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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-103823-99]

RIN 1545-AX12

Guidance on Cost Recovery Under the Income Forecast Method

AGENCY: Internal Revenue Service (IRS), Treasury.

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

SUMMARY: This document contains proposed regulations relating to deductions available to taxpayers using the income forecast method of depreciation under section 167(g). These proposed regulations reflect changes to the law made by the Small Business Job Protection Act of 1996 and the Taxpayer Relief Act of 1997 and affect taxpayers that produce, own, or license films, videos, sound recordings, books, copyrights, patents, and certain other similar properties. This document also provides notice of a public hearing on these regulations.

DATES: Written comments must be received by August 29, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for September 4, 2002, at 10 a.m., must be received by August 13, 2002.

ADDRESSES: Send submissions to: CC:IT&A:RU (REG-103823-99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:IT&A:RU (REG-103823-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC. Alternatively, taxpayers may submit comments directly to the IRS Internet site at

www.irs.gov/regs. A public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Bernard P. Harvey, (202) 622-3110; concerning submissions and, the hearing and/or to be placed on the building access list to attend the hearing, Guy R. Traynor, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

### **Background**

This document contains proposed amendments to 26 CFR part 1 to provide regulations under section 167(g) of the Internal Revenue Code of 1986 (Code). Section 167(g) was added to the Code by the Small Business Job Protection Act of 1996, Public Law 104-188, 1604 (110 Stat. 1755, 1836) (Aug. 20, 1996), and significant amendments were made to the provision by the Taxpayer Relief Act of 1997, Public Law 105-34, 1086 (111 Stat. 788, 957) (Aug. 5, 1997).

### **Explanation of Provisions**

The income forecast method of depreciation has been a permissible method for certain properties since the early 1960s. The income forecast method permits taxpayers to recover the depreciable basis in property over the anticipated income to be earned from the property. The income forecast method is available for interests (including interests involving limited rights in property) in motion picture films, video tapes, sound recordings, copyrights, books, and patents. See Rev. Rul. 60-358 (1960-2 C.B. 68); Rev. Rul. 64-273 (1964-2 C.B. 62); Rev. Rul. 79-285 (1979-2 C.B. 91); and Rev. Rul. 89-62 (1989-1 C.B. 78). The income forecast method is appropriate for these types of property because they possess unique income earning characteristics (for example, the income earning potential of a film may vary as a direct result of

the film's popularity) and, therefore, the economic usefulness of these properties cannot be measured adequately by the property's physical condition or by the passage of time. In 1996, Congress enacted statutory income forecast rules to ensure that, for certain properties, the allowances for depreciation appropriately match the basis of an income forecast property with the income derived therefrom. In 1997, Congress placed limitations on the type of property that could be depreciated using the income forecast method.

#### Computation of Allowances for Depreciation

The proposed regulations provide that, under the income forecast method, a taxpayer's allowance for depreciation for a given year for an income forecast property generally is an amount that bears the same relationship to the depreciable basis of the property that the "current year income" for that year bears to the "forecasted total income" for the property. The proposed regulations provide a revised computation for computing a taxpayer's allowance for depreciation in years when conditions necessitate using a revised forecasted total income that differs from the forecasted total income used in computing depreciation allowances in previous years. Pursuant to these rules, taxpayers may revise forecasted total income and use the revised computation in taxable years after income forecast property is placed in service when information becomes available that indicates that forecasted total income (or revised forecasted total income) previously used to compute income forecast depreciation is inaccurate. Under the revised computation, a taxpayer's allowance for depreciation for the current and all future years for an income forecast property is an amount that bears the same relationship to the unrecovered depreciable basis of the property that the current year income for that year bears to the result obtained by subtracting from revised forecasted total income for the property the amounts of

current year income for prior taxable years. Taxpayers are required to use the revised computation in certain situations (discussed in this preamble under the heading of Income From the Property).

The proposed regulations also provide several special rules for computing allowances for depreciation under the income forecast method. A special rule applies for certain basis redeterminations whereby an additional “catch up” allowance for depreciation is allowed in the year that basis is redetermined. Under this special rule, the additional depreciation allowance is an amount equal to the cumulative allowances for depreciation that would have been permitted in previous years had the basis redetermination amount been included in basis in the year the property was placed in service. It is intended that this additional allowance will ameliorate the potential back-loading of depreciation deductions that may otherwise occur if the additional amount were taken into account over the remaining income from the property and diminish the amount of look-back interest that may otherwise accrue. This special rule does not apply if the additional basis is treated as separate property.

Pursuant to section 167(g)(1)(C), a taxpayer’s adjusted basis in an income forecast property is to be recovered by the end of the tenth taxable year following the taxable year in which the income forecast property is placed in service. The proposed regulations also provide that generally a taxpayer may deduct the adjusted basis in income forecast property in the year income from the property ceases completely and permanently (unless the income cessation arises in connection with the disposition of income forecast property). If additional amounts are paid or incurred with respect to income forecast property in taxable years after either of these special rules is applied, the additional amounts may be deducted when paid or incurred unless such

amounts give rise to separate property.

Use of the income forecast method is elected on a property-by-property basis. Once elected, the income forecast method is a method of accounting that may not be changed without the consent of the Commissioner. Modifications to forecasted total income to take into account information that becomes available after the property is placed in service in accordance with these proposed regulations is not a change in a method of accounting requiring the Commissioner's consent.

Section 167(g) sets forth rules for the use of the income forecast method and any similar method. Thus, any method that calculates depreciation based on the flow of income generated by a property (or group of properties) is a "similar method" subject to the requirements of this regulation, including, e.g., the requirement that the look-back method be applied in certain circumstances. Congress did not identify any method that should be treated as a similar method. Treasury and the IRS seek comments on other methods that should be treated as coming within the scope of the term any similar method.

Commentators suggested that we specifically approve a method of depreciation based on the application of percentages derived from historical patterns of income for similar properties as a similar method because to do so would simplify the computation of depreciation deductions for large groupings of properties. This suggestion has not been adopted because it is not clear that the historical patterns of income used to apply the suggested approach will accurately reflect the income from any particular income forecast property. Moreover, this suggested approach is not predicated upon the unique income earning characteristics of an income forecast property.

#### Basis Rules

The cost of producing income forecast property is capitalized and recovered through an allowance for depreciation. The proposed regulations follow the general principles set forth in the regulations under sections 263, 263A, 446, and 461 for determining the basis of income forecast property. Commentators have written to Treasury and the IRS requesting guidance on various issues involving the timing of inclusion in basis of direct costs of income forecast property that are contingent upon the amount of income earned from the property (or other similar factors) and the means by which those costs may be deducted. In accordance with these requests, and in light of section 167(g)(1)(B), the proposed regulations address certain basis issues that are peculiar to the income forecast method of computing depreciation allowances.

Section 263A applies to income forecast property produced by the taxpayer. Section 1.263A-1(c)(2)(ii) provides that an amount required to be capitalized under section 263A may not be included in basis any earlier than the taxable year during which the amount is incurred within the meaning of §1.446-1(c)(1)(ii). Section 1.446-1(c)(1)(ii) provides that under an accrual method of accounting a liability is incurred, and generally is taken into account for Federal income tax purposes, in the taxable year in which the “all events test” is satisfied. Sections 1.446-1(c)(1)(ii) and 1.461-1(a)(2) set forth the “all events test” which provides that a liability is incurred in the taxable year in which: (1) all the events have occurred that establish the fact of liability; (2) the amount of the liability can be determined with reasonable accuracy; and (3) economic performance has occurred with respect to the liability. Because section 167(g)(1)(B) provides that the adjusted basis of income forecast property depreciated using the income forecast method includes only amounts with respect to which the requirements of section 461(h) are satisfied, these rules are specifically restated in the proposed regulations.

The proposed regulations reiterate that contingent amounts that are either direct costs of the production of income forecast property or indirect costs properly allocable to the production of income forecast property are not added to basis until the taxable year in which the all events test, including the economic performance requirement of section 461(h), is satisfied. Under the proposed rules, the timing of the inclusion of certain of these costs in basis may be affected by §1.461-1(a)(2)(iii)(A), §1.461-1(a)(2)(iii)(D) and section 404.

Thus, the proposed regulations provide that contingent basis amounts that are either direct costs of income forecast property or indirect costs properly allocable to income forecast property are generally treated as basis redetermination amounts which increase the basis of income forecast property in the year paid or incurred. As noted above, the proposed regulations provide a special allowance applicable to certain basis redetermination amounts.

Commentators have also suggested that Transamerica Corp. v. United States, 999 F.2d 1362 (9<sup>th</sup> Cir. 1993), supports including contingent amounts in the basis of income forecast property beginning in the year the property is placed in service. In Transamerica, the Ninth Circuit interpreted Rev. Rul. 60-358, supra, as it applied in taxable years prior to the enactment of section 167(g), the economic performance requirements of section 461(h), the uniform capitalization requirement of section 263A, and other changes. The Ninth Circuit held that contingent basis amounts may be included in the basis of income forecast property in the year that the property is placed in service so long as the forecasted total income used in the computation of depreciation under the income forecast method includes an amount of income from the property sufficient to indicate that the contingency will be satisfied. Commentators urge the continuing application of the Transamerica approach because this approach matches most closely the costs of creating an

income forecast property with the income earned therefrom. Treasury and the IRS recognize that it may appear to be reasonable to include estimated amounts in the basis of income forecast property when the operation of the income forecast formula requires the use of estimated amounts in the forecasts of income that are used to determine the amount of income forecast depreciation, particularly where the income forecasts indicate that the contingencies will be resolved, and resolved relatively quickly, after the property is placed in service. Treasury and the IRS also recognize that the historic operation of the income forecast formula deters taxpayers from increasing their forecast of income in order to increase the contingent basis amounts includible in the basis of income forecast property because the increases in forecasted total income operate to increase the denominator of the income forecast formula and thus diminish the amount of depreciation of the income forecast property. This deterrent effect operates in most (but not all) situations to prevent the cumulative amount of income forecast depreciation deductions in any given taxable year from exceeding the total amount actually incurred in any given taxable year, which is the primary concern with the inclusion of contingent amounts in basis. However, because Congress specifically provided in section 167(g)(1)(B) that the adjusted basis of income forecast property includes only those amounts which satisfy the requirements of section 461(h) and because all events that establish the fact of the liability for contingent amounts have not occurred, the proposed regulations do not follow the Transamerica approach.

