DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 5c, 5f, 18, and 602

[TD 8996]

RIN 1545–AX15

Changes in Accounting Periods

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations relating to certain adoptions, changes, and retentions of annual accounting periods. The final regulations are necessary to update, clarify, and reorganize the rules and procedures for adopting, changing, and retaining a taxpayer's annual accounting period. The final 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.

DATES: *Effective Date:* These regulations are effective May 17, 2002.

Applicability Date: These regulations are applicable for taxable years ending on or after May 17, 2002.

FOR FURTHER INFORMATION CONTACT: Michael Schmit or Roy Hirschhorn at (202) 622–4960 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collections of information contained in these final regulations have been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545–1748. Responses to these collections of information are required for certain taxpayers to adopt, change, or retain an annual accounting period.

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

The estimated annual burden per respondent varies from 20 minutes to one hour, depending on individual circumstances, with an estimated average of 30 minutes.

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

Books or records relating to this 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

On June 12, 2001, the IRS and Treasury Department published in the **Federal Register** proposed amendments to regulations under section 441 (period for computing taxable income), and sections 442, 706, 898, and 1378 (regarding the requirement to obtain the approval of the Commissioner to adopt, change, or retain an annual accounting period) [REG–106917–99 (66 FR 31850)]. Written and electronic comments were solicited, and a public hearing was scheduled for October 2, 2001. Several comments were received, and are discussed below. Because no requests to speak were received, the public hearing was cancelled. After consideration of all comments, the proposed regulations under sections 441, 442, 706, and 1378 are adopted as revised by this Treasury decision.

Summary of Comments and Explanation of Revisions

1. Comments and Changes Relating to § 1.441 of the Proposed Regulations

A. Definition of 52–53-Week Taxable Year

The proposed regulations both define the term *taxable year consisting of 52–53-weeks* and provide an *Example* illustrating a 52–53-week taxable year that ends on a particular day of the week that last occurs in a calendar month or that is nearest to the last day of that calendar month. A commentator observed that many taxpayers have difficulty correctly applying the rules for 52–53-week taxable years, and suggested that certain explanatory text contained in the *Example* be moved to the regulations text itself where it would be more apparent and helpful. This suggestion has been adopted in the final regulations.

B. Changes to or From a 52–53-Week Taxable Year

The proposed regulations generally provide that changes to or from a 52–53-week taxable year are treated as changes in annual accounting periods that require the approval of the Commissioner, and describe some specific instances in which such approval may be obtained automatically under administrative procedures to be published by the Commissioner. Consistent with the general framework of the regulations, the descriptions of these specific changes have been removed from the final regulations. Taxpayers should see Rev. Proc. 2002–37 and Rev. Proc. 2002–38, 2002–22 I.R.B., for situations in which automatic approval for changes to or from a 52–53-week taxable year will be granted. The final regulations clarify that a taxpayer will not be granted automatic approval for a change from one 52–53-week taxable year to another 52–53-week taxable year, even if both years reference the same calendar month.

C. Short Periods of 6 Days or Less

The proposed regulations provide special rules for certain short periods required to effect a change in annual accounting period to (or from) a 52–53-week taxable year. The proposed regulations provide that if the short period is 6 days or less, such short period is not a separate taxable year but is instead added to and deemed a part of the following taxable year.

One commentator suggested that taxpayers be permitted the option of adding such a short period to either: (1) the following taxable year (as the proposed regulations would require); or (2) the prior taxable year, whichever convention is used by the taxpayer for financial accounting purposes.

The IRS and Treasury Department believe that adopting the commentator's suggestion in this case would present certain administrative difficulties, complicate tax administration, and possibly encourage the use of hindsight in tax reporting. After careful consideration, the IRS and Treasury have concluded that it is in the best interests of sound tax administration to have a uniform and certain rule applicable in all such situations. Thus, the final regulations do not adopt this suggestion.

D. Application of Effective Date Rules to 52–53-Week-Taxable Years

The proposed regulations provide a general rule concerning the application of certain effective dates as they apply to taxpayers employing 52–53-week taxable years. In response to comments, the final regulations clarify that this rule also applies to administrative guidance published by the Commissioner.

A comment was received suggesting that additional *Examples* be provided illustrating how particular terms other than those ''expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month,'' apply to 52–53-week fiscal-year taxpayers. In response to this comment, clarifying language and an additional *Example* have been provided in the final regulations.

E. Definitions of ''Pass-Through Entity'' and ''Owner of a Pass-Through Entity''

The proposed regulations provide rules for certain pass-through entities and owners of pass-through entities relating to the treatment of certain taxable years ending with reference to the same calendar month. These rules are designed to prevent substantial deferral and distortion of income reporting.

