; or E-mail: moab.docketclerk@usda.gov. All comments should reference the docket number and the date and page number of this issue of the **Federal Register** and will be made available for public inspection in the Office of the Docket Clerk during regular business hours, or may be viewed at http://www.ams.usda.gov/fv/moab.html.

FOR FURTHER INFORMATION CONTACT: Martin Engeler, California Marketing Field Office, Marketing Order Administration Branch, Fruit and Vegetable Programs, AMS, USDA, 2202 Monterey Street, Suite 102B, Fresno, California 93721; telephone: (209) 487–5901; Fax: (209) 487–5906; E-mail: Martin.Engeler@usda.gov; or George Kelhart, Marketing Order Administration Branch, Fruit and Vegetable Programs, AMS, USDA, room 2525–S, P.O. Box 96456, Washington, DC 20090–6456; telephone: (202) 720–2491; Fax: (202) 720–8938; E-mail: George.Kelhart@usda.gov.

SUPPLEMENTARY INFORMATION: Marketing Order No. 981, as amended (7 CFR part 981), regulates the handling of almonds grown in California. The marketing order is effective under the Agricultural Marketing Agreement Act of 1937 (AMAA), as amended (7 U.S.C. 601–674).

AMS published in the **Federal Register** (63 FR 8014; February 18, 1999), its plan to review certain regulations, including Marketing Order No. 981, under criteria contained in section 610 of the Regulatory Flexibility Act (RFA; 5 U.S.C. 601–612). Because many AMS regulations impact small entities, AMS decided, as a matter of policy, to review certain regulations which, although they may not meet the threshold requirement under section 610 of the RFA, warrant review. The February 18 notice stated that AMS would list the regulations to be reviewed in AMS' regulatory agenda which is published in the **Federal Register** as part of the Unified Agenda. However, after further consideration, AMS has decided to announce the reviews in the **Federal Register** separate from the Unified Agenda. Accordingly, this notice and request for comments is made for California almonds.

The purpose of the review will be to determine whether the California marketing order for almonds should be continued without change, amended, or rescinded (consistent with the objectives of the AMAA) to minimize the impacts on small entities. In conducting this review, AMS will consider the following factors: (1) The continued need for the marketing order; (2) the nature of complaints or comments received from the public concerning the marketing order; (3) the complexity of the marketing order; (4) the extent to which the marketing order overlaps, duplicates, or conflicts with other Federal rules, and, to the extent feasible, with State and local governmental rules; and (5) the length of time since the marketing order has been evaluated or the degree to which technology, economic conditions, or other factors have changed in the area affected by the marketing order.

Written comments, views, opinions, and other information regarding the almond marketing order's impact on small businesses are invited.

Dated: June 7, 2001.

Kenneth C. Clayton,

Acting Administrator, Agricultural Marketing Service.

[FR Doc. 01–14832 Filed 6–12–01; 8:45 am]

BILLING CODE 3410–02–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 5c, 5f, 18, and 301

[REG–106917–99]

RIN 1545–AX15

Changes in Accounting Periods

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations under sections 441, 442, 706, and 1378 of the Internal Revenue Code of 1986 that relate to certain adoptions, changes, and retentions of annual accounting periods. The proposed regulations are necessary to update, clarify, and reorganize the rules and procedures for adopting, changing, and retaining a taxpayer's annual accounting period. The proposed regulations primarily affect taxpayers that want to adopt an annual accounting period under section 441 or that must receive approval from the Commissioner to adopt, change, or retain their annual accounting periods under section 442. This document also contains a notice of public hearing on these proposed regulations.

DATES: Written and electronic comments and requests to speak (with outlines of oral comments) at a public hearing scheduled for October 2, 2001, must be received by September 11, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG–106917–99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG–106917–99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC. Alternatively,

taxpayers may submit comments electronically via the Internet by selecting the ''Tax Regs'' option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.ustreas.gov/tax_regs/regslist.html. The public hearing will be held in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Roy A. Hirschhorn and Martin Scully, Jr. (202) 622–4960; concerning submissions of comments and the hearing, and/or to be placed on the building access list to attend the hearing, Treena Garrett (202) 622–7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in this notice of proposed rulemaking have been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collections of information should be sent 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, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O, Washington, DC 20224. Comments on the collections of information should be received by August 13, 2001. Comments are specifically requested concerning:

Whether the proposed collections of information are necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collections of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collections of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information can be found in §§ 1.441–2(b)(1), 1.442–1(b)(1) and (b)(4) and (d), and 1.1378–1 of these regulations. Section 1.441–2(b)(1) requires certain taxpayers to file statements on their federal income tax returns to notify the Commissioner of the taxpayers' election to adopt a 52–53-week taxable year. Section 1.442–1(b)(4) provides that certain taxpayers must establish books and records that clearly reflect income for the short period involved when changing their taxable year from their taxable year to a proposed fiscal taxable year. Section 1.442–1(d) requires a newly married husband or wife to file a statement with their short period return when changing to the other spouse's taxable year. This collection of information is mandatory. The likely respondents are businesses or other profit entities and individuals.

The estimated average annual burden per respondent and/or recordkeeper required by §§ 1.442–1(b)(1) and 1.1378–1 are reflected in the burdens of Forms 1128 and 2553.

Further, the estimated average burden per respondent and/or recordkeeper required by §§ 1.441–2(b)(1), 1.442–1(b)(4) and 1.442–1(d) is as follows:

Estimated total reporting/recordkeeping burden: 3,500 hours.

Estimated average burden per respondent/recordkeeper: 21 minutes.

Estimated number of respondents/recordkeepers: 10,000.

Estimated annual frequency of responses: On occasion.

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.

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.

Background and Explanation of Provisions

A. Overview

This document contains proposed amendments to regulations under section 441 (period for computing taxable income), and sections 442, 706, and 1378 (regarding the requirement to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period).

B. Section 441: Period for Computing Taxable Income

1. *Background.* Section 441 provides that taxable income must be computed on the basis of the taxpayer's taxable year and generally defines the term ''taxable year.'' The current temporary regulations under section 441 are primarily the product of two separate Treasury Decisions, TD 8167, 52 FR 485241 (published with a cross reference to a notice of proposed rulemaking) and TD 8123, 52 FR 3615 (1988). Prior to the issuance of TD 8167 and TD 8123 (the temporary regulations), the regulations under section 441 contained provisions relating mostly to the period for computing taxable income and the election of a 52–53-week taxable year. The temporary regulations retain these provisions, but also add new provisions to implement section 806 of the Tax Reform Act of 1986, Public Law 99–512 (100 Stat. 2362), 1986–3 C.B. (Vol. 1) 1, 279, (the 1986 Act). Enacted with the principal intent of eliminating the deferral period between certain entities and their owners, the 1986 Act generally required partnerships, S corporations, and personal service corporations (PSCs) to conform their taxable years to the taxable years of their partners, shareholders, or employee-owners, respectively. H.R. Conf. Rep. No. 99–514, 99th Cong., 2d Sess 318 (1986).

In addition to general implementation provisions, the temporary regulations include transition and anti-abuse provisions specific to taxpayers in existence at the time the 1986 Act became effective. For example, § 1.441–3T provides rules intended to prevent taxpayers from circumventing the effective date of the provisions of the 1986 Act by adopting or changing to (or from) a 52–53-week taxable year during the period beginning after September 29, 1986, and ending before January 5, 1987.

Generally, this document reproposes the temporary regulations under section 441. However, this document also reorganizes, clarifies, modifies, and updates the temporary regulations. Many of the provisions contained in the temporary regulations remain essentially the same, including the general rules for adopting a taxable year, the provisions relating to electing a 52–53-week taxable year, and the rules for PSCs. However, provisions that are now obsolete have been removed, and new rules and definitions have been added, as described in more detail below. In addition, new cross-references to section 442 and the proposed regulations thereunder are included to guide taxpayers, where appropriate, to the rules and procedures for obtaining approval to adopt, change, or retain their annual accounting periods.

2. *General Rules and Definitions.* Most of the substantive provisions in § 1.441–1T of the temporary regulations

have been retained, including the general rules for the period for computing tax, numerous definitions, and the requirement that partnerships, S corporations, electing S corporations, and PSCs generally must demonstrate a business purpose and obtain the Commissioner's approval to adopt or retain a taxable year other than their required taxable year. However, § 1.441–1T has been reorganized, obsolete transition rules have been removed, and some rules have been clarified. For example, the proposed regulations now define the term required taxable year, identify entities that have such a year (with appropriate cross-references), and clarify the applicable exceptions.

In addition, the proposed regulations clarify the meaning of the requirement to keep books for taxpayers using a fiscal year. The temporary regulations provide that a fiscal year will be recognized only if the books of the taxpayer are kept in accordance with that fiscal year. The proposed regulations conform the book keeping requirement for taxpayers using a fiscal year to that of § 1.446–1(a)(4), which allows for a reconciliation between the taxpayer's books and return. However, as a term and condition of obtaining approval to adopt, change to, or retain an annual accounting period under section 442, certain taxpayers nevertheless may be required to compute income and keep their books (including financial statements and reports to creditors) on the basis of the requested annual accounting period. See, e.g., Rev. Proc. 2000–11 (2000–3 I.R.B. 309).

The proposed regulations also provide that a taxable year is adopted by filing the first federal income tax return using that taxable year. Accordingly, filing an application for an employer identification number, filing an extension, or making estimated tax payments, indicating a particular taxable year do not constitute an adoption of that year. Consequently, Rev. Rul. 57–589 (1957–2 C.B. 298), and Rev. Rul. 69–563 (1969–2 C.B. 104), holding that the filing of an extension and estimated tax payments establishes a taxable year, are proposed to be superseded. The IRS will continue to follow the decision in *E.G. Wilson,* 267 F. Supp. 89 (East. Dist. MO, 1967), with respect to the classification of an amended return as a ''first return.''

3. *52–53-week Taxable Years.* The proposed regulations retain most of the rules provided in § 1.441–2T of the temporary regulations for taxpayers electing to use a 52–53-week taxable year or changing to or from a 52–53-week taxable year. However, the procedures for certain taxpayers to obtain approval (automatic or otherwise) to change to or from a 52–53-week taxable year have been removed and are now contained in administrative procedures published by the Commissioner. See Rev. Proc. 2000–11; and Notice 2001–35 (IRB 2001–23). In addition, although these administrative procedures continue to provide automatic approval for a change to a 52–53-week taxable year ending with reference to the same calendar month, the change will be effected with a Form 1128 (Application to Adopt, Change or Retain a Tax Year) rather than with a statement, consistent with most other changes.

The proposed regulations also expand the applicability of the rules for determining the inclusion of income and deductions from a pass-through entity where either the entity or its owner uses a 52–53-week taxable year. In addition to applying to partnerships, S corporations, and PSCs (as in the temporary regulations), the proposed regulations apply these inclusion rules to trusts, common trust funds, controlled foreign corporations, foreign personal holding companies, and passive foreign investment companies that are qualified electing funds.

4. *Transition Rules.* Section 1.441–3T of the temporary regulations provide transition rules for the 1986 Act that generally were effective from September 29, 1986, through January 5, 1987. Moreover, the rules contained in § 1.441–3T regarding 52–53-week taxable years and the definition of a PSC were superseded by similar rules promulgated under §§ 1.441–2T and 1.441–4T, respectively. Because these rules are now obsolete, this section has been removed from the proposed regulations.