Commentators have also argued that Associated Patentees, Inc. v. Commissioner, 4 T.C. 979 (1945), supports an immediate deduction for contingent basis amounts arising from the provision of either property or services in the production of income forecast property that are paid or incurred in years after the year in which income forecast property is placed in service. The

proposed regulations do not adopt this interpretation of Associated Patentees because providing a more favorable cost recovery rule for contingent basis amounts than for fixed amounts would create an unwarranted incentive for characterizing costs as contingent amounts. Contingent basis amounts arising from the provision of either property or services in the production of income forecast property must be capitalized into the basis of income forecast property in accordance with §1.263A-1(e).

### Salvage Value

The proposed regulations do not provide that the basis upon which depreciation is computed under the income forecast method is reduced for salvage value. The unique statutory scheme Congress adopted for income forecast property requires this departure from the rules generally applicable to property depreciated under section 167, and from the provisions of Rev. Rul. 60-358, *supra*, which had governed income forecast depreciation prior to the enactment of section 167(g). Based on the provisions of section 167(g), Congress intended that taxpayers be able to recover their entire basis in income forecast property within the period beginning with the year income forecast property is placed in service and ending with the 10<sup>th</sup> taxable year after the year the property is placed in service and that basis be recovered over the total income earned in connection with the property within that same time frame.

Section 167(g)(1)(C) requires taxpayers to recover the adjusted basis of income forecast property as of the beginning of the 10<sup>th</sup> taxable year after the property is placed in service as an allowance for depreciation in such year. The term adjusted basis refers to the basis of property for purposes of determining gain or loss, which is determined generally by adjusting the cost or other basis in property prescribed by section 1012 by the adjustments required by section 1016.

See §1.1011-1. The use of this term in section 167(g)(1)(C) indicates that Congress intended that the entire basis of an income forecast property be recovered within the period beginning with the year income forecast property is placed in service and ending with the 10<sup>th</sup> taxable year after the year the property is placed in service. The legislative history confirms this reading of the provision, stating that “(a)ny costs that are not recovered by the end of the tenth taxable year after the property was placed in service may be taken into account as depreciation in such year.”

H.R. Conf. Rep. No. 737, 104<sup>th</sup> Cong., 2d Sess. 299 (1996).

Consistent with this rule, the estimated income from the property is all the income projected to be earned over the first eleven taxable years the property is used by any taxpayer. Under section 167(g)(1)(A), the adjusted basis of income forecast property is to be recovered through allowances for income forecast depreciation over the “amount of income earned in connection with the property” through the end of the tenth taxable year after the year in which the income forecast property is placed in service. The legislative history to section 167(g)(1)(A) states that “income to be taken into account under the income forecast method includes all estimated income generated by the property.” H.R. Conf. Rep. No. 737, at 297. By referring to income generated by the property, and not to income to be earned by the taxpayer, Congress established a regime whereby a taxpayer using the income forecast method must include within forecasted total income amounts that are to be earned not only by the taxpayer, but also by any subsequent owner during the eleven year period.

### Income From the Property

The income forecast formula uses the ratio of current year income to forecasted total income from the property to determine the current allowance for depreciation. Both current year income

and forecasted total income are to be computed in accordance with a taxpayer's method of accounting. Pursuant to Code section 167(g)(1)(A) and (g)(5)(C), forecasted total income is to include all anticipated income from any source through the end of the tenth taxable year following the year in which the income forecast property is placed in service (except, as discussed below, in the year of disposition of income forecast property). Thus, for example, in the case of a film, such income includes income from foreign and domestic theatrical, television, and other releases and syndications; income from video tape releases, sales, rentals, and syndications; and incidental income associated with the property such as income from the financial exploitation of characters, designs, titles, scripts, and scores, but only to the extent that such incidental income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related to the taxpayer (within the meaning of section 267(b)). Apportionment rules are provided for situations when income from the exploitation of characters, designs, titles, scripts, scores, and other incidental income may relate to more than one income forecast property.

Under the proposed regulations, taxpayers are required at the end of the taxable year in which income forecast property is placed in service to make an accurate projection of all anticipated income to be earned from the income forecast property based on the conditions known to exist at that time. This estimate is referred to as forecasted total income. As discussed above, forecasted total income includes not only the income that the taxpayer forecasts it will earn by the end of the tenth taxable year after the year in which the income forecast property is placed in service, but also income that may be earned by other owners of the income forecast property during that same period.

The proposed regulations also require taxpayers to evaluate the accuracy of their forecasts

annually. In order to perform these evaluations of forecasted total income, taxpayers must compute revised forecasted total income. Revised forecasted total income is the sum of current year income for the current taxable year and all prior taxable years, plus all income from the income forecast property that the taxpayer reasonably believes will be includible in current year income in taxable years after the current taxable year up to and including the 10<sup>th</sup> taxable year after the year in which the income forecast property is placed in service. Taxpayers are required to use the revised computation if forecasted total income in the immediately preceding taxable year falls outside a range bounded on the low end by 90 percent of revised forecasted total income for the current taxable year, and on the upper end by 110 percent of revised forecasted total income for the current taxable year. (In the situation where revised forecasted total income was used to compute income forecast depreciation in the immediately preceding taxable year, this comparison is made by comparing the revised forecasted total income for the current taxable year to revised forecasted total income for the immediately preceding taxable year.) Taxpayers may elect to alter their computations of income forecast depreciation (using the revised computation detailed below) when revised forecasted total income differs from forecasted total income.

Pursuant to Code section 167(g)(5)(B), income from the syndication of a television series need not be included in the income forecast computation prior to the fourth taxable year beginning after the date the first episode of the series is placed in service, unless an arrangement relating to future syndication exists. In such a case, syndication income is included in the income forecast computation at the time the arrangement relating to future syndication is made. This special rule also applies for purposes of applying the look-back method.

Special rules apply if income forecast property is disposed of prior to the end of the 10<sup>th</sup>

taxable year after the year the property is placed in service. In such a case, section 167(g)(5)(E) requires that for purposes of applying the look-back method, income from the disposition of the property is to be taken into account. Failure to apply a similar rule for purposes of computing income forecast depreciation in the year of disposition may permit a depreciation differential that would not be corrected through the operation of the look-back method (because the differential would arise in a year for which the period of time to which look-back interest would apply would be zero). Accordingly, the proposed regulations require taxpayers to take income from the disposition of income forecast property into account in the year of disposition in computing revised forecasted total income both for purposes of computing its income forecast depreciation and for purposes of applying the look-back method.

#### Income Forecast Property

Section 167(g)(6) limits the types of property for which the income forecast method may be utilized. The income forecast method is available for interests (including interests involving limited rights in property) in motion picture films, video tapes, sound recordings, copyrights, books, and patents. In addition, section 167(g)(6)(E) provides the authority for Treasury and the IRS to extend the income forecast method to other types of property. The proposed regulations extend the method to theatrical productions and authorize the Commissioner to publish guidance designating other properties.

The proposed regulations generally require the income forecast method to be applied on a property-by-property basis. In certain limited circumstances, interests in multiple properties may be grouped together and treated as a single income forecast property. The ability to treat multiple income forecast properties as a single property for purposes of applying the income forecast

method of depreciation is limited, however, to certain episodes of a television series or to multiple interests in specified income forecast properties acquired for broadcast pursuant to a single contract. The special allowance applicable to certain basis redetermination amounts is not available to basis redetermination amounts associated with interests in multiple income forecast properties treated as a single income forecast property under these rules. Commentators have requested that broad groupings of dissimilar properties be permitted in accordance with historic financial accounting practices. Because it is not clear that income would be clearly reflected if broader groupings of properties were permitted, this suggestion has not been incorporated into the proposed regulations. Treasury and the IRS request comments on whether the proposed permitted groupings are appropriate and whether additional groupings should be allowed.

Under section 167(g)(5)(A)(ii), an amount incurred after income forecast property is placed in service that is significant and that gives rise to a significant increase in income when compared to the previous amount of forecasted total income is treated as a separate income forecast property and depreciated accordingly. Under the proposed regulations, an amount that does not exceed the lesser of 5 percent of the depreciable basis of the income forecast property with which the amount is associated or \$100,000 is not considered significant for this purpose. An amount incurred after income forecast property is placed in service that is not significant or that does not give rise to a significant increase in income is subject to the general rules and is treated as a basis redetermination amount.

In addition, a cost incurred in a taxable year following the year in which the taxpayer has recovered through depreciation the entire adjusted basis of an income forecast property is treated as a separate income forecast property. If it is expected to give rise to a significant increase in

income, the amount of the cost is treated as income forecast property that is newly placed in service. Otherwise, it is deductible in the year paid or incurred.

### Look-back

In general, the look-back method applies any time property is depreciated using the income forecast method. A taxpayer using the income forecast method is required to pay, or is entitled to receive, interest computed under the look-back method for any year to which the look-back requirement applies. A taxpayer must pay look-back interest if deductions are accelerated due to the underestimation of total income expected to be earned with respect to the property.