The IRS and Treasury have become aware of a potentially abusive situation involving the deferral of income reporting in the case of closely-held Real Estate Investment Trusts (REITs) (within the meaning of section 6655(e)(5)(B)) and certain owners of interests in closely-held REITs (within the meaning of section 6655(e)(5)(A)).

For estimated tax purposes, certain owners of interests in closely-held REITs are required to recognize income from the REIT in a manner similar to partners in a partnership. Unlike a partnership, however, REITs are not required to use a taxable year that conforms to the taxable year of their owners but rather are required to use a taxable year ending December 31 pursuant to section 859. Thus, the potential for deferral of estimated taxes exists with respect to certain owners of interests in closely-held REITs, including owners with 52–53-week taxable years that reference December 31, as well as fiscal-year owners.

In an attempt to reduce the potential for deferral of estimated taxes in the case of certain owners of interests in closely-held REITs, the final regulations have been modified to add: (1) a closely-held REIT (within the meaning of section 6655(e)(5)(B)) to the definition of a *pass-through entity*; and (2) an owner of an interest (within the meaning of section 6655(e)(5)(A)) in a closely-held REIT to the definition of an *owner of a pass-through entity*. Thus, these owners of interests in a closely-held REIT with 52–53-week taxable years that reference December 31 will be required under the final regulations to recognize income from the closely-held REIT as if their taxable year ends on December 31.

F. Accrual of Foreign Taxes

The IRS recognizes that changes to the taxable year of a taxpayer may shift the taxable year in which foreign taxes are treated as accruing for U.S. purposes. The IRS also recognizes that similar results may occur in the case of taxpayers that use a 52–53-week taxable year, which will not always include the last day of the taxpayer's taxable year in a foreign jurisdiction. The IRS is working on guidance that it expects will be issued this year to ensure that changes in U.S. taxable years, or the use of a 52–53-week taxable year, do not result in unintended and inappropriate consequences for foreign tax credit purposes. Comments are requested on the changes necessary and appropriate to address the accrual of foreign taxes in these situations.

2. Comments and Changes Relating to § 1.442 of the Proposed Regulations

A. Time and Manner for Filing an Application

The proposed regulations provide specific rules for the time and manner of filing an application to adopt, change, or retain an annual accounting period. Consistent with the general framework of the regulations, the IRS and Treasury have concluded that it is more appropriate to remove the specific time and manner requirements for filing applications for adoptions, changes, and retentions in annual accounting period from the final regulations, and provide them instead in administrative procedures published by the Commissioner. See Rev. Proc. 2002–37, Rev. Proc. 2002–38, and Rev. Proc. 2002–39. The IRS and Treasury believe that providing these rules in administrative guidance, rather than in regulations, allows the IRS more flexibility to respond in the future to the changing needs of taxpayers and the IRS.

The proposed regulations provide that an application for non-automatic approval of an annual accounting period change may be filed no earlier than the day following the close of the first effective year and no later than the 15th day of the third calendar month following the close of the first effective year. One commentator suggested that such applications be permitted to be filed no earlier than the later of: (1) The first day of the short period resulting from the proposed tax year change; or (2) 60 days prior to the end of the short period.

The IRS currently allows taxpayers to file applications with the national office within the referenced 60-day period and believes that many taxpayers take advantage of early filing, even knowing that their applications lack adequate information, in an effort to obtain priority over other applications processed by the national office. However, the lack of adequate financial and other required information common to such early applications requires that the IRS devote additional resources to properly develop and process the applications. Ultimately, this causes a delay in processing both the early applications, and other applications as well. For this reason, the administrative guidance issued concurrently with these final regulations do not adopt this suggestion. However, the IRS and Treasury Department intend to study filing patterns under the new rules, and will consider expanding or modifying the time frame for filing applications with the national office if circumstances warrant.

One commentator recommended that instead of requiring all taxpayers to file the application by the 15th day of the third calendar month 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), as the proposed regulations provide, the due date for the application should be the due date of the taxpayer's return for the short period, without extensions. The IRS and Treasury believe that such a rule will be simpler for taxpayers (such as individuals and partnerships) and the IRS. Accordingly, this change is adopted in the administrative guidance issued concurrently with these final regulations.