5. *Personal Service Corporations.* The rules for PSCs contained in § 1.441–4T of the temporary regulations generally have been retained in the proposed regulations. However, the proposed regulations reorganize and clarify the required taxable year of a PSC and the rules for adopting, changing to, and retaining a year other than the required taxable year. For example, the proposed regulations make clear that a PSC may have a year other than a required taxable year by making an election under section 444. In addition, the provision allowing a PSC to obtain automatic approval to change to its required taxable year has been removed and is now contained in Notice 2001–35 (I.R.B. 2001–23). Similarly, the rules regarding establishing a business purpose and obtaining approval for the use of a fiscal year have been moved to § 1.442–1(b) and Notice 2001–34 (I.R.B. 2001–23).

Comments were received on the notice of proposed rulemaking that is cross-referenced by the temporary regulations under § 1.441–4T. Most significantly, one commentator suggested that the testing period for determining whether a taxpayer is a PSC should be the three preceding taxable years, rather than the preceding taxable year, to prevent taxpayers from becoming a PSC due to temporary or aberrational conditions. The proposed regulations retain the one-year testing period provided in the temporary regulations. However, the IRS and Treasury Department will reconsider this testing period, as well as other comments received on the temporary regulations, to the extent similar comments are received on these proposed regulations now that taxpayers have significantly more experience with the provisions in the temporary regulations.

C. Section 442: Changes of Annual Accounting Period

1. *Background.* Under section 442 and the current regulations, a taxpayer generally can change its annual accounting period only by obtaining the approval of the Commissioner. The current regulations set forth the general rules for obtaining such approval, including: (1) The manner and time for filing an application to change an annual accounting period; (2) the requirement that the taxpayer demonstrate a substantial business purpose for the change; and (3) the need for agreement between the taxpayer and the Commissioner to the terms, conditions, and adjustments that are necessary to effect the change. Under the current regulations, both tax and non-tax factors are considered in determining whether a taxpayer has established a substantial business purpose.

2. *Manner and Time for Filing.* The proposed regulations retain the general requirement to file a Form 1128 to request approval, but extend the time for filing the Form 1128. The current regulations require that the Form 1128 be filed on or before the 15th day of the second calendar month (generally 45 days) following the close of the short period. Under the proposed regulations, the Form 1128 must be filed by the 15th day of the third calendar month (generally 75 days) after the close of the taxable year in which the taxpayer wants the adoption, change, or retention to be effective (i.e., the first effective year). However, taxpayers are encouraged to file their Forms 1128 as

soon after the close of the first effective year as possible to allow the IRS adequate time to process the Form 1128 before the extended due date of the return for the first effective year. Because the IRS has found that Forms 1128 filed before the close of the short period often lack complete information and result in processing delays, the proposed regulation provides that the Form 1128 may not be filed prior to the close of the first effective year.

3. *Business Purpose, Terms, Conditions, and Adjustments.* Taxpayers have expressed concern with the substantial business purpose requirement set forth in the current regulations. In particular, taxpayers have complained that the Commissioner's interpretation of a substantial business purpose as demonstrated in the IRS's ruling practice has been unclear, inconsistent, and overly restrictive.

As a result, the IRS and Treasury Department published Notice 99–19 (1999–1 C.B. 919) soliciting comments on how the rules for obtaining approval of an adoption, change, or retention in annual accounting period could be clarified and simplified. In response, commentators urged the IRS and Treasury Department to expand the categories of taxpayers that would be granted automatic approval for an annual accounting period and to revise the substantial business purpose requirement to broaden the circumstances in which a taxpayer will be granted approval to change an annual accounting period.

The IRS and Treasury Department believe that the proposed regulations, in combination with automatic and prior approval revenue procedures, will clarify the rules governing accounting periods, expand the circumstances in which taxpayers will be granted approval (automatically and otherwise), and result in a more clear, uniform ruling practice.

The proposed regulations continue to provide the general standards for obtaining approval for an adoption, change, or retention in annual accounting period: taxpayers must demonstrate the existence of a ''business purpose'' and must agree to the terms, conditions, and adjustments for the adoption, change, or retention. In modifying the ''substantial business purpose'' requirement to ''business purpose,'' the IRS and Treasury Department intend merely to conform to the language of the business purpose requirement found in sections 441(i), 706, and 1378 and not to lower the current standard. In addition, the proposed regulations contain business purpose guidelines generally applicable to all taxpayers. For example, the proposed regulations provide the general rule that deferral of income will not be treated as a business purpose. They also explain that a taxpayer will have demonstrated a business purpose by applying to adopt, change to, or retain a year coinciding with its required taxable year, ownership taxable year, or natural business year.

The prior approval revenue procedure is intended to provide more detailed guidance about how a taxpayer's business purpose will be evaluated, and the terms, conditions, and adjustments that will apply to an adoption, change, or retention of annual accounting period. Notice 2001–34, issued concurrently with these proposed regulations, proposes a revenue procedure that, when finalized, will provide the rules and procedures applicable to taxpayers who must apply to the national office to obtain the Commissioner's prior approval for an adoption, change, or retention. Under the proposed revenue procedure, the IRS in its ruling practice would no longer weigh the merit of the taxpayer's stated business purpose against the amount of distortion of income or other tax consequences resulting from an adoption, change, or retention. Taxpayers wanting to adopt, change to, or retain a natural business year generally would be granted approval (provided they agree to general terms and conditions) under the proposed revenue procedure as under the current IRS ruling practice. Also consistent with the current IRS ruling practice, establishing a natural business year generally will be the only circumstance under which a partnership, S corporation, electing S corporation, or PSC will be granted approval. However, the IRS ruling practice for other taxpayers generally will be liberalized. These other taxpayers that do not establish a natural business year generally would be granted approval under the proposed revenue procedure if they agree to certain additional terms, conditions, and adjustments designed to neutralize the tax effects of substantial distortion of income resulting from the change. Under the IRS's current ruling practice, these other taxpayers generally would have been denied approval to change their annual accounting period if the change would have resulted in more than de minimis distortion of income.

4. *Automatic Approval.* Under the current regulations, automatic approval is granted to a C corporation that satisfies certain conditions through the filing of a statement with the District Director. Among the requirements for automatic approval are that the taxpayer not have changed its annual accounting period at any time within the preceding ten calendar years, and that a C corporation not elect S corporation status for the taxable year immediately following the short period. The rules for C corporations contained in the current regulations are inconsistent with, and generally more restrictive than, the automatic approval procedures in Rev. Proc. 2000–11. For example, under Rev. Proc. 2000–11, six years (rather than ten) is the required period of time between automatic changes and an S corporation election is allowed for the tax year following the short period. Consequently, the proposed regulations remove the automatic approval provision contained in the current regulations.

Further, the proposed regulations provide that the procedures to obtain automatic approval of the Commissioner for an adoption, change, or retention of annual accounting period generally are contained in administrative procedures. The IRS and Treasury Department believe that this structure will allow for the issuance of more detailed and useful guidance. See, for example, Rev. Proc. 2000–11 (2000–3 I.R.B. 309), which provides procedures for automatic approval for corporations; Notice 2001–35, proposing to update and supersede Rev. Proc. 87–32 (1987–2 C.B. 396), which provides procedures for automatic approval for partnerships, S corporations, electing S corporations, and PSCs; and Rev. Proc. 66–50 (1966–2 C.B. 1260), which provides automatic approval provisions for individuals. As part of the finalization of these proposed regulations and the proposed revenue procedures contained in Notices 2001–34 and 2001–35, the IRS and Treasury Department intend to update the procedures in Rev. Proc. 2000–11 to make conforming changes. For example, Rev. Proc. 2000–11 may be modified to reduce the time period between automatic changes from six to four years (as proposed in Notice 2001–34) and to provide audit protection for taxpayers making voluntary period changes (as proposed in both notices).

5. *Obsolete Provisions.* The rules relating to partners and partnerships contained in the current regulations are proposed to be removed because they have been superseded by the 1986 Act. Updated rules for partners and partnerships are provided in new proposed regulations under § 1.706–1 contained in this notice of proposed rulemaking.

Similarly, the rules relating to certain foreign corporations contained in the current regulations are proposed to be

removed because they have been superseded by section 898. Updated rules for these foreign corporations are contained in proposed regulations under section 898.

Finally, the proposed regulations would remove the following transitional provisions, which are now obsolete: §§ 5c.442–1, 5f.442–1, 1.442–2T, and 1.442–3T.

D. Sections 706: Taxable Years of Partners and Partnerships

1. Partnership Taxable Year

The current regulations under § 1.706–1 have not been updated to reflect changes made to section 706(b) by the 1986 Act. These proposed regulations modify the current regulations to reflect the required taxable year of a partnership consistent with the 1986 Act and § 1.706–1T (regarding the taxable year that results in the least aggregate deferral of income). The proposed regulations also remove the procedural aspects of establishing a business purpose and requesting approval of the Commissioner to adopt or change a taxable year and instead refer to the procedures in § 1.442–1 (including the administrative procedures prescribed thereunder).

These regulations also propose to remove § 1.706–1T. This removal is not intended to effect a substantive change because the provisions of § 1.706–1T generally are adopted by the proposed regulations. The IRS and Treasury recently expressed a commitment to the finalization of § 1.706–1T, as well as other previously proposed regulations under section 706, LR–183–84 (49 FR 47048) and LR–53–88 (53 FR 19715). See 66 FR 3920, 3922. However, it is believed that adopting the substantive provisions of § 1.706–1T in the current proposed regulations will promote clarity and efficiency.

2. Inclusion Rule for Distributions, Sales, and Exchanges

Section 1.706–1(a)(2) of the current regulations provides that any gain or loss from a partnership distribution or from a sale or exchange of all or part of a partnership interest is includible in the partner's gross income for the taxable year in which the payment is made. Gain or loss from a distribution or a sale or exchange of a partnership interest generally is includible in gross income in the taxable year in which payment is made, but not always. For example, a partner who sells his partnership interest in exchange for an installment note may be able to defer inclusion of the gain from that sale under the installment method of accounting. Because the IRS and Treasury Department believe that other provisions of the Code and regulations provide adequate guidance on the time for including gain or loss from a partnership distribution or from a sale or exchange of a partnership interest, the inclusion rule in § 1.706–1(a)(2) is proposed to be removed.

3. Determination of Interest in Profits and Capital

To apply any of the three required taxable year tests, a partnership must determine the partners' interests in partnership profits and capital. The proposed regulations elaborate on the meaning of a partner's interest in partnership profits and capital for purposes of these tests. With respect to profits interests, the regulations clarify that a partner's profits interest is the partner's share of the taxable income, rather than the book income, of the partnership. The regulations also clarify that the partners' profits interests are determined on an annual basis based on the manner in which the partnership expects to allocate its income for the year. If the partnership does not expect to have income in the current year, then the partnership determines the partner's profits interests based on the manner in which it expects to allocate its income in the first taxable year in which the partnership expects to have income.

Generally, a partner's interest in partnership capital is determined through reference to the assets of the partnership that the partner would be entitled to upon withdrawal from the partnership or upon the liquidation of the partnership. See, e.g., § 1.704–1(e)(v), Rev. Proc. 93–27 (1993 C.B. 343). As a practical matter, such a determination will require a valuation of the partnership's assets. Because the determination under section 706 must be made on an annual basis, the burden associated with actual valuations may make it difficult for partnerships to identify their taxable years quickly and easily. Therefore, for partnerships that maintain capital accounts in accordance with § 1.704–1(b)(2)(iv), these proposed regulations provide that in making this determination, it will be reasonable for the partnership to assume that a partner's interest in partnership capital is the ratio of the partner's capital account to all partners' capital accounts. The IRS and Treasury Department are aware that this method will not always be as precise as an actual valuation, but believe that any imprecision is outweighed by the strong interest that partnerships have in being able to easily determine their taxable year.