Conversely, a taxpayer is entitled to receive look-back interest if deductions are delayed as a result of overestimating total income expected to be earned with respect to the property. The look-back method applies separately to each income forecast property, unless properties are aggregated pursuant to special rules contained in the proposed regulations.

Generally, the look-back method is applied in the third and tenth taxable years following the year in which the income forecast property is placed in service. The look-back method also applies in the year income from the income forecast property ceases with respect to the taxpayer (and with respect to all persons who would be treated as a single taxpayer with the taxpayer under rules similar to those in section 41(f)(1)).

The look-back method does not apply to any income forecast property the basis of which is \$100,000 or less in the year the look-back method would otherwise apply (redetermined without any reduction for depreciation allowed or allowable). In addition, the look-back method is not applicable for any year which would otherwise be a recomputation year if a 10 percent test is satisfied. The 10 percent test is met if forecasted total income (and, if applicable, revised

forecasted total income) for each prior year is greater than 90 percent of revised forecasted total income for the year which would otherwise be a recomputation year and is less than 110 percent of revised forecasted total income for the year which would otherwise be a recomputation year. If the look-back method is applied for the third taxable year following the year in which income forecast property is placed in service, a special rule applies in determining whether the 10 percent test is satisfied in any subsequent year. Under the special rule, the amount of the forecasted total income or the revised forecasted total income for each taxable year up to and including the third taxable year following the year in which income forecast property is placed in service is deemed to be equal to the revised forecasted total income that was used for purposes of applying the look-back method in the third taxable year following the year in which income forecast property is placed in service.

In order to apply the look-back method, prior year allowances for depreciation for income forecast property are recomputed using revised forecasted total income for the recomputation year in lieu of forecasted total income (or, if appropriate, revised forecasted income) from the property that was used in the computation of depreciation under the income forecast method in the prior year. If a taxpayer sells or otherwise disposes of income forecast property, the amount realized upon the disposition of the property is included in determining revised forecasted total income from the property in the year of disposition. These recomputed depreciation allowances are then used to determine either a hypothetical overpayment of tax or a hypothetical underpayment of tax.

Generally, taxpayers must determine the hypothetical overpayment or underpayment of tax arising from the change in depreciation allowances by recomputing their tax liability. Thus, a

taxpayer's tax liability for each prior year is recomputed by substituting the recomputed depreciation allowances for the depreciation allowances originally claimed. The recomputed tax liability is then compared to the taxpayer's actual liability. For purposes of this comparison, the taxpayer must determine the actual tax liability for each prior year based on the information available on the later of (1) the due date of the return, including extensions, (2) the date of an amended return, (3) the date a return is adjusted by examination, or (4) the date of any previous application of the look-back requirement for the income forecast property. The result of this comparison is a hypothetical overpayment or underpayment of tax for each prior year in which allowances for depreciation were claimed for income forecast property subject to the look-back method.

Pass-through entities that are not closely-held pass-through entities must use a simplified method to compute their hypothetical overpayment or underpayment for each prior year in which allowances for depreciation were claimed for income forecast property subject to the look-back method. Under the simplified method, taxpayers apply a set rate (i.e., the highest rate applicable under section 1 or 11) to the net changes in depreciation allowances for each year. Treasury and the IRS considered, but did not provide, an election for other taxpayers to use the simplified method similar to the election set forth in §1.460-6(d)(4)(ii). Treasury and the IRS request comments on whether the use of the simplified method should be extended to taxpayers other than those required to use the simplified method, and if so, whether additional safeguards beyond the consistency rules for related taxpayers, the rules precluding changes from the simplified method without permission, and the overpayment ceiling would be appropriate.

Regardless of the method used, the resulting hypothetical overpayments or underpayments are

then used to compute interest that is to be charged or credited on each of these amounts. Interest is generally computed from the due date of the return (not including extensions) for the years in which changes in depreciation allowances occur to the due date of the recomputation year (not including extensions). Special rules are provided for taxpayers who do not use the simplified method where changes in depreciation allowances affect tax liability in years other than the year in which the changes in depreciation allowances occur. Interest is computed using the overpayment rate under section 6621. The amounts resulting from these computations are netted to arrive at look-back interest due to the taxpayer or payable to the government for the recomputation year. For purposes of computing taxable income, look-back interest is treated as interest on an overpayment or underpayment of tax. Under section 167(g)(5)(D), look-back interest required to be paid is treated as a tax liability for penalty purposes.

### **Proposed Effective Date**

The regulations are proposed to apply to property placed in service on or after the date that final regulations are published in the **Federal Register**.

### **Special Analyses**

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and, because these regulations do not impose on small entities a collection of information requirement, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel

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

### **Comments and Public Hearing**

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

A public hearing has been scheduled for September 4, 2002, at 10 a.m. in the Internal Revenue Service Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW, Washington, DC. All visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts at the Constitution Avenue entrance. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to this hearing. Persons that wish to present oral comments at the hearing must submit timely written comments and an outline of the topics to be discussed and the time to be devoted to each topic (preferably a signed original and eight (8) copies) by August 13, 2002.

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

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

## **Drafting Information**

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

## **List of Subjects in 26 CFR Part 1**

Income taxes, Reporting and recordkeeping requirements.

## **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is 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. Sections 1.167(n)-0 through 1.167(n)-7 are added to read as follows:

#### §1.167(n)-0 Outline of regulation sections for section 167(g).

This section lists the major captions contained in §1.167(n)-1 through §1.167(n)-7

#### §1.167(n)-1 Income forecast method.

- (a) Overview.
- (b) Method of accounting.
  - (1) In general.
  - (2) Election of the income forecast method.

#### §1.167(n)-2 Basis.

- (a) Depreciable basis.
  - (1) In general.
  - (2) Timing of basis determinations and redeterminations.
  - (3) Separate Property.
- (b) Basis redeterminations.
- (c) Unrecovered depreciable basis.

(d) Example.

§1.167(n)-3 Income from the property.

- (a) Current year income.
  - (1) In general.
  - (2) Special rule for advance payments.
- (b) Forecasted total income.
- (c) Revised forecasted total income.
- (d) Special rules.
  - (1) Disposition of the property.
  - (2) Syndication income from television series.
  - (3) Apportionment of income in certain circumstances.
  - (4) Examples.

§1.167(n)-4 Computation of depreciation using the income forecast method.

- (a) Computation of depreciation allowance.
- (b) Revised computation.
  - (1) Change in estimated income.
  - (2) Requirement to use the revised computation.
- (c) Basis redeterminations.
  - (1) Calculation of depreciation allowance.
  - (2) Example.
- (d) Special rules.
  - (1) Final year depreciation.
  - (2) Certain basis redeterminations.
  - (3) Disposition of property.
  - (4) Separate property.
- (e) Examples.

§1.167(n)-5 Property for which the income forecast method may be used.

- (a) In general.
- (b) Specific exclusions.
- (c) Costs treated as separate property.
  - (1) Costs giving rise to a significant increase in income.
  - (2) Significant increase in income.
  - (3) Special rule for costs paid or incurred after the end of the final year.
  - (4) Time separate property is placed in service.
- (5) Examples.
- (d) Aggregations treated as a single income forecast property.
  - (1) Multiple episodes of a television series produced in the same taxable year.

- (2) Multiple episodes of a television series produced in more than one taxable year.
- (3) Multiple interests acquired pursuant to a single contract.
- (4) Videocassettes and DVDs.

§1.167(n)-6 Look-back method.

- (a) Application of the look-back method.
- (b) Operation of the look-back method.
  - (1) In general.
  - (2) Property-by-property application.
- (c) Recalculation of depreciation allowances.
  - (1) Computation.
  - (2) Revised forecasted total income from the property.
  - (3) Special rule for basis redeterminations.
- (d) Hypothetical overpayment or underpayment of tax.
  - (1) In general.
  - (2) Hypothetical overpayment or underpayment, actual recomputation.
  - (3) Hypothetical overpayment or underpayment, simplified method.
  - (4) Definitions.
- (e) Recomputation year.
  - (1) In general.
  - (2) Look-back method inapplicable in certain de minimis cases.
- (f) De minimis basis exception.
- (g) Treatment of look-back interest.
  - (1) In general.
  - (2) Additional interest due on interest only after tax liability due.
  - (3) Timing of look-back interest.
  - (4) Statute of limitations; compounding of interest on look-back interest.
- (h) Example.

§1.167(n)-7 Effective date.

§1.167(n)-1 Income forecast method.

(a) Overview. This section and §§1.167(n)-2 through 1.167(n)-7 provide rules for computing depreciation allowances under section 167 for property depreciated using the income forecast method. Because the income forecast method is only appropriate for property with unique income earning characteristics, only property specified in §1.167(n)-5 may be depreciated under the income forecast method. A taxpayer using the income forecast method generally computes

depreciation allowances each year based upon the ratio of current year income to forecasted total income from the property as described in §1.167(n)-4. Current year income and forecasted total income are determined in accordance with the provisions of §1.167(n)-3. In addition, a taxpayer must determine depreciable basis for income forecast property in accordance with the basis rules of §1.167(n)-2. Property depreciated under the income forecast method generally is subject to the look-back rules of §1.167(n)-6 whereby taxpayers must determine the amount of interest owed on any hypothetical underpayment of tax, or due on any hypothetical overpayment of tax, attributable to the use of estimated income in the computation of income forecast depreciation. Under these rules, look-back computations must be performed in specified recomputation years, which are generally the 3<sup>rd</sup> and 10<sup>th</sup> taxable years after the taxable year that the property is placed in service.