B. Changes to Required Taxable Years by Pass-Through Entities

One commentator suggested that the proposed regulations be modified to waive the Form 1128, ''Application to Adopt, Change, or Retain a Tax Year,'' filing requirement in the case of partnerships, S corporations, and personal service corporations (PSCs) changing to a ''required taxable year'' for the first taxable year for which such change is required. Alternatively, the commentator recommended use of an ''automatic consent'' procedure similar to the procedure outlined in the proposed regulations for subsidiaries changing tax years to conform to the periods of their affiliated groups. The commentator reasoned that changes to statutorily required taxable years should not require the Commissioner's prior approval through any filing or application process.

Except in very limited circumstances (*e.g.*, adoptions of required years, certain section 444 terminations, and certain section 859 changes) applications historically have been required for changes to a required taxable year by a pass-through entity. The IRS and Treasury Department believe that the statutes that require such entities to use or change to a particular taxable year must be read in conjunction with the general requirement under section 442 to obtain the prior approval of the Commissioner to change an existing taxable year. Moreover, the applications serve to provide the IRS with necessary information about the entity's annual accounting period. Accordingly, this comment was not adopted in the final regulations or the administrative guidance issued concurrently with these regulations.

C. Book Conformity Requirements

The proposed regulations conform the record 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, the preamble to the proposed regulations noted that, 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, under administrative procedures published by the Commissioner, to compute income and keep their books (including financial statements and reports to creditors) on the basis of the requested annual accounting period. In fact, strict book conformity is a general requirement in the administrative procedures for approval to make many changes. See, *e.g.,* Rev. Proc. 2002–37.

One commentator objected to the proposed elimination of procedures contained in the existing regulations under section 442 under which certain corporations are granted automatic approval to change their taxable year without a strict book conformity requirement (*i.e.,* by satisfying the general book conformity rules of section 446). The commentator recommended that either the final regulations retain these automatic consent rules or, alternatively, that the administrative procedures eliminate the strict book conformity requirement.

The IRS and Treasury Department believe it is appropriate to apply the more lenient book conformity rule of section 446 in the case of a taxpayer adopting, changing to, or retaining a required or ownership taxable year and in the case of a foreign corporation that is required by foreign law to use a particular year for financial accounting purposes. See, *e.g.*, Rev. Proc. 2002–39. However, for all other changes under the administrative procedures, the IRS and Treasury Department continue to believe that strict book conformity is an appropriate term and condition of a voluntary change in annual accounting period, as it provides assurance that the change is motivated by business, as opposed to tax, considerations. In addition, the IRS and Treasury believe, for reasons stated in the preamble to the proposed regulations, that tax administration and taxpayers are better served by providing the specific rules for adoptions, changes, and retentions of annual accounting periods in administrative pronouncements, rather than regulations. Accordingly, the comment has not been adopted.

3. Comments and Changes Relating to Partnerships, S Corporations, and Personal Service Corporations (PSCs)

A comment was received recommending that the limitation on additional required taxable year changes in the proposed regulations for partnerships using a majority-interest taxable years, be extended to partnerships using other required taxable years (e.g., to principal partners' taxable years and to least-aggregate-deferral taxable years). The limitation for changes to a majority interest taxable year is specifically provided in section 706(b)(4)(B). No such statutory authority exists for providing similar limitations in the case of other required taxable year changes by partnerships. Accordingly, this comment was not adopted in the final regulations. However, the Treasury Department is considering this comment in connection with a legislative simplification study.

The proposed regulations (consistent with the existing temporary regulations) generally provide for a 1-year testing period for determining whether a taxpayer is a PSC. In the preamble to the proposed regulations, the IRS and Treasury Department responded to a comment received in connection with the original notice of proposed rulemaking cross-referenced by the temporary regulations. The original commentator suggested that the testing period be expanded to the three preceding taxable years in order to minimize instances in which taxpayers become PSCs due to temporary or aberrational conditions. In response, the IRS and Treasury Department indicated that they would consider alternatives to the current 1-year period if similar requests were received in comments to the proposed regulations now that taxpayers have significantly more experience with the 1-year rule.

Although some comments were received recommending a general 3-year testing period for both PSCs and S corporations, the suggestions were not directed to particular taxpayer burdens stemming from the 1-year testing period for a PSC or the original concern about taxpayers becoming a PSC because of temporary or aberrational conditions. Rather, commentators suggested that a general 3-year testing period rule would reduce repetitive ''required tax year'' changes, and promote tax-year certainty.

The IRS and Treasury Department believe that these reasons do not warrant extending the 1-year testing period for PSCs and S corporations because the current required taxable year framework for PSCs and S corporations should not result in repetitive required taxable year changes. Once a PSC or S corporation has changed to its required taxable year (i.e., a calendar year), any further changes would be voluntary rather than required. Accordingly, this suggestion has not been adopted in the 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 Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections 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, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for

Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Roy A. Hirschhorn and Michael F. Schmit 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 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 5c, 5f, 18, and 602 are 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 §§ 1.441–1 through 1.441–4 as follows:

§ 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)(1)(A);

(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).