This definition of a partner's interest in partnership profits and capital was designed to be compatible with the provisions of, and policies underlying, section 706(b). Many other sections of the Code also contain references to a partner's interest in partnership profits or capital. As those sections address concerns that differ substantially from the concerns addressed by section 706(b), this proposed regulation should not be read to create any implication as to the meaning of a partner's interest in partnership profits and capital for purposes of those sections.

E. Section 1378: S Corporations

The current regulations under § 18.1378–1 describe the permitted year of an S corporation and provide procedural rules for an S corporation or electing S corporation to obtain approval to adopt, change, or retain its taxable year. However, the automatic change provision contained in these regulations is more restrictive than the automatic change proposed in Notice 2001–35. For this reason, and to be consistent with the policy decision to provide the procedural aspects of adopting, retaining, or changing a taxable year under § 1.442–1 (including the administrative procedures prescribed thereunder), these regulations propose to modify § 18.1378–1 to remove these procedural rules and instead refer to § 1.442–1.

F. Proposed Effective Date

These regulations are proposed to be applicable for taxable years ending on or after the date these regulations are published in the **Federal Register** as final regulations.

Effect on Other Documents

Rev. Rul. 57–589 is obsolete.

Rev. Rul. 65–316 (1965–2 C.B. 149) is obsolete.

Rev. Rul. 68–125 (1968–1 C.B. 189) is obsolete.

Rev. Rul. 69–563 is obsolete.

Rev. Rul. 74–326 (1974–2 C.B. 142) is obsolete.

Rev. Rul. 78–179 (1978–1 C.B. 132) is obsolete.

Special Analyses

It has been determined that this notice of proposed rulemaking 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. It is hereby certified that the collection of information in these regulations will not

have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few small entities are expected to adopt a 52–53 week taxable year, triggering the collection of information, and that for those who do, the burden imposed under § 1.441–2(b)(1)(ii) will be minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f) of the Internal Revenue Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) and electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 2, 2001, at 10 a.m., in the IRS Auditorium, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons who wish to present oral comments at the hearing must submit timely written or electronic comments and must submit an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by September 11, 2001.

A period of 10 minutes will be allocated to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Roy A. Hirschhorn and Martin Scully, Jr. of the Office of Associate Chief Counsel (Income Tax and Accounting). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Parts 1, 5f, and 18

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 5c

Accounting, Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 301

Administrative practice and procedure, Income taxes.

Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1, 5c, 5f, 18, and 301 are proposed to be amended as follows:

PART 1—INCOME TAXES

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

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

Par. 2. In the list below, for each section indicated in the left column, remove the old language in the middle column and add the new language in the right column.

Affected Section	Remove	Add
1.46–1(p)(2)(iv)	paragraph (b)(1) of § 1.441–2	§ 1.441–2
1.48–3(d)(1)(iii)	paragraph (b)(1) of § 1.441–2	§ 1.441–2
1.280H–1T(a), last sentence	§ 1.441–4T(d)	§ 1.441–3(c)
1.443–1(b)(1)(ii)	and paragraph (c)(5) of § 1.441–2	and § 1.441–2(b)(2)(ii)
1.444–1T(a)(1), first sentence	§ 1.441–4T(d)	§ 1.441–3(c)
1.444–2T(a), last sentence	§ 1.441–4T(d)	§ 1.441–3(c)
1.448–1(h)(2)(ii)(B)(*1*)	§ 1.441–2T(b)(1)	§ 1.441–2(c)
1.469–1(h)(4)(ii)(D)	§ 1.441–4T(f)	§ 1.441–3(e)
1.469–1T(g)(2)(i)	§ 1.441–4T(d)	§ 1.441–3(c)
1.1561–1(c)(2)	See paragraph (b)(1) of § 1.441–2	See § 1.441–2
1.6654–2(a), concluding text	paragraph (b) of § 1.441–2	§ 1.441–2(c)
1.6655–2(a)(4), first sentence	paragraph (b) of § 1.441–2	§ 1.441–2(c)
301.7701(b)–6(a), third sentence	§ 1.441–1(e)	§ 1.441–1(b)

Par. 3. Sections 1.441–0, 1.441–1, 1.441–2, 1.441–3, and 1.441–4 are added to read as follows:

§ 1.441–0 Table of contents.

This section lists the captions contained in § 1A1.441–1 through 1.441–4 as follows:

§ 1.441–1 Period for computation of taxable income.

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(B) Partnerships, S corporations, and PSCs.
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(5) Fiscal year.
(i) Definition.
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(1) In general.
(2) Approval required.
(i) Taxpayers with required taxable years.
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(f) Obtaining approval of the Commissioner or making a section 444 election.

§ 1.441–2 Election of taxable year consisting of 52–53 weeks.

(a) In general.
(1) Election.
(2) Eligible taxpayer.
(3) Example.
(b) Procedures to elect a 52–53-week taxable year.

§ 1.441–1 Period for computation of taxable income.

(a) *Computation of taxable income*—(1) *In general.* Taxable income must be computed and a return must be made for a period known as the ''taxable year.'' For rules relating to methods of accounting, the taxable year for which items of gross income are included and deductions are taken, inventories, and adjustments, see parts II and III (section 446 and following), subchapter E, chapter 1 of the Internal Revenue Code, and the regulations thereunder.

(2) *Length of taxable year.* Except as otherwise provided in the Internal Revenue Code and the regulations thereunder (e.g., § 1.441–2 regarding 52–53-week taxable years), a taxable year may not cover a period of more than 12 calendar months.

(b) *General rules and definitions.* The general rules and definitions in this paragraph (b) apply for purposes of sections 441 and 442 and the regulations thereunder.

(1) *Taxable year. Taxable year* means—

(i) The period for which a return is made, if a return is made for a period of less than 12 months (short period). See section 443 and the regulations thereunder;

(ii) Except as provided in paragraph (b)(1)(i) of this section, the taxpayer's required taxable year (as defined in paragraph (b)(2) of this section), if applicable;

(iii) Except as provided in paragraphs (b)(1)(i) and (ii) of this section, the taxpayer's annual accounting period (as defined in paragraph (b)(3) of this section), if it is a calendar year or a fiscal year; or

(iv) Except as provided in paragraphs (b)(1)(i) and (ii) of this section, the calendar year, if the taxpayer keeps no books, does not have an annual accounting period, or has an annual accounting period that does not qualify as a fiscal year.

(2) *Required taxable year*—(i) *In general.* Certain taxpayers must use the particular taxable year that is required under the Internal Revenue Code and the regulations thereunder (the required taxable year). For example, the required taxable year is—

(A) In the case of a foreign sales corporation or domestic international sales corporation, the taxable year determined under section 441(h) and § 1.921–1T(a)(11), (b)(4), and (b)(6);

(B) In the case of a personal service corporation (PSC), the taxable year determined under section 441(i) and § 1.441–3;

(C) In the case of a nuclear decommissioning fund, the taxable year determined under § 1.468A–4(c)(1);

(D) In the case of a designated settlement fund or a qualified settlement fund, the taxable year determined under § 1.468B–2(j);

(E) In the case of a common trust fund, the taxable year determined under section 584(i);

(F) In the case of certain trusts, the taxable year determined under section 644;

(G) In the case of a partnership, the taxable year determined under section 706 and § 1.706–1;

(H) In the case of an insurance company, the taxable year determined under section 843 and § 1.1502–76(a)(2);

(I) In the case of a real estate investment trust, the taxable year determined under section 859;

(J) In the case of a real estate mortgage investment conduit, the taxable year determined under section 860D(a)(5) and § 1.860D–1(b)(6);

(K) In the case of a specified foreign corporation, the taxable year determined under section 898(c) and §§ 1.898–1 through 1.898–4;

(L) In the case of an S corporation, the taxable year determined under section 1378 and § 1.1378–1; or

(M) In the case of a member of an affiliated group that makes a consolidated return, the taxable year determined under § 1.1502–76.

(ii) *Exceptions.* Notwithstanding paragraph (b)(2)(i) of this section, the following taxpayers may have a taxable year other than their required taxable year:

(A) *52–53-week taxable years.* Certain taxpayers may elect to use a 52–53-week taxable year that ends with reference to their required taxable year. See, for example, §§ 1.441–3 (PSCs), 1.706–1 (partnerships), 1.1378–1 (S corporations), and 1.1502–76(a)(1) (members of a consolidated group), and 1.898–4(c)(3) (specified foreign corporations).

(B) *Partnerships, S corporations, and PSCs.* A partnership, S corporation, or PSC may use a taxable year other than its required taxable year if the taxpayer elects a 52–53-week taxable year that ends with reference to its required taxable year as provided in paragraph (b)(2)(ii)(A) of this section, elects to use a taxable year other than its required taxable year under section 444, or establishes a business purpose to the satisfaction of the Commissioner under

section 442 (such as a grandfathered fiscal year).

(C) *Specified foreign corporations.* A specified foreign corporation (as defined in section 898(b)) may use a taxable year other than its required taxable year if it elects a 52–53-week taxable year that ends with reference to its required taxable year as provided in paragraph (b)(2)(ii)(A) of this section or makes a one-month deferral election under section 898(c)(1)(B) and § 1.898–3(a)(2).

(3) *Annual accounting period. Annual accounting period* means the annual period (calendar year or fiscal year) on the basis of which the taxpayer regularly computes its income in keeping its books.

(4) *Calendar year. Calendar year* means a period of 12 consecutive months ending on December 31. A taxpayer who has not established a fiscal year must make its return on the basis of a calendar year.

(5) *Fiscal year*—(i) *Definition. Fiscal year* means—

(A) A period of 12 consecutive months ending on the last day of any month other than December; or

(B) A 52–53-week taxable year, if such period has been elected by the taxpayer. See § 1.441–2.

(ii) *Recognition.* A fiscal year will be recognized only if the books of the taxpayer are kept in accordance with such fiscal year.

(6) *Grandfathered fiscal year. Grandfathered fiscal year* means a fiscal year (other than a year that resulted in a three month or less deferral of income) that a partnership or an S corporation received permission to use on or after July 1, 1974, by a letter ruling (i.e., not by automatic approval).

(7) *Books. Books* include the taxpayer's regular books of account and such other records and data as may be necessary to support the entries on the taxpayer's books and on the taxpayer's return, as for example, a reconciliation of any difference between such books and the taxpayer's return. Records that are sufficient to reflect income adequately and clearly on the basis of an annual accounting period will be regarded as the keeping of books. See section 6001 and the regulations thereunder for rules relating to the keeping of books and records.

(c) *Adoption of taxable year*—(1) *In general.* Except as provided in paragraph (c)(2) of this section, a new taxpayer may adopt any taxable year that satisfies the requirements of section 441 and the regulations thereunder without the approval of the Commissioner. A taxable year of a new taxpayer is adopted by filing its first federal income tax return using that taxable year. The filing of an application for automatic extension of time to file a federal income tax return (e.g., Form 7004), the filing of an application for an employer identification number (i.e., Form SS4), or the payment of estimated taxes, for a particular taxable year do not constitute an adoption of that taxable year.

(2) *Approval required*—(i) *Taxpayers with required taxable years.* A newly-formed partnership, electing S corporation, or newly-formed PSC that wants to adopt a taxable year other than its required taxable year, a 52–53-week taxable year that ends with reference to its required taxable year, or a taxable year elected under section 444, must establish a business purpose and obtain the approval of the Commissioner under section 442.

(ii) *Taxpayers without books.* A taxpayer that must use a calendar year under section 441(g) and paragraph (f) of this section may not adopt a fiscal year without obtaining the approval of the Commissioner.