(b) Method of accounting--(1) In general. The computation of depreciation under the income forecast method is elected on a property-by-property basis, and is a method of accounting under section 446 that may not be changed without the consent of the Commissioner. However, a change in forecasted total income in accordance with the rules of §1.167(n)-4 is not a change in method of accounting requiring the Commissioner's consent.

(2) Election of the income forecast method. A taxpayer elects the income forecast method by computing allowances for depreciation for the eligible property in accordance with the provisions of this section and §§1.167(n)-2 through §1.167(n)-6. See §1.167(n)-5 for rules regarding eligible property.

§1.167(n)-2 Basis.

(a) Depreciable basis--(1) In general. The basis upon which the allowance for depreciation is

computed with respect to income forecast property is the basis of the income forecast property for purposes of section 1011 without regard to the adjustments described in section 1016(a)(2) and (3).

(2) Timing of basis determinations and redeterminations. Costs paid or incurred in or after the taxable year in which the income forecast property is placed in service are taken into account in accordance with a taxpayer's method of accounting in redetermining the basis of income forecast property in the taxable year paid or incurred (i.e., when all events have occurred that establish the fact of the liability, the amount of the liability can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability). See §§1.446-1(c)(1)(i) and (ii), 1.461-1(a)(1) and (2), and 1.263A-1(c). Accordingly, contingent payments may not be included in the basis of income forecast property when the property is placed in service, but are included in the basis of income forecast property in the taxable year in which they are paid or incurred, even if the forecasted total income used in the computation of income forecast depreciation allowances is sufficient to indicate that the contingency will be satisfied.

(3) Separate property. Certain amounts paid or incurred in taxable years after income forecast property is placed in service are treated as separate property for purposes of computing depreciation allowances under the income forecast method. See §1.167(n)-5(c).

(b) Basis redeterminations. If an amount required to be capitalized into the basis of income forecast property is paid or incurred after the income forecast property is placed in service, and if the amount required to be capitalized is not treated as separate property in accordance with §1.167(n)-5(c), the basis of the income forecast property is redetermined and the amount required

to be capitalized is the basis redetermination amount. The redetermined basis of the income forecast property is the depreciable basis of the income forecast property increased by the basis redetermination amount. In the year basis is redetermined (and in subsequent taxable years), the redetermined basis must be used to determine depreciation under the income forecast method. An additional allowance for depreciation under the income forecast method is allowed in the taxable year the basis of certain income forecast property is redetermined. See §1.167(n)-4(c).

(c) Unrecovered depreciable basis. For any taxable year, the unrecovered depreciable basis of an income forecast property is the depreciable basis of the property less the adjustments described in section 1016(a)(2) and (3).

(d) Example. The provisions of §1.167(n)-2 are illustrated by the following example:

(i) *Studio* contracts with *Actor* to star in a motion picture film to be produced by *Studio*. Both *Studio* and *Actor* are calendar year taxpayers; *Studio* is an accrual basis taxpayer and *Actor* is a cash basis taxpayer. As compensation for *Actor*'s services, the contract guarantees *Actor* a payment of five percent of the gross income from the film, beginning after the film has earned a total gross income (net of distribution costs) of \$ 100x. *Studio* estimates that the film will earn a total gross income of \$160x by the end of the 10<sup>th</sup> taxable year following the taxable year that the film is placed in service. The film is placed in service and earns \$ 65x of gross income in year one, \$ 30x in year two, and \$ 25x in year three. Because the income from the film does not exceed \$100x in either year one or year two, *Studio* pays nothing under the contract to *Actor* in years one and two. In year three, the cumulative income from the film reaches \$120x, which exceeds the \$100x threshold by \$20x. Based on this excess, *Studio* calculates that it owes *Actor* \$ 1x, calculated by multiplying \$20x by *Actor*'s contractual percentage of five percent. *Studio* pays \$1x to *Actor* 20 days after the end of year three.

(ii) *Studio* may not include the \$1x paid to *Actor* in the basis of the film in years one or two because *Studio* does not have a fixed liability to pay *Actor* any amount under the contract in years one and two. Furthermore, while *Studio* does have a fixed liability to pay *Actor* \$1x in year three, the requirements of section 404 are not met in year three and *Studio* thus may not include the \$1x in the basis of the film in year three. In year four, when section 404 is satisfied, *Studio* incurs the \$1x in accordance with §1.263A-1(c) and increases its basis in the film. The \$1x is treated as a basis redetermination amount under §1.167(n)-2(b) in year four.

§1.167(n)-3 Income from the property.

(a) Current year income--(1) In general. Current year income is the income from an income forecast property for the current year (less the distribution costs of the income forecast property for such year), determined in accordance with the taxpayer's method of accounting. All income earned in connection with the income forecast property is included in current year income, except as provided in paragraph (d) of this section. In the case of a film, television show, or similar property, such income includes, but is not limited to--

(i) Income from foreign and domestic theatrical, television, and other releases and syndications;

(ii) Income from releases, sales, rentals, and syndications of video tape, DVD, and other media; and

(iii) Incidental income associated with the property, such as income from the financial exploitation of characters, designs, titles, scripts, and scores, but only to the extent that such incidental income is earned in connection with the ultimate use of such items by, or the ultimate sale of merchandise to, persons who are not related to the taxpayer (within the meaning of section 267(b)).

(2) Special rule for advance payments. In the year that income forecast property is placed in service, current year income for an income forecast property includes income included in gross income for any prior taxable year in connection with the property. This paragraph applies separately to any cost treated as separate property under §1.167(n)-5(c).

(b) Forecasted total income. Forecasted total income is the sum of current year income for the year that income forecast property is placed in service, plus all income from the income forecast property that the taxpayer reasonably believes will be includible in current year income in

subsequent taxable years (as adjusted for distribution costs) up to and including the 10<sup>th</sup> taxable year after the year in which the income forecast property is placed in service. Forecasted total income is based on the conditions known to exist at the end of the taxable year for which the income forecast property is placed in service.

(c) Revised forecasted total income. If information is discovered in a taxable year following the year in which income forecast property is placed in service that indicates that forecasted total income is inaccurate, a taxpayer must compute revised forecasted total income for the taxable year. Revised forecasted total income is based on the conditions known to exist at the end of the taxable year for which the revised forecast is being made. Revised forecasted total income for the taxable year is the sum of current year income for the taxable year and all prior taxable years, plus all income from the income forecast property that the taxpayer reasonably believes will be includible in current year income in taxable years after the current taxable year up to and including the 10<sup>th</sup> taxable year after the year in which the income forecast property is placed in service.

Where a taxpayer computes revised forecasted total income in accordance with this §1.167(n)-3(c), see §1.167(n)-4(b) for the computation of the allowance for income forecast depreciation.

(d) Special rules--(1) Disposition of the property. In computing the depreciation allowance for an income forecast property, income from the sale or other disposition of income forecast property is not included in current year income. However, if the income forecast property is disposed of prior to the end of the 10th taxable year following the taxable year in which the property is placed in service, income from the sale or other disposition of income forecast property is taken into account in calculating revised forecasted total income both for purposes of calculating the allowance for depreciation in the year of disposition and for purposes of applying

look-back. See §1.167(n)-4(d)(3) and §1.167(n)-6(c)(2).

(2) Syndication income from television series. (i) In the case of a television series produced for distribution on television networks, current year income and forecasted total income (or, if applicable, revised forecasted total income) used in the computation of the depreciation allowance for such property under §1.167(n)-4 need not include income from syndication of the television series before the earlier of--

(A) The fourth taxable year beginning after the date the first episode in the series is placed in service; or

(B) The earliest taxable year in which the taxpayer has an arrangement relating to the syndication of the series.

(ii) For purposes of this paragraph (d)(2), an arrangement relating to syndication of a series of television shows means any arrangement other than the first run exhibition agreement. For example, an arrangement for exhibition of a television series by individual television stations is an arrangement for syndication if it results in an exhibition of one or more episodes of the series beginning after one or more episodes of the series have been exhibited on a television network. A first run exhibition agreement is an agreement under which any episode (including a pilot episode) of a television series is first placed in service within a particular market.

(3) Apportionment of income in certain circumstances. When income from a particular source relates to more than one income forecast property the taxpayer must make a reasonable allocation of the income among those properties based on all relevant factors. Situations where allocation is necessary include income generated by a syndication arrangement involving more than one income forecast property, incidental income described in paragraph (a)(1)(iii) of this section that relates to

more than one motion picture, and income associated with income forecast property when expenditures relating to the property have given rise to separate property as defined in §1.167(n)-5(c). For example, when a taxpayer sells or licenses merchandise that features the likeness of a character that has appeared in more than one film, relevant factors might include merchandise sales figures prior to the release of the subsequent film, specific identification of certain merchandise with one particular film, and the taxpayer's prior experience with similar situations.

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

Example 1. C produces a motion picture film featuring the adventures of a fictional character. C sells merchandise using the character's image, enters into licensing agreements with unrelated parties for the use of the image, and uses the image to promote a ride at an amusement park that is wholly owned by C. Pursuant to paragraph (a)(1) of this section, income from the sales of merchandise by C to consumers and income from the licensing agreements are included in current year income. No portion of the admission fees for the amusement park is included in current year income because the amusement part is wholly owned by C.