(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 to use a taxable year other than its required taxable year under section 444, 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 to a taxable year elected 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).

(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.

(8) *Taxpayer. Taxpayer* has the same meaning as the term *person* as defined in section 7701(a)(1) (*e.g.,* an individual, trust, estate, partnership, association, or corporation) rather than the meaning of the term taxpayer as defined in section 7701(a)(14) (any person subject to tax).

(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, ''Application for Automatic Extension of Time to File Corporation Income Tax Return''), the filing of an application for an employer identification number (*i.e.,* Form SS–4, ''Application for Employer Identification Number''), 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, S corporation, or PSC that wants to adopt a taxable year other than its required taxable year, a taxable year elected under section 444, or 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, electing 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 section 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 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) *Effect.* 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.

(3) *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)(2)(i)(D) is not an eligible taxpayer.

(4) *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.

(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, S corporation or 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 §§ 1.441–3, 1.706–1, and 1.1378–1. 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 § 1.1502–76(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 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, even if such 52–53-week taxable year ends with reference to the same calendar month. 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, a taxpayer may obtain approval for 52–53-week taxable year changes automatically to the extent provided in 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, regulatory, or administrative changes) or the applicability of any provision of the internal revenue laws 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. Assume that a revenue procedure requires the performance of an act by the taxpayer within ''the first 90 days of the taxable year,'' by ''the 75th day of the taxable year,'' or, alternately, by ''the last day of the taxable year.'' The taxpayer employs a 52–53-week taxable year that ends always on the Saturday closest to the last day of December. These requirements are not expressed in terms of taxable years beginning, including, or ending with reference to the first or last day of a specified calendar month, and are accordingly outside the scope of the rule stated in § 1.441–2(c)(1). Accordingly, the taxpayer must perform the required act by the 90th, 75th, or last day, respectively, of its taxable year.

Example 4. 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, closely-held real estate investment trust (within the meaning of section 6655(e)(5)(B)), 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 generally 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, an owner of a closely-held real estate investment trust (within the meaning of section 6655(e)(5)(A)), 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 with respect to that shareholder.

(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 May 17, 2002 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 entity elects to include all such income in its first taxable year ending on or after May 17, 2002.

§ 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 it makes an election under section 444, elects to use a 52–53-week taxable year that ends with reference to the calendar year or a taxable year elected 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 taxable year elected under section 444, or 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 the language ''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 (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 (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 x .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 x .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 May 17, 2002.

§§ 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.* 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 within such time and in such manner as is provided in administrative procedures published by the Commissioner.

(2) *General requirements for approval.* 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.* The Commissioner will prescribe administrative procedures under which a taxpayer may 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, Rev. Proc. 2002–39, 2002–22 I.R.B., procedures for obtaining the Commissioner's prior approval of an adoption, change, or retention in annual accounting period through application to the national office; Rev. Proc. 2002–37, 2002–22 I.R.B., automatic approval procedures for certain corporations; Rev. Proc. 2002–38, 2002–22 I.R.B., 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 May 17, 2002.

§§ 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 income using a calendar year, while the partnership of which A 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 paragraph (b)(3) of this section.

(ii) *Exceptions.* A partnership may have a taxable year other than its required taxable year if it makes an election under section 444, elects to use a 52–53-week taxable year that ends with reference to its required taxable year or a taxable year elected 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 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. The 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 paragraph (b)(3) of this section 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, sections 704(b), (c), and (e), 736, and 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 taxable year elected under section 444, or 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 May 17, 2002, 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 1.1378–1 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. A permitted year is the required taxable year (*i.e.,* a taxable year ending on December 31), a taxable year elected under section 444, a 52–53-week taxable year ending with reference to the required taxable year or a taxable year elected under section 444, 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 taxable year elected under section 444, or 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*—(1) *Approval required.* 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.

(2) *Short period tax return.* An S corporation or electing S corporation that changes its taxable year must make its return for a short period in accordance with section 443, but must not annualize the corporation's taxable income.

(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 May 17, 2002.

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

Par. 10. 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. 11. Section 5c.442–1 is removed.

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

Par. 12. The authority citation for part 5f continues to read in part as follows:

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

§ 5f.442–1 [Removed]

Par. 13. Section 5f.442–1 is removed.

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

Par. 14. The authority citation for part 18 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 18.1378–1T [Removed]

Par. 15. Section 18.1378–1 is removed.