(d) *Retention of taxable year.* In certain cases, a partnership, S corporation, or PSC will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that either becomes a PSC or elects to be an S corporation and, as a result, is required to use the calendar year under sections 441(i) or 1378, respectively, must obtain the approval of the Commissioner to retain its current fiscal year. Similarly, a partnership using a taxable year that corresponds to its required taxable year must obtain the approval of the Commissioner to retain such taxable year if its required taxable year changes as a result of a change in ownership. However, a partnership that previously established a business purpose to the satisfaction of the Commissioner to use a taxable year is not required to obtain the approval of the Commissioner if its required taxable year changes as a result of a change in ownership.

(e) *Change of taxable year.* Once a taxpayer has adopted a taxable year, such taxable year must be used in computing taxable income and making returns for all subsequent years unless the taxpayer obtains approval from the Commissioner to make a change or the taxpayer is otherwise authorized to change without the approval of the Commissioner under the Internal Revenue Code (e.g., section 444 or section 859) or the regulations thereunder.

(f) *Obtaining approval of the Commissioner or making a section 444 election.* See § 1.442–1(b) for procedures for obtaining approval of the Commissioner (automatically or otherwise) to adopt, change, or retain an annual accounting period. See §§ 1.444–1T and 1.444–2T for qualifications, and 1.444–3T for procedures, for making an election under section 444.

§ 1.441–2 Election of taxable year consisting of 52–53 weeks.

(a) *In general*—(1) *Election.* An eligible taxpayer may elect to compute its taxable income on the basis of a fiscal year that—

(i) Varies from 52 to 53 weeks;

(ii) Ends always on the same day of the week; and

(iii) Ends always on—

(A) Whatever date this same day of the week last occurs in a calendar month; or

(B) Whatever date this same day of the week falls that is the nearest to the last day of the calendar month.

(2) *Eligible taxpayer.* A taxpayer is eligible to elect a 52–53-week taxable year if such fiscal year would otherwise satisfy the requirements of section 441 and the regulations thereunder. For example, a taxpayer that is required to use a calendar year under § 1.441–1(b)(1)(D) is not an eligible taxpayer.

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

Example. If the taxpayer elects a taxable year ending always on the last Saturday in November, then for the year 2001, the taxable year would end on November 24, 2001. On the other hand, if the taxpayer had elected a taxable year ending always on the Saturday nearest to the end of November, then for the year 2001, the taxable year would end on December 1, 2001. Thus, in the case of a taxable year described in paragraph (a)(1)(iii)(A) of this section, the year will always end within the month and may end on the last day of the month, or as many as six days before the end of the month. In the case of a taxable year described in paragraph (a)(1)(iii)(B) of this section, the year may end on the last day of the month, or as many as three days before or three days after the last day of the month.

(b) *Procedures to elect a 52–53-week taxable year*—(1) *Adoption of a 52–53 week taxable year*—(i) *In general.* A new eligible taxpayer elects a 52–53-week taxable year by adopting such year in accordance with § 1.441–1(c). A newly-formed partnership, electing S corporation, or newly-formed personal service corporation (PSC) may adopt a 52–53-week taxable year without the approval of the Commissioner if such year ends with reference to either the taxpayer's required taxable year (as

defined in § 1.441–1(b)(2)) or the taxable year elected under section 444. See §§ 1.706–1, 1.1378–1 and 1.441–3. Similarly, a newly-formed specified foreign corporation (as defined in section 898(b)) may adopt a 52–53-week taxable year if such year ends with reference to the taxpayer's required taxable year, or, if the one-month deferral election under section 898(c)(1)(B) is made, with reference to the month immediately preceding the required taxable year. See § 1.898–4(c)(3). See also § 1.1502–76(a)(1) for special rules regarding subsidiaries adopting 52–53-week taxable years.

(ii) *Filing requirement.* A taxpayer adopting a 52–53-week taxable year must file with its federal income tax return for its first taxable year a statement containing the following information—

(A) The calendar month with reference to which the new 52–53-week taxable year ends;

(B) The day of the week on which the 52–53-week taxable year always will end; and

(C) Whether the 52–53-week taxable year will always end on the date on which that day of the week last occurs in the calendar month, or on the date on which that day of the week falls that is nearest to the last day of that calendar month.

(2) *Change to (or from) a 52–53 week taxable year*—(i) *In general.* An election of a 52–53-week taxable year by an existing eligible taxpayer with an established taxable year is treated as a change in annual accounting period that requires the approval of the Commissioner in accordance with § 1.442–1. Thus, a taxpayer must obtain approval to change from its current taxable year to a 52–53-week taxable year. Similarly, a taxpayer must obtain approval to change from a 52–53-week taxable year, or to change from one 52–53-week taxable year to another 52–53-week taxable year. However, if a change to a 52–53-week taxable year ends with reference to the same calendar month as the existing taxable year, or if a change from a 52–53-week taxable year ends with reference to the same calendar month as the proposed taxable year, the taxpayer may obtain approval for the change automatically pursuant to administrative procedures published by the Commissioner. See § 1.442–1(b) for procedures for obtaining such approval.

(ii) *Special rules for the short period required to effect the change.* If a change to or from a 52–53-week taxable year results in a short period (within the meaning of § 1.443–1(a)) of 359 days or more, or six days or less, the tax computation under § 1.443–1(b) does not apply. If the short period is 359 days or more, it is treated as a full taxable year. If the short period is six days or less, such short period is not a separate taxable year but instead is added to and deemed a part of the following taxable year. (In the case of a change to or from a 52–53-week taxable year not involving a change of the month with reference to which the taxable year ends, the tax computation under § 1.443–1(b) does not apply because the short period will always be 359 days or more, or six days or less.) In the case of a short period which is more than six days and less than 359 days, taxable income for the short period is placed on an annual basis for purposes of § 1.443–1(b) by multiplying such income by 365 and dividing the result by the number of days in the short period. In such case, the tax for the short period is the same part of the tax computed on such income placed on an annual basis as the number of days in the short period is of 365 days (unless § 1.443–1(b)(2), relating to the alternative tax computation, applies). For an adjustment in deduction for personal exemption, see § 1.443–1(b)(1)(v).

(3) *Examples.* The following examples illustrate paragraph (b)(2)(ii) of this section:

Example 1. A taxpayer having a fiscal year ending April 30, obtains approval to change to a 52–53-week taxable year ending the last Saturday in April for taxable years beginning after April 30, 2001. This change involves a short period of 362 days, from May 1, 2001, to April 27, 2002, inclusive. Because the change results in a short period of 359 days or more, it is not placed on an annual basis and is treated as a full taxable year.

Example 2. Assume the same conditions as *Example 1,* except that the taxpayer changes for taxable years beginning after April 30, 2002, to a taxable year ending on the Thursday nearest to April 30. This change results in a short period of two days, May 1 to May 2, 2002. Because the short period is less than seven days, tax is not separately computed. This short period is added to and deemed part of the following 52–53-week taxable year, which would otherwise begin on May 3, 2002, and end on May 1, 2003.

(c) *Application of effective dates*—(1) *In general.* Except as provided in paragraph (c)(3) of this section, for purposes of determining the effective date (e.g., of legislative or regulatory changes) or the applicability of any provision of this title that is expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, a 52–53-week taxable year is deemed to begin on the first day of the calendar month nearest to the first day of the 52–53-week taxable year, and is deemed to end or close on the last day of the calendar month nearest to the last day of the 52–53-week taxable year, as the case may be. Examples of provisions of this title, the applicability of which is expressed in terms referred to in the preceding sentence, include the provisions relating to the time for filing returns and other documents, paying tax, or performing other acts, and the provisions of part II, subchapter B, chapter 6 (section 1561 and following) relating to surtax exemptions of certain controlled corporations.

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

Example 1. Assume that an income tax provision is applicable to taxable years beginning on or after January 1, 2001. For that purpose, a 52–53-week taxable year beginning on any day within the period December 26, 2000, to January 4, 2001, inclusive, is treated as beginning on January 1, 2001.

Example 2. Assume that an income tax provision requires that a return must be filed on or before the 15th day of the third month following the close of the taxable year. For that purpose, a 52–53-week taxable year ending on any day during the period May 25 to June 3, inclusive, is treated as ending on May 31, the last day of the month ending nearest to the last day of the taxable year, and the return, therefore, must be made on or before August 15.

Example 3. X, a corporation created on January 1, 2001, elects a 52–53-week taxable year ending on the Friday nearest the end of December. Thus, X's first taxable year begins on Monday, January 1, 2001, and ends on Friday, December 28, 2001; its next taxable year begins on Saturday, December 29, 2001, and ends on Friday, January 3, 2003; and its next taxable year begins on Saturday, January 4, 2003, and ends on Friday, January 2, 2004. For purposes of applying the provisions of Part II, subchapter B, chapter 6 of the Internal Revenue Code, X's first taxable year is deemed to end on December 31, 2001; its next taxable year is deemed to begin on January 1, 2002, and end on December 31, 2002, and its next taxable year is deemed to begin on January 1, 2003, and end on December 31, 2003. Accordingly, each such taxable year is treated as including one and only one December 31st.

(3) *Changes in tax rates.* If a change in the rate of tax is effective during a 52–53-week taxable year (other than on the first day of such year as determined under paragraph (c)(1) of this section), the tax for the 52–53-week taxable year must be computed in accordance with section 15, relating to effect of changes, and the regulations thereunder. For the purpose of the computation under section 15, the determination of the number of days in the period before the change, and in the period on and after the change, is to be made without regard to the provisions of paragraph (b)(1) of this paragraph.

(4) *Examples.* The provisions of paragraph (c)(3) of this section may be illustrated by the following examples:

Example 1. Assume a change in the rate of tax is effective for taxable years beginning after June 30, 2002. For a 52–53-week taxable year beginning on Friday, November 2, 2001, the tax must be computed on the basis of the old rates for the actual number of days from November 2, 2001, to June 30, 2002, inclusive, and on the basis of the new rates for the actual number of days from July 1, 2002, to Thursday, October 31, 2002, inclusive.

Example 2. Assume a change in the rate of tax is effective for taxable years beginning after June 30, 2001. For this purpose, a 52–53-week taxable year beginning on any of the days from June 25 to July 4, inclusive, is treated as beginning on July 1. Therefore, no computation under section 15 will be required for such year because of the change in rate.

(d) *Computation of taxable income.* The principles of section 451, relating to the taxable year for inclusion of items of gross income, and section 461, relating to the taxable year for taking deductions, generally are applicable to 52–53-week taxable years. Thus, except as otherwise provided, all items of income and deduction must be determined on the basis of a 52–53-week taxable year. However, a taxpayer may determine particular items as though the 52–53-week taxable year were a taxable year consisting of 12 calendar months, provided that practice is consistently followed by the taxpayer and clearly reflects income. For example, an allowance for depreciation or amortization may be determined on the basis of a 52–53-week taxable year, or as though the 52–53-week taxable year is a taxable year consisting of 12 calendar months, provided the taxpayer consistently follows that practice with respect to all depreciable or amortizable items.