Example 2. Assume the same facts as in Example 1. C forecasts that the cumulative amount of current year income it will earn (net of distribution costs) from the year it places the motion picture film in service through the end of the 7<sup>th</sup> taxable year thereafter to be \$345x. C also forecasts that the motion picture film will earn current year income of \$155x from the beginning of the 8<sup>th</sup> taxable year through the end of the 10<sup>th</sup> taxable year after the year the income forecast property is placed in service. C anticipates the sale of the motion picture film at the end of the 7<sup>th</sup> taxable year after the year the property is placed in service and in fact sells the motion picture film for \$200x on the last day of the 7<sup>th</sup> taxable year after the year the property is placed in service. C's computations of forecasted total income must reflect the fact that C forecasts that \$500x will be earned by the motion picture film through the end of the 10<sup>th</sup> taxable year after the year the property is placed in service (\$345x from the year the film is placed in service through the end of the 7<sup>th</sup> taxable year after the taxable year that the property was placed in service, plus \$155x C forecasts from the beginning of the 8<sup>th</sup> taxable year through the end of the 10<sup>th</sup> taxable year after the year the property is placed in service). Even though C only expects to earn \$345x prior to the sale of the film, C may not use \$345x as forecasted total income in computing its depreciation allowance under the income forecast method. Similarly, C may not use the combination of the amounts it expects to earn prior to the sale (\$345x) plus the anticipated sales proceeds (\$200x) or \$545x as forecasted total income, except when computing its depreciation allowance for the 7<sup>th</sup> taxable year after the year in which the income forecast property was placed in service and for purposes of computing look-back interest.

§1.167(n)-4 Computation of depreciation using the income forecast method.

(a) Computation of depreciation allowance. Generally, the depreciation allowance for an income forecast property for a given taxable year is computed by multiplying the depreciable or redetermined basis of the property (as defined in §1.167(n)-2) by a fraction, the numerator of which is current year income (as defined in §1.167(n)-3(a)) and the denominator of which is forecasted total income (as defined in §1.167(n)-3(b)).

(b) Revised computation--(1) Change in estimated income. The depreciation allowance for an income forecast property for any taxable year following the year in which income forecast property is placed in service may be computed using the computation provided in this paragraph (b)(1) if revised forecasted total income differs from forecasted total income. Thus, for example, a taxpayer using the income forecast method for a motion picture may revise upward the forecast of total income from the motion picture (to arrive at revised forecasted total income) in a taxable year wherein the taxpayer discovers that the motion picture is more popular than originally expected, and may thereafter use the revised computation to compute the allowance for income forecast depreciation for the motion picture. Under the revised computation, the unrecovered depreciable basis of the income forecast property (as defined in §1.167(n)-2(c)) is multiplied by a fraction, the numerator of which is current year income and the denominator of which is obtained by subtracting from revised forecasted total income the amounts of current year income from prior taxable years.

(2) Requirement to use the revised computation. The revised computation described in paragraph (b)(1) of this section must be used in any taxable year following the year in which income forecast property is placed in service if forecasted total income (as defined in §1.167(n)-

3(b)) (or, if applicable, revised forecasted total income (as defined in §1.167(n)-3(c)) in the immediately preceding taxable year is either--

- (i) Less than 90 percent of revised forecasted total income for the taxable year; or
- (ii) Greater than 110 percent of revised forecasted total income for the taxable year.

(c) Basis redeterminations--(1) Calculation of depreciation allowance. An additional depreciation allowance is available under this paragraph in the taxable year that basis is redetermined under §1.167(n)-2(b) when that taxable year is subsequent to the taxable year in which income forecast property is placed in service, but prior to the 10<sup>th</sup> taxable year following the taxable year in which the property is placed in service. The additional depreciation allowance is that portion of the basis redetermination amount that would have been recovered through depreciation allowances in prior taxable years if the basis redetermination amount had been included in depreciable basis in the taxable year that the property was placed in service. This §1.167(n)-4(c) does not apply to property treated as a single income forecast property pursuant to §1.167(n)-5(d)(1) through (4).

(2) Example. The provisions of paragraph (c)(1) of this section are illustrated by the following example:

Example. D, an accrual basis movie producer, enters into a contract with E, an author, under which D will make a film based on E's book. E performs no services for D, but merely permits D to use the book as a basis for D's film. D pays E a fixed dollar amount upon entry into the agreement and promises to pay E a contingent payment of five percent of D's income from the film, beginning after the film has earned \$100,000 (net of distribution costs). D estimates that forecasted total income from the film will be \$200,000. The film earns \$65,000 of current year income in year one, \$30,000 in year two, and \$25,000 in year three. D takes allowances for depreciation in year one (\$65,000 divided by \$200,000, multiplied by the basis of the film) and year two (\$30,000 divided by \$200,000, multiplied by the basis of the film). In year three, D's liability to E becomes fixed and D pays E \$1,000. The \$1,000 incurred by D is a basis redetermination amount that increases the basis of the film for purposes of computing D's

depreciation allowance for the film for year three. In addition to the year three allowance based on current year income (\$25,000 divided by \$200,000 multiplied by the basis of the film, which includes for year three the \$1,000 basis redetermination amount), D is entitled to an additional allowance for depreciation for year three under paragraph (c)(1). This additional allowance is \$475, the sum of the allowance of \$325 that would have been allowed in year one (\$65,000 divided by \$200,000, multiplied by the \$1,000 payment to E) and the allowance of \$150 that would have been allowed in year two (\$30,000 divided by \$200,000, multiplied by \$1,000) if the \$1,000 had been included in basis in the year that the film was placed in service.

(d) Special rules--(1) Final year depreciation. Except as provided in paragraphs (d)(2) and (3) of this section, a taxpayer may deduct as a depreciation allowance the remaining depreciable basis of income forecast property depreciated under the income forecast method in the earlier of--

(i) The year in which the taxpayer reasonably believes, based on the conditions known to exist at the end of the taxable year, that no income from the income forecast property will be included in current year income in any subsequent taxable year up to and including the 10<sup>th</sup> taxable year following the taxable year the income forecast property is placed in service; or

(ii) The 10<sup>th</sup> taxable year following the taxable year the income forecast property is placed in service.

(2) Certain basis redeterminations. A taxpayer may deduct as a depreciation allowance the amount of any basis redetermination that occurs in a taxable year in which the taxpayer reasonably believes, based on the conditions known to exist at the end of the taxable year, that no income from the income forecast property will be included in current year income in any subsequent taxable year. In addition, a taxpayer may deduct as a depreciation allowance the amount of any basis redetermination that occurs in a taxable year following a taxable year in which a deduction is allowable under paragraph (d)(1) of this section.

(3) Disposition of property. Paragraph (d)(1) of this section does not apply to income forecast property that is sold or otherwise disposed of before the end of the 10<sup>th</sup> taxable year following the taxable year that the property is placed in service. In the case of such a disposition, the allowance for depreciation in the year of disposition is calculated by multiplying the depreciable basis (or, if applicable, the redetermined basis) of the property by a fraction, the numerator of which is current year income and the denominator of which is the sum of the amount realized on the disposition of the property plus all amounts included in current year income in the year of disposition and in taxable years prior to the year of disposition.

(4) Separate property. The deductions provided in paragraphs (d)(1) and (2) of this section apply separately to property that is treated as separate property under §1.167(n)-5(c).

(e) Examples. The provisions of this section are illustrated by the following examples:

Example 1. F places in service income forecast property with a depreciable basis of \$100x, and estimates that forecasted total income from the property will be \$200x. In taxable year one, current year income is \$80x. The depreciation allowance for year one is \$40x, computed by multiplying the depreciable basis of the property of \$100x by the fraction obtained by dividing current year income of \$80x by forecasted total income of \$200x.

Example 2. Assume the same facts as in Example 1. In year two, F's current year income is \$40x. In addition, F computes revised forecasted total income to be \$176x. F is required to compute its depreciation allowance for this property using the revised computation of paragraph (b)(1) of this section because forecasted total income in year one of \$200x is greater than 110 percent of revised forecasted total income in year two (110 percent of \$176x = \$193.6x). The depreciation allowance for taxable year two computed under the revised computation is \$25x, computed by multiplying the unrecovered depreciable basis of \$60x by the fraction obtained by dividing current year income of \$40x by \$96x (revised forecasted total income of \$176x less current year income from prior taxable years of \$80x).

Example 3. Assume the same facts as in Example 2. Because F used the revised computation in year two, the revised computation applies in year three. In year three, F's current year income is \$32x. The depreciation allowance for year three computed under the revised computation is \$20x, computed by multiplying the unrecovered depreciable basis of \$60x by the fraction obtained by dividing current year income of \$32x by \$96x (revised forecasted total income of \$176x less

current year income from taxable years prior to the change in estimate taxable year of \$80x).

§1.167(n)-5 Property for which the income forecast method may be used.

(a) In general. The depreciation allowance under §1.167(n)-4 may be computed under the income forecast method only with respect to eligible property. Eligible property is limited to an interest (including interests involving limited rights in property) in the following property--

- (1) Property described in section 168(f)(3) and (4);
- (2) Copyrights;
- (3) Books;
- (4) Patents;
- (5) Theatrical productions; and
- (6) Other property as designated in published guidance by the Commissioner.

(b) Specific exclusions. The income forecast method does not apply to any amortizable section 197 intangible (as defined in section 197(c) and §1.197-2(d)).

(c) Costs treated as separate property--(1) Costs giving rise to a significant increase in income--(i) In general. For purposes of §1.167(n)-1 through §1.167(n)-6 , any amount paid or incurred after the income forecast property is placed in service must be treated as a separate property if the cost is significant and gives rise to an increase in income that is significant and that was not included in either forecasted total income or revised forecasted total income in a prior taxable year.

(ii) Exception for de minimis amounts. For purposes of this paragraph, a cost that is less than the lesser of 5 percent of the depreciable basis (as of the date the amount is paid or incurred) of the income forecast property to which the amount relates or \$100,000 is not significant. Such a

cost is therefore not treated as separate property but is instead treated as a basis redetermination amount in accordance with §1.167(n)-2(b).