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 16. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 17. In § 602.101, paragraph (b) is amended by adding an entry for ''1.441–2'', removing the entries for ''1.441–3T'', ''1.442–2T'', and ''1.442–3T'', revising the entry for ''1.442–1'', and adding an entry for ''1.1378–1'' in numerical order to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.441–2	1545–1748
* * * * *	
1.442–1	1545–0074
	1545–0123
	1545–0134
	1545–0152
	1545–1748
* * * * *	
1.1378–1	1545–1748
* * * * *	

Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.

Approved: May 3, 2002.

Pamela F. Olson,

Acting Assistant Secretary of the Treasury.

[FR Doc. 02–12169 Filed 5–16–02; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE INTERIOR

Office of Surface Mining Reclamation and Enforcement

30 CFR Part 904

[AR–036–FOR]

Arkansas Abandoned Mine Land Reclamation Plan and Regulatory Program

AGENCY: Office of Surface Mining Reclamation and Enforcement, Interior.

ACTION: Final rule; approval of amendment.

SUMMARY: We, the Office of Surface Mining Reclamation and Enforcement (OSM), are approving an amendment to the Arkansas abandoned mine land (AML) reclamation plan (Arkansas plan) and the Arkansas regulatory program (Arkansas program) under the Surface Mining Control and Reclamation Act of 1977 (SMCRA or the Act). Arkansas proposed revisions to its AML reclamation plan regulations concerning eligible lands and water, reclamation objectives and priorities, and reclamation project evaluation. Arkansas proposed to revise its regulatory program regulations concerning procedures for assessment conference and to add revegetation success standards for grazingland and prime farmland. Arkansas revised its plan and program to be consistent with the corresponding Federal regulations.

EFFECTIVE DATE: May 17, 2002.

FOR FURTHER INFORMATION CONTACT: Michael C. Wolfrom, Director, Tulsa Field Office, Telephone: (918) 581–6430, Internet: *mwolfrom@osmre.gov.*

SUPPLEMENTARY INFORMATION:

I. Background on the Arkansas Plan and Program

The Abandoned Mine Land Reclamation Program was established by Title IV of the Act (30 U.S.C. 1201 *et seq.*) in response to concerns over extensive environmental damage caused by past coal mining activities. The program is funded by a reclamation fee collected on each ton of coal that is produced. The money collected is used to finance the reclamation of abandoned coal mines and for other authorized activities. Section 405 of the Act allows States and Indian tribes to assume exclusive responsibility for reclamation activity within the State or on Indian lands if they develop and submit to the Secretary of the Interior for approval, a program (often referred to as a plan) for the reclamation of abandoned coal mines. On May 2, 1983, the Secretary of the Interior approved the Arkansas plan. You can find background information on the Arkansas plan, including the Secretary's findings, the disposition of comments, and the approval of the plan in the May 2, 1983, **Federal Register** (48 FR 19710). You can find later actions on the Arkansas plan at 30 CFR 904.25 and 904.26.

Section 503(a) of the Act permits a State to assume primacy for the regulation of surface coal mining and reclamation operations on non-Federal and non-Indian lands within its borders by demonstrating that its State program includes, among other things, ''* * * a State law which provides for the regulation of surface coal mining and reclamation operations in accordance with the requirements of this Act * * *; and rules and regulations consistent with regulations issued by the Secretary pursuant to this Act.'' *See* 30 U.S.C. 1253(a)(1) and (7). On the basis of these criteria, the Secretary of the Interior conditionally approved the Arkansas program on November 21, 1980. You can find background information on the Arkansas program, including the Secretary's findings, the disposition of comments, and the conditions of approval in the November 21, 1980, **Federal Register** (45 FR 77003). You can find later actions on the Arkansas program at 30 CFR 904.10, 904.12, 904.15, and 904.16.

II. Submission of the Amendment

By letter dated August 13, 2001 (Administrative Record No. AR–568), Arkansas sent us an amendment to its plan and program under SMCRA (30 U.S.C. 1201 *et seq.*). Arkansas sent the amendment in response to our letters dated November 26, 1985, and October 14, 1997 (Administrative Record Nos. AR–332 and AR–559.02, respectively), that we sent to Arkansas under 30 CFR 732.17(c). Arkansas also sent the amendment in response to our letter dated May 5, 1999 (Administrative Record No. AAML–30) that we sent Arkansas under 30 CFR 884.15(d). The amendment also includes a change made at Arkansas' own initiative. Arkansas proposes to amend the Arkansas Surface Coal Mining and Reclamation Code.

We announced receipt of the proposed amendment in the October 5, 2001, **Federal Register** (66 FR 50952). In the same document, we opened the public comment period and provided an