(e) *Treatment of taxable years ending with reference to the same calendar month*—(1) *Pass-through entities.* If a pass-through entity (as defined in paragraph (e)(3)(i) of this section) or an owner of a pass-through entity (as defined in paragraph (e)(3)(ii) of this section), or both, use a 52–53-week taxable year and the taxable year of the pass-through entity and the owner end with reference to the same calendar month, then, for purposes of determining the taxable year in which items of income, gain, loss, deductions, or credits from the pass-through entity are taken into account by the owner of the pass-through, the owner's taxable year will be deemed to end on the last day of the pass-through's taxable year. Thus, if the taxable year of a partnership and a partner end with reference to the same calendar month, then for purposes of determining the taxable year in which that partner takes into account items described in section 702 and items that are deductible by the partnership (including items described in section 707(c)) and includible in the income of that partner, that partner's taxable year will be deemed to end on the last day of the partnership's taxable year. Similarly, if the taxable year of an S corporation and a shareholder end with reference to the same calendar month, then for purposes of determining the taxable year in which that shareholder takes into account items described in section 1366(a) and items that are deductible by the S corporation and includible in the income of that shareholder, that shareholder's taxable year will be deemed to end on the last day of the S corporation's taxable year.

(2) *Personal service corporations and employee-owners.* If the taxable year of a PSC (within the meaning of § 1.441–3(c)) and an employee-owner (within the meaning of § 1.441–3(g)) end with reference to the same calendar month, then for purposes of determining the taxable year in which an employee-owner takes into account items that are deductible by the PSC and includible in the income of the employee-owner, the employee-owner's taxable year will be deemed to end on the last day of the PSC's taxable year.

(3) *Definitions*—(i) *Pass-through entity.* For purposes of this section, a pass-through entity means a partnership, S corporation, trust, estate, common trust fund (within the meaning of section 584(i)), controlled foreign corporation (within the meaning of section 957), foreign personal holding company (within the meaning of section 552), or passive foreign investment company that is a qualified electing fund (within the meaning of section 1295).

(ii) *Owner of a pass-through entity.* For purposes of this section, an owner of a pass-through entity means a taxpayer that owns an interest in, or stock of, a pass-through entity. For example, an owner of a pass-through entity includes a partner in a partnership, a shareholder of an S corporation, a beneficiary of a trust or an estate, a participant in a common trust fund, a U.S. shareholder (as defined in section 951(b)) of a controlled foreign corporation, a U.S. shareholder (as defined in section 551(a)) of a foreign personal holding company, or a U.S. person that holds stock in a passive foreign investment company that is a qualified electing fund.

(4) *Examples.* The provisions of paragraph (e)(2) of this section may be illustrated by the following examples:

Example 1. ABC Partnership uses a 52–53-week taxable year that ends on the Wednesday nearest to December 31, and its partners, A, B, and C, are individual calendar year taxpayers. Assume that, for ABC's taxable year ending January 3, 2001, each partner's distributive share of ABC's taxable income is $10,000. Under section 706(a) and paragraph (e)(1) of this section, for the taxable year ending December 31, 2000, A, B, and C each must include $10,000 in income with respect to the ABC year ending January 3, 2001. Similarly, if ABC makes a guaranteed payment to A on January 2, 2001, A must include the payment in income for A's taxable year ending December 31, 2000.

Example 2. X, a PSC, uses a 52–53-week taxable year that ends on the Wednesday nearest to December 31, and all of the employee-owners of X are individual calendar year taxpayers. Assume that, for its taxable year ending January 3, 2001, X pays a bonus of $10,000 to each employee-owner on January 2, 2001. Under paragraph (e)(2) of this section, each employee-owner must include its bonus in income for the taxable year ending December 31, 2000.

(5) *Transition rule.* In the case of an owner of a pass-through entity (other than the owner of a partnership or S corporation) that is required by this paragraph (e) to include in income for its first taxable year ending on or after the date these regulations are published in the **Federal Register** as final regulations amounts attributable to two taxable years of a pass-through entity, the amount that otherwise would be required to be included in income for such first taxable year by reason of this paragraph (e) should be included in income ratably over the four-taxable-year period beginning with such first taxable year under principles similar to § 1.702–3T, unless the owner of the pass-through elects to include all such income in its first taxable year ending on or after the date these regulations are published in the **Federal Register** as final regulations.

§ 1.441–3 Taxable year of a personal service corporation.

(a) *Taxable year*—(1) *Required taxable year.* Except as provided in paragraph (a)(2) of this section, the taxable year of a personal service corporation (PSC) (as defined in paragraph (c) of this section) must be the calendar year.

(2) *Exceptions.* A PSC may have a taxable year other than its required taxable year (i.e., a fiscal year) if elects to use a 52–53-week taxable year that ends with reference to the calendar year, makes an election under section 444, or establishes a business purpose for such fiscal year and obtains the approval of the Commissioner under section 442.

(b) *Adoption, change, or retention of taxable year—(1) Adoption of taxable year.* A PSC may adopt, in accordance with § 1.441–1(c), the calendar year, a 52–53-week taxable year ending with reference to the calendar year, or a taxable year elected under section 444 without the approval of the Commissioner. See § 1.441–1. A PSC that wants to adopt any other taxable year must establish a business purpose and obtain the approval of the Commissioner under section 442.

(2) *Change in taxable year.* A PSC that wants to change its taxable year must obtain the approval of the Commissioner under section 442 or make an election under section 444. However, a PSC may obtain automatic approval for certain changes, including a change to the calendar year or to a 52–53-week taxable year ending with reference to the calendar year, pursuant to administrative procedures published by the Commissioner.

(3) *Retention of taxable year.* In certain cases, a PSC will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that becomes a PSC and, as a result, is required to use the calendar year must obtain the approval of the Commissioner to retain its current fiscal year.

(4) *Procedures for obtaining approval or making a section 444 election.* See § 1.442–1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§ 1.444–1T and 1.444–2T for qualifications, and 1.444–3T for procedures, for making an election under section 444.

(5) *Examples.* The provisions of paragraph (b)(4) of this section may be illustrated by the following examples:

Example 1. X, whose taxable year ends on January 31, 2001, becomes a PSC for its taxable year beginning February 1, 2001, and does not obtain the approval of the Commissioner for using a fiscal year. Thus, for taxable years ending before February 1, 2001, this section does not apply with respect to X. For its taxable year beginning on February 1, 2001, however, X will be required to comply with paragraph (a) of this section. Thus, unless X obtains approval of the Commissioner to use a January 31 taxable year, or makes a section 444 election, X will be required to change its taxable year to the calendar year under paragraph (b) of this section by using a short taxable year that begins on February 1, 2001, and ends on December 31, 2001. Under paragraph (b)(1) of this section, X may obtain automatic approval to change its taxable year to a calendar year. See § 1.442–1(b).

Example 2. Assume the same facts as in *Example 1*, except that X desires to change to a 52–53-week taxable year ending with reference to the month of December. Under paragraph (b)(1) of this section X may obtain automatic approval to make the change. See § 1.442–1(b).

(c) *Personal service corporation defined*—(1) *In general.* For purposes of this section and section 442, a taxpayer is a PSC for a taxable year only if—

(i) The taxpayer is a C corporation (as defined in section 1361(a)(2)) for the taxable year;

(ii) The principal activity of the taxpayer during the testing period is the performance of personal services;

(iii) During the testing period, those services are substantially performed by employee-owners (as defined in paragraph (g) of this section); and

(iv) Employee-owners own (as determined under the attribution rules of section 318, except that ''any'' applies instead of ''50 percent'' in section 318(a)(2)(C)) more than 10 percent of the fair market value of the outstanding stock in the taxpayer on the last day of the testing period.

(2) *Testing period*—(i) *In general.* Except as otherwise provided in paragraph (c)(2)(ii) of this section, the testing period for any taxable year is the immediately preceding taxable year.

(ii) *New corporations.* The testing period for a taxpayer's first taxable year is the period beginning on the first day of that taxable year and ending on the earlier of—

(A) The last day of that taxable year; or

(B) The last day of the calendar year in which that taxable year begins.

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

Example 1. Corporation A's first taxable year begins on June 1, 2001, and A desires to use a September 30 taxable year. However, if A is a personal service corporation, it must obtain the Commissioner's approval to use a September 30 taxable year. Pursuant to paragraph (c)(2)(ii) of this section, A's testing period for its first taxable year beginning June 1, 2001, is the period June 1, 2001 through September 30, 2001. Thus, if, based upon such testing period, A is a personal service corporation, A must obtain the Commissioner's permission to use a September 30 taxable year.

Example 2. The facts are the same as in *Example 1*, except that A desires to use a March 31 taxable year. Pursuant to paragraph (c)(2)(ii) of this section, A's testing period for its first taxable year beginning June 1, 2001, is the period June 1, 2001, through December 31, 2001. Thus, if, based upon such testing period, A is a personal service corporation, A must obtain the Commissioner's permission to use a March 31 taxable year.

(d) *Performance of personal services*—(1) *Activities described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer described in section 448(d)(2)(A) or the regulations thereunder will be treated as the performance of personal services. Therefore, any activity of the taxpayer that involves the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting (as such fields are defined in § 1.448–1T) will be treated as the performance of personal services for purposes of this section.

(2) *Activities not described in section 448(d)(2)(A).* For purposes of this section, any activity of the taxpayer not described in section 448(d)(2)(A) or the regulations thereunder will not be treated as the performance of personal services.

(e) *Principal activity*—(1) *General rule.* For purposes of this section, the principal activity of a corporation for any testing period will be the performance of personal services if the cost of the corporation's compensation (the compensation cost) for such testing period that is attributable to its activities that are treated as the performance of personal services within the meaning of paragraph (d) of this section (i.e., the total compensation for personal service activities) exceeds 50 percent of the corporation's total compensation cost for such testing period.

(2) *Compensation cost*—(i) *Amounts included.* For purposes of this section, the compensation cost of a corporation for a taxable year is equal to the sum of the following amounts allowable as a deduction, allocated to a long-term contract, or otherwise chargeable to a capital account by the corporation during such taxable year—

(A) Wages and salaries; and

(B) Any other amounts, attributable to services performed for or on behalf of the corporation by a person who is an employee of the corporation (including an owner of the corporation who is treated as an employee under paragraph (g)(2) of this section) during the testing period. Such amounts include, but are not limited to, amounts attributable to deferred compensation, commissions, bonuses, compensation includible in income under section 83, compensation for services based on a percentage of profits, and the cost of providing fringe benefits that are includible in income.

(ii) *Amounts excluded.* Notwithstanding paragraph (e)(2)(i) of this section, compensation cost does not include amounts attributable to a plan qualified under section 401(a) or 403(a),

or to a simplified employee pension plan defined in section 408(k).

(3) *Attribution of compensation cost to personal service activity*—(i) *Employees involved only in the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are treated as personal services under paragraph (d) of this section, or employees involved only in supporting the work of such employees, are considered to be attributable to the corporation's personal service activity.

(ii) *Employees involved only in activities that are not treated as the performance of personal services.* The compensation cost for employees involved only in the performance of activities that are not treated as personal services under paragraph (d) of this section, or for employees involved only in supporting the work of such employees, are not considered to be attributable to the corporation's personal service activity.

(iii) *Other employees.* The compensation cost for any employee who is not described in either paragraph (e)(3)(i) or paragraph (e)(3)(ii) of this section (a mixed-activity employee) is allocated as follows—

(A) *Compensation cost attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is attributable to the corporation's personal service activity equals the compensation cost for that employee multiplied by the percentage of the total time worked for the corporation by that employee during the year that is attributable to activities of the corporation that are treated as the performance of personal services under paragraph (d) of this section. That percentage is to be determined by the taxpayer in any reasonable and consistent manner. Time logs are not required unless maintained for other purposes;

(B) *Compensation cost not attributable to personal service activity.* That portion of the compensation cost for a mixed activity employee that is not considered to be attributable to the corporation's personal service activity is the compensation cost for that employee less the amount determined in paragraph (e)(3)(iii)(A) of this section.