(2) Significant increase in income. For purposes of this paragraph, whether an increase in income is significant is determined by comparing the amount that would be considered revised forecasted total income from the amounts treated as separate property to the most recent estimate of forecasted total income or revised forecasted total income used in calculating an allowance for depreciation with respect to the income forecast property.

(3) Special rule for costs paid or incurred after the end of the final year. For purposes of §1.167(n)-1 through §1.167(n)-6, any amount paid or incurred with respect to an income forecast property in a taxable year following the year in which the taxpayer claims a depreciation allowance in accordance with the final year depreciation rules of §1.167(n)-4(d)(1) is treated as a basis redetermination amount under §1.167(n)-2(b) provided the amount is not expected to give rise to a significant increase in current year income in any taxable year.

(4) Time separate property is placed in service. Separate property is treated as placed in service in the year the amount giving rise to the property is paid or incurred.

(5) Examples. The provisions of this paragraph (c) are illustrated in the following examples:

Example 1. G releases a film in 2001 and begins to recover the depreciable basis in the film using the income forecast method in the year 2001. In 2003, the film is re-edited and restored, and director's commentary is added in order to prepare the film for release on DVD. The total cost of preparing the film for the DVD release exceeds both 5 percent of the depreciable basis of the film and \$100,000. G did not anticipate the income from the DVD market, and did not include any DVD release income in the income projections for the film in prior years. If G anticipates that the additional DVD release income will be significant in relation to the forecasted total income used in calculating an allowance for depreciation for 2002 (the previous taxable year), the additional amount gives rise to separate property and must be recovered over the forecasted total income from the DVD. If not, G must treat the additional amounts as additions to basis under §1.167(n)-2(b).

Example 2. G releases a film in 2001 and recovers the depreciable basis in the film using the income forecast method in the years 2001 through 2011. In 2018, the film is re-edited and restored, and director's commentary is added in order to prepare the film for release on a newly discovered technology. If G anticipates that the additional new technology release income will be significant in relation to the revised forecasted total income used in calculating an allowance for depreciation for 2011 (the last taxable year for which an allowance was claimed), the cost of preparing the release gives rise to separate property and must be recovered over the forecasted total income from the new technology release. If not, G may deduct the cost in 2018, the year paid or incurred.

(d) Aggregations treated as a single income forecast property. Taxpayers must apply the income forecast method on a property-by-property basis, unless one of the aggregation rules provided in paragraphs (d)(1) through (4) of this section applies. If a taxpayer applies one of the aggregation rules provided in paragraphs (d)(1) through (4) of this section, costs incurred in taxable years after the initial income forecast property is placed in service are treated as basis redeterminations under §1.167(n)-2; however, the additional allowance for depreciation provided in §1.167(n)-4(c)(1) does not apply. The application of the provisions of paragraphs (d)(1) through (d)(4) is a method of accounting that may not be changed without the consent of the Commissioner. Permissible aggregations are limited to the following:

(1) Multiple episodes of a television series produced in the same taxable year. The producer of a television series may treat multiple episodes of a single television series produced in the same taxable year as a single unit of property for purposes of the income forecast method.

(2) Multiple episodes of a television series produced in more than one taxable year. The producer of a television series may treat multiple episodes of a single television series that are produced as a single season of episodes and placed in service over a period not in excess of twelve consecutive calendar months as a single unit of property for purposes of the income forecast method notwithstanding that the twelve-month period may span more than one taxable

year.

(3) Multiple interests acquired pursuant to a single contract. Multiple interests in specifically identified income forecast properties acquired for broadcast pursuant to a single contract may be treated as a single unit of property for purposes of the income forecast method.

(4) Videocassettes and DVDs. The purchaser or licensee of videocassettes and DVDs for rental to the public may treat multiple copies of the same title purchased or licensed in the same taxable year as a single unit of property for purposes of the income forecast method.

§1.167(n)-6 Look-back method.

(a) Application of the look-back method. If a taxpayer claims a depreciation deduction under the income forecast method for any eligible income forecast property, such taxpayer is required to pay (or is entitled to receive) interest computed as described in this paragraph for any year to which the look-back method applies (a recomputation year). The look-back method generally must be applied when income forecast property is disposed of or ceases to generate income. Further, the look-back method generally applies in the 3<sup>rd</sup> and 10<sup>th</sup> taxable years following the year in which income forecast property is placed in service. Under the look-back method, taxpayers must pay interest on deductions accelerated by the underestimation of either forecasted total income or revised forecasted total income from income forecast property. Conversely, taxpayers are entitled to receive interest on deductions delayed by the overestimation of either forecasted total income or revised forecasted total income from income forecast property. If either forecasted total income or revised forecasted total income are overestimated or underestimated, interest may arise from basis redeterminations. The computation of adjusted tax liability as part of the look-back method is hypothetical; application of the look-back method does not require a

taxpayer to adjust tax liability as reported on the taxpayer's tax returns, on an amended return, or as adjusted on examination for prior years.

(b) Operation of the look-back method--(1) In general. Under the look-back method, a taxpayer must perform a series of computations to determine look-back interest that the taxpayer is either required to pay or entitled to receive. As specified in paragraph (c) of this section, a taxpayer must first recompute depreciation allowances using revised forecasted total income rather than forecasted total income from income forecast property for the recomputation year (as defined in paragraph (e) of this section) and each prior year. These recomputed depreciation amounts are then used to determine a hypothetical tax liability that would have arisen had the taxpayer used revised forecasted total income rather than forecasted total income in determining depreciation allowances. The hypothetical tax liability is compared to the taxpayer's prior tax liability and interest is calculated in accordance with paragraph (d) of this section on the resulting hypothetical overpayments or underpayments of tax for each year. Reporting requirements and special rules for the resulting amounts of interest are specified in paragraph (g) of this section.

(2) Property-by-property application. Except as provided in this section, the look-back method applies to each property for which the income forecast method is used. Aggregations properly treated as a single income forecast property pursuant to §1.167(n)-5(d) are treated as a single property for purposes of applying the look-back method.

(c) Recalculation of depreciation allowances--(1) Computation. Under the look-back method, a taxpayer must compute the depreciation allowances for each income forecast property subject to the look-back method that would have been allowable under §1.167(n)-1 through §1.167(n)-5 for prior taxable years if the computation of the amounts so allowable had been made using revised

forecasted total income as calculated at the end of the recomputation year.

(2) Revised forecasted total income from the property--(i) In general. Except as provided in this paragraph (c)(2), revised forecasted total income is determined in accordance with §1.167(n)-3(c).

(ii) Syndication income from television series. Income excluded from forecasted total income (or, if appropriate revised forecasted total income) in any taxable year prior pursuant to §1.167(n)-3(d)(2) is excluded from revised forecasted total income for purposes of this section for that year.

(iii) Disposition of income forecast property For purposes of this section, income from the disposition of property must be taken into account in determining the amount of revised forecasted total income. Thus, when income forecast property is disposed of prior to the end of the 10<sup>th</sup> taxable year following the taxable year the property is placed in service, revised forecasted total income from the property for the year of disposition is deemed to be the sum of the amount realized on the disposition of the property plus all amounts included in current year income in the year of disposition and in taxable years prior to the year of disposition.

(3) Special rule for basis redeterminations. For purposes of the look-back calculation, any amount that is not treated as a separate property under §1.167(n)-5(c) that is paid or incurred with respect to income forecast property after the property is placed in service is taken into account by discounting (using the Federal mid-term rate determined under section 1274(d) as of the time the cost is paid or incurred) the amount to its value as of the date the property is placed in service. The taxpayer may elect for the recomputation year with respect to any income forecast property to have the preceding sentence not apply to the property by taking the amount

into account in the year that the amount was paid or incurred in the same manner as it was taken into account under §1.167(n)-2.

(d) Hypothetical overpayment or underpayment of tax--(1) In general--(i) Years for which a hypothetical overpayment or underpayment must be computed. After recalculating depreciation allowances in accordance with paragraph (c) of this section, a taxpayer must calculate a hypothetical overpayment or underpayment of tax for each prior taxable year for which income tax liability is affected by the change in depreciation allowances. A redetermination of income tax liability is required for every tax year for which the income tax liability would have been affected by a change in the allowance for income forecast depreciation in any year. For example, if the change in depreciation allowance results in a net operating loss carryforward that affects income tax liability in a subsequent taxable year, income tax liability must be recomputed for such subsequent year.

(ii) Methods of determining a hypothetical overpayment or underpayment. Generally, the calculation of the hypothetical overpayment or underpayment of tax must be made under the method described in paragraph (d)(2) of this section. Certain taxpayers are required to use the simplified method contained in paragraph (d)(3) of this section.

(iii) Cumulative determination of hypothetical income tax liability. The redetermination of income tax liability in any prior taxable year for which income tax liability is affected by the change in depreciation allowances must take into account all previous applications of the look-back calculation. Thus, for example, in computing the amount of a hypothetical overpayment or underpayment of tax for a prior taxable year for which income tax liability is affected by the change in depreciation allowances, the hypothetical income tax liability is compared to the

hypothetical income tax liability for that year determined as of the previous application of the look-back method.

(2) Hypothetical overpayment or underpayment, actual recomputation--(i) Computation of change in income tax liability. The hypothetical overpayment or underpayment is calculated first by redetermining the tax liability for each prior taxable year (either as originally reported, or as subsequently adjusted on examination or by amended return) using depreciation allowances calculated in paragraph (c) of this section for each prior taxable year in which depreciation allowances were determined under the income forecast method for the income forecast property (affected year). These recomputed depreciation allowances are then substituted for the depreciation allowances allowed (or allowable) for each affected year (whether originally reported, or as subsequently adjusted on examination or by amended return) and a revised taxable income is computed. A hypothetical income tax liability is then computed for each affected year using revised taxable income for that year. The hypothetical income tax liability for any affected year must be computed by taking into account all applicable additions to tax, credits, and net operating loss carrybacks and carryforwards. The tax, if any, imposed under section 55 (relating to alternative minimum tax) must be taken into account. Hypothetical income tax liability for each affected year is then compared to the tax liability determined as of the latest of the following dates--

(A) The original due date of the return (including extensions);

(B) The date of a subsequently amended or adjusted return; or

(C) The date of the previous application of the look-back method, in which case the hypothetical income tax liability for the affected year used in the most recent previous application

of the look-back method (previous hypothetical tax liability) is used.

(ii) Determination of interest. Once the hypothetical overpayment or underpayment for each year is computed, the adjusted overpayment rate under section 460(b)(7), compounded daily, is applied to the overpayment or underpayment determined under paragraph (d)(2)(i) of this section for the period beginning with the due date of the return (determined without regard to extensions) for the year in which either an overpayment or underpayment arises, and ending on the earlier of the due date of the return (determined without regard to extensions) for the redetermination year, or the first date by which both the income tax return for the filing year is filed and the tax for that year has been paid in full. The amounts of interest on overpayments are then netted against interest on underpayments to arrive at look-back interest that must be paid by the taxpayer or that the taxpayer is entitled to receive.

(iii) Changes in the amount of a loss or credit carryback or carryforward. If a recomputation of income forecast depreciation results in an increase or decrease to a net operating loss carryback (but not a carryforward), the interest a taxpayer is entitled to receive or required to pay must be computed on the decrease or increase in tax attributable to the change to the carryback only from the due date (not including extensions) of the return for the prior taxable year that generated the carryback and not from the due date of the return for the prior taxable year in which the carryback was absorbed. In the case of a change in the amount of a carryforward as a result of applying the look-back method, interest is computed from the due date of the return for the years in which the carryforward was absorbed.

(iv) Changes in the amount of income tax liability that generated a subsequent refund. If the hypothetical income tax liability for any affected year is less than the amount of the affected

year tax liability (as reported on the taxpayer's original return, as subsequently adjusted on examination, as adjusted by amended return, or as redetermined by the last previous application of the look-back method), and any portion of the affected year tax liability was refunded as a result of a loss or credit carryback arising in a year subsequent to the affected year, the look-back method applies as follows to properly reflect the time period of the use of the tax overpayment. To the extent the amount of refund because of the carryback exceeds the hypothetical income tax liability for the affected year, the taxpayer is entitled to receive interest only until the due date (not including extensions) of the return for the year in which the carryback arose.

(v) Example. The provisions of this paragraph (d)(2) are illustrated by the following example:

Example. Upon the cessation of income from an income forecast property in 2003, the taxpayer computes a hypothetical income tax liability for 2001 under the look-back method. This computation results in a hypothetical income tax liability (\$1,200x) that is less than the actual income tax liability the taxpayer originally reported (\$1,500x). In addition, the taxpayer had already received a refund of some or all of the actual 2001 income tax liability by carrying back a net operating loss (NOL) that arose in 2002. The time period over which interest would be computed on the hypothetical overpayment of \$300x for 2001 would depend on the amount of the refund generated by the carryback, as illustrated by the following three alternative situations:

(i) If the amount refunded because of the NOL is \$1,500x, interest is credited to the taxpayer on the entire hypothetical overpayment of \$300x from the due date of the 2001 return, when the hypothetical overpayment occurred, until the due date of the 2002 return, when the taxpayer received a refund for the entire amount of the 2001 tax, including the hypothetical overpayment.

(ii) If the amount refunded because of the NOL is \$1,000x, interest is credited to the taxpayer on the entire amount of the hypothetical overpayment of \$300x from the due date of the 2001 return, when the hypothetical overpayment occurred, until the due date of the 2003 return. In this situation interest is credited until the due date of the return for the recomputation year, rather than the due date of the return for the year in which the carryback arose, because the amount refunded was less than the hypothetical income tax liability of \$1,200x. Therefore, no portion of the hypothetical overpayment is treated as having been refunded to the taxpayer before the recomputation year.

(iii) If the amount refunded because of the NOL is \$1,300x, interest is credited to the taxpayer on \$100x (\$1,300x-\$1,200x) from the due date of the 2001 return until the due date of the 2002

return because only this portion of the total hypothetical overpayment is treated as having been refunded to the taxpayer before the recomputation year. However, the taxpayer did not receive a refund for the remaining \$200x of the overpayment at that time and, therefore, is credited with interest on \$200x through the due date of the tax return for 2003, the recomputation year.

(3) Hypothetical overpayment or underpayment, simplified method--(i) Introduction. This paragraph provides a simplified method for calculating look-back interest. A pass-through entity that is not a closely held pass-through entity is required to apply the simplified method at the entity level with respect to income forecast property and the owners of the entity do not calculate look-back interest for the property. Under the simplified method, a taxpayer calculates the hypothetical underpayments or overpayments of tax for a prior year based on an assumed marginal tax rate.

(ii) Operation of the simplified method. Under the simplified method, depreciation allowances for income forecast property are first recomputed in accordance with the procedures contained in paragraph (c) of this section. These recomputed depreciation allowances are then compared with depreciation allowances allowed (or allowable) for each prior taxable year (whether originally reported, as subsequently adjusted on examination or by amended return, or as recomputed in the most recent previous application of the look-back method) to arrive at changes in depreciation allowances for the income forecast property. When multiple properties are subject to the look-back method in any given affected year, the changes in depreciation allowances attributable to each income forecast property determined in accordance with paragraph (c) of this section for each such year are cumulated or netted against one another to arrive at a net change in income forecast depreciation for purposes of computing the hypothetical overpayment or underpayment attributable to the year. The hypothetical underpayment or overpayment of tax for each affected

year is then determined by multiplying the applicable regular tax rate (as defined in paragraph (d)(3)(iv) of this section) by the increase or decrease in depreciation allowances.

(iii) Determination of interest. Interest is credited to the taxpayer on the net overpayment and is charged to the taxpayer on the net underpayment for each affected year by applying the adjusted overpayment rate under section 460(b)(7), compounded daily, to the overpayment or underpayment determined under paragraph (d)(3)(ii) of this section for the period beginning with the due date of the return (determined without regard to extensions) for the affected year, and ending on the earlier of the due date of the return (determined without regard to extensions) for the recomputation year, or the first date by which both the income tax return for the recomputation year is filed and the tax for that year has been paid in full. The resulting amounts of interest are then netted to arrive at look-back interest that must be paid by the taxpayer or that the taxpayer is entitled to receive.

(iv) Applicable tax rate. For purposes of determining hypothetical underpayments or overpayments of tax under the simplified method, the applicable regular rate is generally the highest rate of tax in effect for corporations under section 11. However, the applicable regular tax rate is the highest rate of tax imposed on individuals under section 1 if, at all times during all affected years, more than 50 percent of the interests in the entity were held by individuals directly or through 1 or more pass-through entities. The highest rate of tax imposed on individuals is determined without regard to any additional tax imposed for the purpose of phasing out multiple tax brackets or exemptions.

(4) Definitions--(i) Pass-through entity. For purposes of this section, a pass-through entity is either a partnership, an S corporation, an estate or a trust.

(ii) Closely-held pass-through entity. A closely-held pass-through entity is a pass-through entity that, at any time during any year for which allowances for depreciation are recomputed, 50 percent or more (by value) of the beneficial interests in that entity are held (directly or indirectly) by or for 5 or fewer persons. For this purpose, the term person has the same meaning as in section 7701(a)(1), except that a pass-through entity is not treated as a person. In addition, the constructive ownership rules of section 1563(e) apply by substituting the term beneficial interest for the term stock and by substituting the term pass-through entity for the term corporation used in that section, as appropriate, for purposes of determining whether a beneficial interest in a pass-through entity is indirectly owned by any person.

(e) Recomputation year--(1) In general. Except as provided in this paragraph (e), the term recomputation year means, with respect to any income forecast property--

(i) The earlier of--

(A) The year the income from the income forecast property ceases with respect to the taxpayer (and with respect to any person who would be treated as a single taxpayer with the taxpayer under rules similar to those in section 41(f)(1)); or

(B) The 3<sup>rd</sup> taxable year beginning after the taxable year in which the income forecast property was placed in service; and

(ii) The earlier of--

(A) The year the income from the income forecast property ceases with respect to the taxpayer (and with respect to any person who would be treated as a single taxpayer with the taxpayer under rules similar to those in section 41(f)(1)); or

(B) The 10<sup>th</sup> taxable year following the taxable year the income forecast property is placed in

service.

(2) Look-back method inapplicable in certain de minimis cases-- (i) De minimis difference between actual and forecasted income. A taxable year described in paragraph (e)(1) of this section is not a recomputation year if forecasted total income (as defined in §1.167(n)-3(b)) or, where applicable, revised forecasted total income (as defined in §1.167(n)-3(c)), for each preceding taxable years is--

(A) Greater than 90 percent of revised forecasted total income for the taxable year that would otherwise be a recomputation year; and

(B) Less than 110 percent of revised forecasted total income for the taxable year that would otherwise be a recomputation year.

(ii) Application of the de minimis rule where the look-back method was previously applied.

For purposes of applying paragraph (e)(2)(i) of this section in any taxable year after a taxable year in which the look-back method has previously been applied, revised forecasted total income for the year the look-back method was applied, forecasted total income for the year the income forecast property was placed in service, and revised forecasted total income for all taxable years preceding the taxable year in which the look-back method was previously applied are deemed to be equal to the amount of revised forecasted total income that was used for purposes of applying the look-back method in the most recent taxable year for which the look-back method was applied.