(f) *Services substantially performed by employee-owners*—(1) *General rule.* Personal services are substantially performed during the testing period by employee-owners of the corporation if more than 20 percent of the corporation's compensation cost for that period attributable to its activities that are treated as the performance of personal services within the meaning of paragraph (d) of this section (i.e., the total compensation for personal service activities) is attributable to personal services performed by employee-owners.

(2) *Compensation cost attributable to personal services.* For purposes of paragraph (f)(1) of this section—

(i) The corporation's compensation cost attributable to its activities that are treated as the performance of personal services is determined under paragraph (e)(3) of this section; and

(ii) The portion of the amount determined under paragraph (f)(2)(i) of this section that is attributable to personal services performed by employee-owners is to be determined by the taxpayer in any reasonable and consistent manner.

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

Example 1. For its taxable year beginning February 1, 2001, Corp A's testing period is the taxable year ending January 31, 2000. During that testing period, A's only activity was the performance of personal services. The total compensation cost of A (including compensation cost attributable to employee-owners) for the testing period was $1,000,000. The total compensation cost attributable to employee-owners of A for the testing period was $210,000. Pursuant to paragraph (f)(1) of this section, the employee-owners of A substantially performed the personal services of A during the testing period because the compensation cost of A's employee-owners was more than 20 percent of the total compensation cost for all of A's employees (including employee-owners).

Example 2. Corp B has the same facts as corporation A in *Example 1*, except that during the taxable year ending January 31, 2001, B also participated in an activity that would not be characterized as the performance of personal services under this section. The total compensation cost of B (including compensation cost attributable to employee-owners) for the testing period was $1,500,000 ($1,000,000 attributable to B's personal service activity and $500,000 attributable to B's other activity). The total compensation cost attributable to employee-owners of B for the testing period was $250,000 ($210,000 attributable to B's personal service activity and $40,000 attributable to B's other activity). Pursuant to paragraph (f)(1) of this section, the employee-owners of B substantially performed the personal services of B during the testing period because more than 20 percent of B's compensation cost during the testing period attributable to its personal service activities was attributable to personal services performed by employee-owners ($210,000).

(g) *Employee-owner defined*—(1) *General rule.* For purposes of this section, a person is an employee-owner of a corporation for a testing period if—

(i) The person is an employee of the corporation on any day of the testing period; and

(ii) The person owns any outstanding stock of the corporation on any day of the testing period.

(2) *Special rule for independent contractors who are owners.* Any person who is an owner of the corporation within the meaning of paragraph (g)(1)(ii) of this section and who performs personal services for, or on behalf of, the corporation is treated as an employee for purposes of this section, even if the legal form of that person's relationship to the corporation is such that the person would be considered an independent contractor for other purposes.

(h) *Special rules for affiliated groups filing consolidated returns*—(1) *In general.* For purposes of applying this section to the members of an affiliated group of corporations filing a consolidated return for the taxable year—

(i) The members of the affiliated group are treated as a single corporation;

(ii) The employees of the members of the affiliated group are treated as employees of such single corporation; and

(iii) All of the stock of the members of the affiliated group that is not owned by any other member of the affiliated group is treated as the outstanding stock of that corporation.

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

Example 1. The affiliated group AB, consisting of corporation A and its wholly owned subsidiary B, filed a consolidated Federal income tax return for the taxable year ending January 31, 2001, and AB is attempting to determine whether it is affected by this section for its taxable year beginning February 1, 2001. During the testing period (i.e., the taxable year ending January 31, 2001), A did not perform personal services. However, B's only activity was the performance of personal services. On the last day of the testing period, employees of A did not own any stock in A. However, some of B's employees own stock in A. In the aggregate, B's employees own 9 percent of A's stock on the last day of the testing period. Pursuant to paragraph (h)(1) of this section, this section is effectively applied on a consolidated basis to members of an affiliated group filing a consolidated federal income tax return. Because the only employee-owners of AB are the employees of B, and because B's employees do not own more than 10 percent of AB on the last day of the testing period, AB is not a PSC subject to the provisions of this section. Thus, AB is not required to determine on a consolidated basis whether, during the testing period, its principal activity is the providing of personal services, or the personal services are substantially performed by employee-owners.

Example 2. The facts are the same as in *Example 1*, except that on the last day of the testing period A owns only 80 percent of B.

The remaining 20 percent of B is owned by employees of B. The fair market value of A, including its 80 percent interest in B, as of the last day of the testing period, is $1,000,000. In addition, the fair market value of the 20 percent interest in B owned by B's employees is $50,000 as of the last day of the testing period. Pursuant to paragraphs (c)(1)(iv) and paragraph (h)(1) of this section, AB must determine whether the employee-owners of A and B (i.e., B's employees) own more than 10 percent of the fair market value of A and B as of the last day of the testing period. Because the $140,000 [($1,000,000 × .09) + $50,000] fair market value of the stock held by B's employees is greater than 10 percent of the aggregate fair market value of A and B as of the last day of the testing period, or $105,000 [$1,000,000 + $50,000 × .10], AB may be subject to this section if, on a consolidated basis during the testing period, the principal activity of AB is the performance of personal services and the personal services are substantially performed by employee-owners.

§ 1.441–4 Effective date.

Sections 1.441–0 through 1.441–3 are applicable for taxable years ending on or after the date these regulations are published in the **Federal Register** as final regulations.

§§ 1.441–1T, 1.441–2T, 1.441–3T and 1.441–4T [Removed]

Par. 4. Sections 1.441–1T, 1.441–2T, 1.441–3T and 1.441–4T are removed.

Par 5. Section 1.442–1 is revised to read as follows:

§ 1.442–1 Change of annual accounting period.

(a) *Approval of the Commissioner.* A taxpayer that has adopted an annual accounting period (as defined in § 1.441–1(b)(3)) as its taxable year generally must continue to use that annual accounting period in computing its taxable income and for making its federal income tax returns. If the taxpayer wants to change its annual accounting period and use a new taxable year, it must obtain the approval of the Commissioner, unless it is otherwise authorized to change without the approval of the Commissioner under either the Internal Revenue Code (e.g., section 444 and section 859) or the regulations thereunder (e.g., paragraph (c) of this section). In addition, as described in § 1.441–1(c) and (d), a partnership, S corporation, electing S corporation, or personal service corporation (PSC) generally is required to secure the approval of the Commissioner to adopt or retain an annual accounting period other than its required taxable year. The manner of obtaining approval from the Commissioner to adopt, change, or retain an annual accounting period is provided in paragraph (b) of this section. However, special rules for obtaining approval may be provided in other sections.

(b) *Obtaining approval*—(1) *Time and manner for requesting approval.* Except as otherwise provided in paragraph (b)(3) of this section, in order to secure the approval of the Commissioner to adopt, change, or retain an annual accounting period, a taxpayer must file an application, generally on Form 1128 (Application To Adopt, Change, or Retain a Tax Year), with the Commissioner. The Form 1128 must be filed no earlier than the day following the close of the first taxable year in which the taxpayer wants the adoption, change, or retention to be effective (the first effective year) and no later than the 15th day of the third calendar month following the close of the first effective year. However, in the case of a change that results in a short period of six days or less, the Form 1128 must be filed no later than the 15th day of the third calendar month following the close of the short period, even though the short period is not treated as a separate taxable year under § 1.441–2(b)(2).

(2) *General requirements for approval.* Except as provided in paragraph (b)(3) of this section, an adoption, change, or retention in annual accounting period will be approved where the taxpayer establishes a business purpose for the requested annual accounting period and agrees to the Commissioner's prescribed terms, conditions, and adjustments for effecting the adoption, change, or retention. In determining whether a taxpayer has established a business purpose and which terms, conditions, and adjustments will be required, consideration will be given to all the facts and circumstances relating to the adoption, change, or retention, including the tax consequences resulting therefrom. Generally, the requirement of a business purpose will be satisfied, and adjustments to neutralize any tax consequences will not be required, if the requested annual accounting period coincides with the taxpayer's required taxable year (as defined in § 1.441–1(b)(2)), ownership taxable year, or natural business year. In the case of a partnership, S corporation, electing S corporation, or PSC, deferral of income to partners, shareholders, or employee-owners will not be treated as a business purpose.

(3) *Administrative procedures.* Notwithstanding the provisions of paragraphs (b)(1) and (2) of this section, the Commissioner may prescribe administrative procedures under which a taxpayer will be permitted to adopt, change, or retain an annual accounting period. These administrative procedures will describe the business purpose requirements (including an ownership taxable year and a natural business year) and the terms, conditions, and adjustments necessary to obtain approval. Such terms, conditions, and adjustments may include adjustments necessary to neutralize the tax effects of a substantial distortion of income that would otherwise result from the requested annual accounting period including: a deferral of a substantial portion of the taxpayer's income, or shifting of a substantial portion of deductions, from one taxable year to another; a similar deferral or shifting in the case of any other person, such as a beneficiary in an estate; the creation of a short period in which there is a substantial net operating loss, capital loss, or credit (including a general business credit); or the creation of a short period in which there is a substantial amount of income to offset an expiring net operating loss, capital loss, or credit. See, for example, Notice 2001–34 (2001–23 I.R.B. 1302), procedures to obtain the Commissioner's prior approval of an adoption, change, or retention in annual accounting period through application to the national office; Rev. Proc. 2000–11 (2000–3 I.R.B. 309), automatic approval procedures for certain corporations; Notice 2001–35 (2001–23 I.R.B. 1314), automatic approval procedures for partnerships, S corporations, electing S corporations, and PSCs; and Rev. Proc. 66–50 (1966–2 C.B. 1260), automatic approval procedures for individuals. For availability of Revenue Procedures and Notices, see § 601.601(d)(2) of this chapter.

(4) *Taxpayers to whom section 441(g) applies.* If section 441(g) and § 1.441–1(b)(1)(iv) apply to a taxpayer, the adoption of a fiscal year is treated as a change in the taxpayer's annual accounting period under section 442. Therefore, that fiscal year can become the taxpayer's taxable year only with the approval of the Commissioner. In addition to any other terms and conditions that may apply to such a change, the taxpayer must establish and maintain books that adequately and clearly reflect income for the short period involved in the change and for the fiscal year proposed.

(c) *Special rule for change of annual accounting period by subsidiary corporation.* A subsidiary corporation that is required to change its annual accounting period under § 1.1502–76, relating to the taxable year of members of an affiliated group that file a consolidated return, does not need to obtain the approval of the

Commissioner or file an application on Form 1128 with respect to that change.

(d) *Special rule for newly married couples.* (1) A newly married husband or wife may obtain automatic approval under this paragraph (d) to change his or her annual accounting period in order to use the annual accounting period of the other spouse so that a joint return may be filed for the first or second taxable year of that spouse ending after the date of marriage. Such automatic approval will be granted only if the newly married husband or wife adopting the annual accounting period of the other spouse files a federal income tax return for the short period required by that change on or before the 15th day of the 4th month following the close of the short period. See section 443 and the regulations thereunder. If the due date for any such short-period return occurs before the date of marriage, the first taxable year of the other spouse ending after the date of marriage cannot be adopted under this paragraph (d). The short-period return must contain a statement at the top of page one of the return that it is filed under the authority of this paragraph (d). The newly married husband or wife need not file Form 1128 with respect to a change described in this paragraph (d). For a change of annual accounting period by a husband or wife that does not qualify under this paragraph (d), see paragraph (b) of this section.

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

Example. H & W marry on September 25, 2001. H is on a fiscal year ending June 30, and W is on a calendar year. H wishes to change to a calendar year in order to file joint returns with W. W's first taxable year after marriage ends on December 31, 2001. H may not change to a calendar year for 2001 since, under this paragraph (d), he would have had to file a return for the short period from July 1 to December 31, 2000, by April 16, 2001. Since the date of marriage occurred subsequent to this due date, the return could not be filed under this paragraph (d). Therefore, H cannot change to a calendar year for 2001. However, H may change to a calendar year for 2002 by filing a return under this paragraph (d) by April 15, 2002, for the short period from July 1 to December 31, 2001. If H files such a return, H and W may file a joint return for calendar year 2002 (which is W's second taxable year ending after the date of marriage).

(e) *Effective date.* The rules of this section are applicable for taxable years ending on or after the date these regulations are published in the **Federal Register** as final regulations.

§§ 1.442–2T and 1.442–3T [Removed]

Par. 6. Sections 1.442–2T and 1.442–3T are removed.

Par. 7. Section 1.706–1 is amended by revising paragraphs (a) and (b) and adding paragraph (d) to read as follows:

§ 1.706–1 Taxable years of partner and partnership.

(a) *Year in which partnership income is includible.* (1) In computing taxable income for a taxable year, a partner is required to include the partner's distributive share of partnership items set forth in section 702 and the regulations thereunder for any partnership taxable year ending within or with the partner's taxable year. A partner must also include in taxable income for a taxable year guaranteed payments under section 707(c) that are deductible by the partnership under its method of accounting in the partnership taxable year ending within or with the partner's taxable year.

(2) The rules of this paragraph (a)(1) may be illustrated by the following example:

Example. Partner A reports his income using a calendar year, while the partnership of which he is a member reports its income using a fiscal year ending May 31. The partnership reports its income and deductions under the cash method of accounting. During the partnership taxable year ending May 31, 2002, the partnership makes guaranteed payments of $120,000 to A for services and for the use of capital. Of this amount, $70,000 was paid to A between June 1 and December 31, 2001, and the remaining $50,000 was paid to A between January 1 and May 31, 2002. The entire $120,000 paid to A is includible in A's taxable income for the calendar year 2002 (together with A's distributive share of partnership items set forth in section 702 for the partnership taxable year ending May 31, 2002).

(3) If a partner receives distributions under section 731 or sells or exchanges all or part of a partnership interest, any gain or loss arising therefrom does not constitute partnership income.

(b) *Taxable year*—(1) *Partnership treated as a taxpayer.* The taxable year of a partnership must be determined as though the partnership were a taxpayer.

(2) *Partnership's taxable year*—(i) *Required taxable year.* Except as provided in paragraph (b)(2)(ii) of this section, the taxable year of a partnership must be—

(A) The majority interest taxable year, as defined in section 706(b)(4);

(B) If there is no majority interest taxable year, the taxable year of all of the principal partners of the partnership, as defined in 706(b)(3) (the principal partners' taxable year); or;

(C) If there is no majority interest taxable year or principal partners' taxable year, the taxable year that produces the least aggregate deferral of income as determined under § 1.706–1(b)(3).

(ii) *Exceptions.* A partnership may have a taxable year other than its required taxable year if it elects to use a 52–53-week taxable year that ends with reference to its required taxable year, makes an election under section 444, or establishes a business purpose for such taxable year and obtains approval of the Commissioner under section 442.

(3) *Least aggregate deferral*—(i) *Taxable year that results in the least aggregate deferral of income.* The taxable year that results in the least aggregate deferral of income will be the taxable year of one or more of the partners in the partnership which will result in the least aggregate deferral of income to the partners. The aggregate deferral for a particular year is equal to the sum of the products determined by multiplying the month(s) of deferral for each partner that would be generated by that year and each partner's interest in partnership profits for that year. The partner's taxable year that produces the lowest sum when compared to the other partner's taxable years is the taxable year that results in the least aggregate deferral of income to the partners. If the calculation results in more than one taxable year qualifying as the taxable year with the least aggregate deferral, the partnership may select any one of those taxable years as its taxable year. However, if one of the qualifying taxable years is also the partnership's existing taxable year, the partnership must maintain its existing taxable year. The determination of the taxable year that results in the least aggregate deferral of income generally must be made as of the beginning of the partnership's current taxable year. The district director, however, may determine that the first day of the current taxable year is not the appropriate testing day and require the use of some other day or period that will more accurately reflect the ownership of the partnership and thereby the actual aggregate deferral to the partners where the partners engage in a transaction that has as its principal purpose the avoidance of the principles of this section. Thus, for example the preceding sentence would apply where there is a transfer of an interest in the partnership that results in a temporary transfer of that interest principally for purposes of qualifying for a specific taxable year under the principles of this section. For purposes of this section, deferral to each partner is measured in terms of months from the end of the partnership's taxable year forward to the end of the partner's taxable year.

(ii) *Determination of the taxable year of a partner or partnership that uses a 52–53 week taxable year.* For purposes

of the calculation described in paragraph (b)(3)(i) of this section, the taxable year of a partner or partnership that uses a 52–53 week taxable year must be the same year determined under the rules of section 441(f) and the regulations thereunder with respect to the inclusion of income by the partner or partnership.

(iii) *Special de minimis rule.* If the taxable year that results in the least aggregate deferral produces an aggregate deferral that is less than .5 when compared to the aggregate deferral of the current taxable year, the partnership's current taxable year will be treated as the taxable year with the least aggregate deferral. Thus, the partnership will not be permitted to change its taxable year.

(iv) *Examples.* The principles of this section may be illustrated by the following examples:

Example 1. Partnership P is on a fiscal year ending June 30. Partner A reports income on the fiscal year ending June 30 and Partner B reports income on the fiscal year ending July 31. A and B each have a 50 percent interest in partnership profits. For its taxable year beginning July 1, 1987, the partnership will be required to retain its taxable year since the fiscal year ending June 30 results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 6/30	Year end	Interest in partnership profits	Months of deferral for 6/30 year end	Interest × Deferral
Partner A	6/30	.5	0	0
Partner B	7/31	.5	1	.5
Aggregate deferral				.5

Test 7/31	Year end	Interest in partnership profits	Months of deferral for 7/31 year end	Interest × deferral
Partner A	6/30	.5	11	5.5
Partner B	7/31	.5	0	0
Aggregate deferral				5.5

Example 2. The facts are the same as in *Example 1* except that A reports income on the calendar year and B reports on the fiscal year ending November 30. For the partnership's taxable year beginning July 1, 1987, the partnership is required to change its taxable year to a fiscal year ending November 30 because such year results in the least aggregate deferral of income to the partners. This determination is made as follows:

Test 12/31	Year end	Interest in partnership profits	Months of deferral for 12/31 year end	Interest × deferral
Partner A	12/31	.5	0	0
Partner B	11/30	.5	11	5.5
Aggregate deferral				5.5

Test 11/30	Year end	Interest in partnership profits	Months of deferral for 11/30 year end	Interest × deferral
Partner A	12/31	.5	1	.5
Partner B	11/30	.5	0	0
Aggregate deferral				.5

Example 3. The facts are the same as in *Example 2* except that B reports income on the fiscal year ending June 30. For the partnership's taxable year beginning July 1, 1987, each partner's taxable year will result in identical aggregate deferral of income. If the partnership's current taxable year was neither a fiscal year ending June 30 nor the calendar year, the partnership would select either the fiscal year ending June 30 or the calendar year as its taxable year. However, since the partnership's current taxable year ends June 30, it must retain its current taxable year. This determination is made as follows:

Test 12/31	Year end	Interest in partnership profits	Months of deferral for 12/31 year end	Interest × deferral
Partner A	12/31	.5	0	0
Partner B	6/30	.5	6	3.0
Aggregate deferral				3.0

Test 6/30	Year end	Interest in partnership profits	Months of deferral for 6/30 year end	Interest × deferral
Partner A	12/31	.5	6	3.0
Partner B	6/30	.5	0	0
Aggregate deferral				3.0

Example 4. The facts are the same as in *Example 1*except that on December 31, 1987, partner A sells a 4 percent interest in the partnership to Partner C, who reports income on the fiscal year ending June 30, and a 40 percent interest in the partnership to Partner D, who also reports income on the fiscal year ending June 30. The taxable year beginning July 1, 1987, is unaffected by the sale. However, for the taxable year beginning July 31, 1988, the partnership must determine the taxable year resulting in the least aggregate deferral as of July 1, 1988. In this case, the partnership will be required to retain its taxable year since the fiscal year ending June 30 continues to be the taxable year that results in the least aggregate deferral of income to the partners.

Example 5. The facts are the same as in *Example 4*except that Partner D reports income on the fiscal year ending April 30. As in Example 4, the taxable year during which the sale took place is unaffected by the shifts in interests. However, for its taxable year beginning July 1, 1988, the partnership will be required to change its taxable year to the fiscal year ending April 30. This determination is made as follows:

Test 7/31	Year end	Interest in partnership profits	Months of deferral for 7/31 year end	Interest × deferral
Partner A	6/30	.06	11	.66
Partner B	7/31	.5	0	0
Partner C	6/30	.04	11	.44
Partner D	4/30	.4	9	3.60
Aggregate deferral				4.70

Test 6/30	Year end	Interest in partnership profits	Months of deferral for 6/30 year end	Interest × deferral
Partner A	6/30	.06	0	0
Partner B	7/31	.5	1	.5
Partner C	6/30	.04	0	0
Partner D	4/30	.4	10	4.0
Aggregate deferral				4.5

Test 4/30	Year end	Interest in partnership profits	Months of deferral for 4/30 year end	Interest × deferral
Partner A	6/30	.06	2	.12
Partner B	7/31	.5	3	1.50
Partner C	6/30	.04	2	.08
Partner D	4/30	.4	0	0
Aggregate deferral				1.70

§ 1.706–1(b)(3) Test:	
Current taxable year (June 30)	4.5
Less: Taxable year producing the least aggregate deferral (April 30)	1.7
Additional aggregate deferral (greater than .5)	2.8

Example 6. (i) Partnership P has two partners, A who reports income on the fiscal year ending March 31, and B who reports income on the fiscal year ending July 31. A and B share profits equally. P has determined its taxable year under § 1.706–1(b)(3) to be the fiscal year ending March 31 as follows:

Test 3/31	Year end	Interest in partnership profits	Deferral for 3/31 year end	Interest × deferral
Partner A	3/31	.5	0	0
Partner B	7/31	.5	4	2
Aggregate deferral				2

Test 7/31	Year end	Interest in partnership profits	Deferral for 7/31 year end	Interest × deferral
Partner A	3/31	.5	8	4
Partner B	7/31	.5	0	0
Aggregate deferral				4

(ii) In May 1988, Partner A sells a 45 percent interest in the partnership to C, who reports income on the fiscal year ending April 30. For the taxable period beginning April 1, 1989, the fiscal year ending April 30 is the taxable year that produces the least aggregate deferral of income to the partners. However, under paragraph (b)(3)(iii) of this section the partnership is required to retain its fiscal year ending March 31. This determination is made as follows:

Test 3/31	Year end	Interest in partnership profits	Deferral for 3/31 year end	Interest × deferral
Partner A	3/31	.05	0	0
Partner B	7/31	.5	4	2.0
Partner C	4/30	.45	1	.45
Aggregate deferral				2.45

Test 7/31	Year end	Interest in partnership profits	Deferral for 7/31 year end	Interest × deferral
Partner A	3/31	.05	8	.40
Partner B	7/31	.5	0	0
Partner C	4/30	.45	9	4.05
Aggregate deferral				4.45

Test 4/30	Year end	Interest in partnership profits	Deferral for 4/30 year end	Interest × deferral
Partner A	3/31	.05	11	.55
Partner B	7/31	.5	3	1.50
Partner C	4/30	.45	0	0
Aggregate deferral				2.05

§ 1.706–1(b)(3) Test:	
Current taxable year (3/31)	2.45
Less: Taxable year producing the least aggregate deferral (4/30)	2.05
Additional aggregate deferral (less than .5)	.40

(4) *Measurement of partner's profits and capital interest*— (i) *In general.* The rules of this paragraph (b)(4) apply in determining the majority interest taxable year, the principal partners' taxable year, and the least aggregate deferral taxable year.