(f) De minimis basis exception. The look-back method does not apply to any income forecast property with an adjusted basis, determined in accordance with section 1011 but without regard to the adjustments described in section 1016(a)(2) and (3), as of the close of any year that would

otherwise be a recomputation year of \$100,000 or less.

(g) Treatment of look-back interest--(1) In general. The amount of interest a taxpayer is required to pay is treated as an income tax under Subtitle A of the Internal Revenue Code, but only for purposes of Subtitle F of the Internal Revenue Code (other than sections 6654 and 6655), which addresses tax procedure and administration. Thus, a taxpayer that fails to report look-back interest when due is subject to any penalties under Subtitle F of the Internal Revenue Code applicable to a failure to report and pay a tax liability. However, look-back interest to be paid is treated as interest arising from an underpayment of tax under Subtitle A of the Internal Revenue Code, even though it is treated as an income tax liability for penalty purposes. Thus, look-back interest required to be paid by an individual, or by a pass-through entity on behalf of an individual owner (or beneficiary) under the simplified method, is personal interest and, therefore, is not deductible in accordance with §1.163-9T(b)(2). Interest received under the look-back method is treated as taxable interest income for all purposes, and is not treated as a reduction in tax liability. The determination of whether interest computed under the look-back method is treated as income tax under Subtitle A of the Internal Revenue Code is determined on a net basis for each recomputation year. Thus, if a taxpayer computes both hypothetical overpayments of tax and hypothetical underpayments of tax for years prior to any given recomputation year, the taxpayer has an increase in tax only if the total interest computed on underpayments for all prior taxable years for which income tax liability is affected by the application of the look-back method exceeds the total interest computed on overpayments for such years, taking into account all income forecast property for which the look-back method is required. Interest determined at the entity level under the simplified method is allocated among the owners (or beneficiaries) for reporting

purposes in the same manner that interest income and interest expense are allocated to owners (or beneficiaries) and subject to the allocation rules applicable to such entities.

(2) Additional interest due on interest only after tax liability due. For each recomputation year, taxpayers are required to file a Form 8866, "Interest Computation Under the Look-back Method for Property Depreciated Under the Income Forecast Method," at the time the return for that recomputation year is filed to report the interest a taxpayer is required to pay or entitled to receive under the look-back method. Even if the taxpayer has received an extension to file its income tax return for the recomputation year, look-back interest is computed with respect to the hypothetical increase (or decrease) in the tax liability determined under the look-back method only until the initial due date of that return (without regard to the extension). Interest is charged, unless the taxpayer otherwise has a refund that fully offsets the amount of interest due, (or credited) with respect to the amount of look-back interest due (or to be refunded) under the look-back method from the initial due date of the return through the date the return is filed. No interest is charged (or credited) after the due date of the return with respect to the amount of the hypothetical increases (or decreases) in tax liability determined under the look-back method.

(3) Timing of look-back interest. For purposes of determining taxable income under Subtitle A of the Internal Revenue Code, any amount refunded to the taxpayer as a result of the application of the look-back method is includible in gross income in accordance with the taxpayer's method of accounting for interest income. Any amount required to be paid is taken into account as interest expense arising from an underpayment of income tax in the tax year it is properly taken into account under the taxpayer's method of accounting for interest expense.

(4) Statute of limitations; compounding of interest on look-back interest. For guidance on the

statute of limitations applicable to the assessment and collection of look-back interest owed by a taxpayer, see sections 6501 and 6502. A taxpayer's claim for credit or refund of look-back interest previously paid by or collected from a taxpayer is a claim for credit or refund of an overpayment of tax and is subject to the statute of limitations provided in section 6511. A taxpayer's claim for look-back interest (or interest payable on look-back interest) that is not attributable to an amount previously paid or collected from a taxpayer is a general claim against the federal government. For guidance on the statute of limitations that applies to general claims against the federal government, see 28 U.S.C. 2401 and 2501. For guidance applicable to the compounding of interest when the look-back interest is not paid, see sections 6601 to 6622.

(h) Example. The provisions of this section are illustrated by the following example:

Example. (i) H, a calendar year corporation, creates a motion picture at a cost of \$60x. H completes the motion picture in 2001 and begins exhibition of the film that same year. Assume that \$60x is greater than \$100,000. In 2001, H anticipates that it will earn \$200x from the motion picture (net of distribution costs). H therefore uses this amount as Forecasted Total Income when computing depreciation allowances for the motion picture.

(ii) H earns current year income of \$80x in 2001, \$60x in 2002, and \$40x in 2003. During the period from 2001 to 2004, one of the actors who appeared in H's film became more popular, and this increase in the actor's popularity increased the demand for H's film. In 2004, therefore, H revised its forecast of income from the film upward to \$240x. H earns \$20x in 2004 from the motion picture and \$10x in 2005.

(iii) Based on these facts, H's allowances for depreciation for the motion picture for 2001 would be \$24x, computed by multiplying the depreciable basis of the motion picture of \$60x by current year income of \$80x divided by forecasted total income of \$200x under §1.167(n)-4(a). Similarly, H's allowances for depreciation for the motion picture for 2002 would be \$18x, computed by multiplying the depreciable basis of the motion picture of \$60x by current year income of \$60x divided by forecasted total income of \$200x, and H's allowances for depreciation for the motion picture for 2003 would be \$12x, computed by multiplying the depreciable basis of the motion picture of \$60x by current year income of \$40x divided by forecasted total income of \$200x.

(iv) In 2004, H determines revised forecasted total income of \$240x in accordance with

§1.167(n)-3(c). Because revised forecasted total income in 2004 of \$240x is greater than 110 percent of forecasted total income used in computing the allowance for depreciation in the immediately preceding year (110 percent of \$200x equals \$220x), H is required under §1.167(n)-4(b)(2) to compute the allowance for depreciation in 2004 and thereafter using the revised computation. H first computes its unrecovered depreciable basis in the motion picture under §1.167(n)-2(c) of \$6x by subtracting from the depreciable basis of \$60x the depreciation allowances for 2001, 2002, and 2003 of \$24x, \$18x, and \$12x. H then multiplies the unrecovered depreciable basis of \$6x by the current year income for 2004 of \$20x divided by \$60x (revised forecasted total income \$240x less current year income for all years prior to 2004 (\$80x + \$60x + \$40x or \$180x), resulting in a depreciation allowance for 2004 of \$2x.

(v) In 2005, H is required to use the revised computation because H used it in 2004. Thus, H multiplies the unrecovered depreciable basis of \$6x times current year income for 2005 of \$10x divided by \$60x (revised forecasted total income as computed in 2004), resulting in a depreciation allowance for 2005 of \$1x.

(vi) Thus, H's allowances for depreciation may be summarized as follows:

| Year | Current Year Income | Forecasted Total Income | Revised Forecasted Total Income | Depreciable Basis | Unrecovered Depreciable Basis | Depreciation Allowance |
|------|---------------------|-------------------------|---------------------------------|-------------------|-------------------------------|------------------------|
| 2001 | 80x                 | 200x                    |                                 | 60x               |                               | 24x                    |
| 2002 | 60x                 | 200x                    |                                 | 60x               |                               | 18x                    |
| 2003 | 40x                 | 200x                    |                                 | 60x               |                               | 12x                    |
| 2004 | 20x                 |                         | 240x                            |                   | 6x                            | 2x                     |
| 2005 | 10x                 |                         | 240x                            |                   | 6x                            | 1x                     |

(vii) Under paragraph (e)(1)(i)(B) of this section, 2004 is a recomputation year (because 2004 is the third taxable year after the year in which the motion picture was placed in service) unless a de minimis rule applies. The de minimis rule in paragraph (e)(2) of this section does not apply in 2004 because forecasted total income of \$200x used in the computation of income forecast depreciation in 2001, 2002 and 2003 is not greater than 90 percent of year 2004 revised forecasted total income of \$240x (90 percent of \$240x = \$216x). Thus, H must apply the look-back method for 2004.

(viii) If H sells the motion picture in 2006 for \$25x prior to earning any current year income from the motion picture, H would not be entitled to any allowance for depreciation in 2006. (The special rule of §1.167(n)-3(d)(1) precludes H from including income from the sale of the motion picture in current year income, H has no other current year income, and §1.167(n)-4(d)(3)

precludes the use of the final year depreciation rule of §1.167(n)-4(d)(1)). Under paragraph (e)(1)(ii)(A) of this section, 2006 is a recomputation year (because in 2006 the income from the property to H ceases) unless a de minimis rule applies.

(ix) To determine whether the de minimis rule applies, H is required to determine revised forecasted total income for 2006. Under paragraph (c)(2) of this section, revised forecasted total income for 2006 is deemed to be the sum of current year income for the years 2001 - 2006 of \$210x (\$80x + \$60x + \$40x + \$20x + \$10x + \$0x) plus the amount realized from the sale of the motion picture of \$25x or \$235x. Revised forecasted total income for 2005 is \$240x, and pursuant to paragraph (e)(2)(ii) of this section, revised forecasted total income for the years 2001 - 2004 is deemed (for purposes of determining whether 2006 is a recomputation year) to be the amount of revised forecasted total income used in the 2004 application of the look-back method of \$240x. Because \$240x is greater than \$212x (90 percent of \$235x) and less than \$259x (110 percent of \$235x), the de minimis rule applies and H is not required to apply the look-back method in 2006.

§1.167(n)-7 Effective date.

The regulations under §1.167(n)-1 through §1.167(n)-6 are applicable for property placed in service on or after the date that final regulations are published in the **Federal Register**.

Robert E. Wenzel

Deputy Commissioner of Internal Revenue.