(ii) *Profits interest*—(A) *In general.* For purposes of section 706(b), a partner's interest in partnership profits is generally the partner's percentage share of partnership profits for the current partnership taxable year. If the partnership does not expect to have net income for the current partnership taxable year, then a partner's interest in partnership profits instead must be the partner's percentage share of partnership net income for the first taxable year in which the partnership expects to have net income.

(B) *Percentage share of partnership net income.* The partner's percentage share of partnership net income for a partnership taxable year is the ratio of: the partner's distributive share of partnership net income for the taxable year, to the partnership's net income for the year. If a partner's percentage share of partnership net income for the taxable year depends on the amount or nature of partnership income for that year (due to, for example, preferred returns or special allocations of specific partnership items), then the partnership must make a reasonable estimate of the amount and nature of its income for the taxable year. This estimate must be based on all facts and circumstances known to the partnership as of the first day of the current partnership taxable year. The partnership must then use this estimate in determining the partners' interests in partnership profits for the taxable year.

(C) *Distributive share.* For purposes of this paragraph (b)(4)(ii), a partner's distributive share of partnership net income is determined by taking into account all rules and regulations affecting that determination, including, without limitation, section 704(b), (c), and (e), section 736, and section 743.

(iii) *Capital interest.* Generally, a partner's interest in partnership capital is determined by reference to the assets of the partnership that the partner would be entitled to upon withdrawal from the partnership or upon liquidation of the partnership. If the partnership maintains capital accounts in accordance with § 1.704–1(b)(2)(iv), then for purposes of section 706(b), the partnership may assume that a partner's interest in partnership capital is the ratio of the partner's capital account to all partners' capital accounts as of the first day of the partnership taxable year.

(5) *Certain tax-exempt partners disregarded.* [Reserved]

(6) *Foreign partners.* [Reserved]

(7) *Adoption of taxable year.* A newly-formed partnership may adopt, in accordance with § 1.441–1(c), its required taxable year, a 52–53-week taxable year ending with reference to its required taxable year, or a taxable year elected under section 444 without securing the approval of the Commissioner. If a newly-formed partnership wants to adopt any other taxable year, it must establish a business purpose and secure the approval of the Commissioner under section 442.

(8) *Change in taxable year*—(i) *Partnerships*—(A) *Approval required.* An existing partnership may change its taxable year only by securing the approval of the Commissioner under section 442 or making an election under section 444. However, a partnership may obtain automatic approval for certain changes, including a change to its required taxable year, pursuant to administrative procedures published by the Commissioner.

(B) *Short period tax return.* A partnership that changes its taxable year must make its return for a short period in accordance with section 443, but must not annualize the partnership taxable income.

(C) *Change in required taxable year.* If a partnership is required to change to its majority interest taxable year, then no further change in the partnership's required taxable year is required for either of the two years following the year of the change. This limitation against a second change within a three-year period applies only if the first change was to the majority interest taxable year and does not apply following a change in the partnership's taxable year to the principal partners' taxable year or the least aggregate deferral taxable year.

(ii) *Partners.* Except as otherwise provided in the Internal Revenue Code or the regulations thereunder (e.g., section 859 regarding real estate investment trusts or § 1.442–2(c) regarding a subsidiary changing to its consolidated parent's taxable year), a partner may not change its taxable year without securing the approval of the Commissioner under section 442. However, certain partners may be eligible to obtain automatic approval to change their taxable years pursuant to the regulations or administrative procedures published by the Commissioner. A partner that changes its taxable year must make its return for a short period in accordance with section 443.

(9) *Retention of taxable year.* In certain cases, a partnership will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a partnership using a taxable year that corresponds to its required taxable year must obtain the approval of the Commissioner to retain such taxable year if its required taxable year changes as a result of a change in ownership, unless the partnership previously obtained approval for its current taxable year or, if appropriate, makes an election under section 444.

(10) *Procedures for obtaining approval or making a section 444 election.* See § 1.442–1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§ 1.444–1T and 1.444–2T for qualifications, and § 1.444–3T for procedures, for making an election under section 444.

* * * * *

(d) *Effective date.* The rules of this section are applicable for taxable years ending on or after the date these regulations are published in the **Federal Register** as final regulations, except for paragraph (c) which applies for taxable years beginning after December 31, 1953.

§ 1.706–1T [Removed]

Par. 8. Section 1.706–1T is removed.

Par. 9. Section 1.898–4, as proposed to be added at 58 FR 297, January 5, 1993, is amended by adding paragraph (c)(3)(iv) to read as follows:

§ 1.898–4 Special rules.

* * * * *

(c) * * *

(3) * * *

(iv) *Recognition of income and deductions.* See § 1.441–2(e) for rules regarding the recognition of income and deductions (e.g., amounts includible in gross income pursuant to sections 951(a) or 553) if either the majority United States shareholder, or the specified foreign corporation, or both, elect to use a 52–53-week taxable year under this paragraph (c)(3).

* * * * *

Par. 10. Section 1.1378–1 is added under the undesignated centerheading ''Small Business Corporations and Their Shareholders'' to read as follows:

§ 1.1378–1 Taxable year of S corporation.

(a) *In general.* The taxable year of an S corporation must be a permitted year or a taxable year elected under section 444. No corporation may make an election to be an S corporation for any taxable year unless the taxable year is a permitted year or a taxable year elected under section 444. In addition, an S corporation may not change its taxable year to any taxable year other than a permitted year or a taxable year elected under section 444. A permitted year is the required taxable year (i.e., a taxable year ending on December 31), a 52–53-week taxable year ending with reference to the required taxable year, or any other taxable year for which the corporation establishes a business purpose to the satisfaction of the Commissioner under section 442.

(b) *Adoption of taxable year.* An electing S corporation may adopt, in accordance with § 1.441–1(c), its required taxable year, a 52–53-week taxable year ending with reference to its required taxable year, or a taxable year elected under section 444 without the

approval of the Commissioner. See § 1.441–1. An electing S corporation that wants to adopt any other taxable year, must establish a business purpose and obtain the approval of the Commissioner under section 442.

(c) *Change in taxable year.* An S corporation or electing S corporation that wants to change its taxable year must obtain the approval of the Commissioner under section 442 or make an election under section 444. However, an S corporation or electing S corporation may obtain automatic approval for certain changes, including a change to its required taxable year, pursuant to administrative procedures published by the Commissioner.

(d) *Retention of taxable year.* In certain cases, an S corporation or electing S corporation will be required to change its taxable year unless it obtains the approval of the Commissioner under section 442, or makes an election under section 444, to retain its current taxable year. For example, a corporation using a June 30 fiscal year that elects to be an S corporation and, as a result, is required to use the calendar year must obtain the approval of the Commissioner to retain its current fiscal year.

(e) *Procedures for obtaining approval or making a section 444 election*—(1) *In general.* See § 1.442–1(b) for procedures to obtain the approval of the Commissioner (automatically or otherwise) to adopt, change, or retain a taxable year. See §§ 1.444–1T and 1.444–2T for qualifications, and 1.444–3T for procedures, for making an election under section 444.

(2) *Special rules for electing S corporations.* An electing S corporation that wants to adopt, change to, or retain a taxable year other than its required taxable year must request approval of the Commissioner on Form 2553 (Election by a Small Business Corporation) when the election to be an S corporation is filed pursuant to section 1362(b) and § 1.1362–6. See § 1.1362–6(a)(2)(i) for the manner of making an election to be an S corporation. If such corporation receives permission to adopt, change to, or retain a taxable year other than its required taxable year, the election to be an S corporation will be effective. Denial of the request renders the election ineffective unless the corporation agrees that, in the event the request to adopt, change to, or retain a taxable year other than its required taxable year is denied, it will adopt, change to, or retain its required taxable year or, if applicable, make an election under section 444.

(f) *Effective date.* The rules of this section are applicable for taxable years ending on or after the date these regulations are published in the **Federal Register** as final regulations.

PART 5c—TEMPORARY INCOME TAX REGULATIONS UNDER THE ECONOMIC RECOVERY TAX ACT OF 1981

Par. 11. The authority citation for part 5c continues to read as follows:

Authority: 26 U.S.C. 168(f)(8)(G) and 7805.

§ 5c.442–1 [Removed]

Par. 12. Section 5c.442–1 is removed.

PART 5f—TEMPORARY INCOME TAX REGULATIONS UNDER THE TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

Par. 13. The authority citation for part 5f continues to read in part as follows:

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

§ 5f.442–1 [Removed]

Par. 14. Section 5f.442–1 is removed.

PART 18—TEMPORARY INCOME TAX REGULATIONS UNDER THE SUBCHAPTER S REVISION ACT OF 1982

Par. 15. The authority citation for part 18 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 18.1378–1 [Removed]

Par. 16. Section 18.1378–1 is removed.

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

[FR Doc. 01–13536 Filed 6–12–01; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF TRANSPORTATION

Coast Guard

33 CFR Part 100

[CGD05–00–046]

RIN 2115–AE46

Special Local Regulations for Marine Events; Fireworks Displays, Patapsco River, Baltimore, Maryland

AGENCY: Coast Guard, DOT.

ACTION: Notice of proposed rulemaking.

SUMMARY: The Coast Guard proposes to establish permanent special local regulations for fireworks displays to be held over the waters of the Patapsco River, Baltimore, Maryland. These special local regulations are necessary to provide for the safety of life on navigable waters during the fireworks displays. This action is intended to temporarily restrict vessel traffic in the Patapsco River to protect spectator craft and other vessels transiting the event area from the dangers associated with the fireworks.

DATES: Comments and related material must reach the Coast Guard on or before August 13, 2001.

ADDRESSES: You may mail comments and related material to Commander (Aoax), Fifth Coast Guard District, 431 Crawford Street, Portsmouth, Virginia 23704–5004, hand-deliver them to Room 119 at the same address between 9 a.m. and 2 p.m., Monday through Friday, except Federal holidays, or fax them to (757) 398–6203. Commander (Aoax), Fifth Coast Guard District, maintains the public docket for this rulemaking. Comments and materials received from the public as well as documents indicated in this preamble as being available in the docket, will become part of this docket and will be available for inspection or copying at the above address between 9 a.m. and 2 p.m., Monday through Friday, except Federal holidays.

FOR FURTHER INFORMATION CONTACT: Chief Warrant Officer R. Houck, Marine Events Coordinator, Commander, Coast Guard Activities Baltimore, telephone number (410) 576–2674.

SUPPLEMENTARY INFORMATION:

Request for Comments

We encourage you to participate in this rulemaking by submitting comments and related material. If you do so, please include your name and address, identify the docket number for this rulemaking (CGD05–00–046), indicate the specific section of this document to which each comment applies, and give the reason for each comment. Please submit all comments and related material in an unbound format, no larger than 8½ by 11 inches, suitable for copying. If you would like to know that your comments reached us, please enclose a stamped, self-addressed postcard or envelope. We will consider all comments and material received during the comment period. We may change this proposed rule in view of them.

Public Meeting

We do not now plan to hold a public meeting. But you may submit a request for a meeting by writing to the address listed under **ADDRESSES** explaining why one would be beneficial. If we determine that one would aid this rulemaking, we will hold one at a time and place announced by a later notice in the **Federal Register**.