

**WEST VIRGINIA  
SECRETARY OF STATE  
JOE MANCHIN, III  
ADMINISTRATIVE LAW DIVISION**

Form #2

Do Not Mark In This Box

**FILED**

2003 MAY 29 A 10: 25

OFFICE WEST VIRGINIA  
SECRETARY OF STATE

**NOTICE OF A COMMENT PERIOD ON A PROPOSED RULE**

AGENCY: STATE LOTTERY COMMISSION TITLE NUMBER: 179

RULE TYPE: LEGISLATIVE CITE AUTHORITY: W.VA. CODE 29-22B-402

AMENDMENT TO AN EXISTING RULE: YES  NO

IF YES, SERIES NUMBER OF RULE BEING AMENDED: 5

TITLE OF RULE BEING AMENDED: LIMITED VIDEO LOTTERY RULE

IF NO, SERIES NUMBER OF RULE BEING PROPOSED: \_\_\_\_\_

TITLE OF RULE BEING PROPOSED: \_\_\_\_\_

IN LIEU OF A PUBLIC HEARING, A COMMENT PERIOD HAS BEEN ESTABLISHED DURING WHICH ANY INTERESTED PERSON MAY SEND COMMENTS CONCERNING THESE PROPOSED RULES. THIS COMMENT PERIOD WILL END ON JUNE 30, 2003 AT 5:00 P.M. ONLY WRITTEN COMMENTS WILL BE ACCEPTED AND ARE TO BE MAILED TO THE FOLLOWING ADDRESS:

Director, WV Lottery  
P.O. Box 2067  
Charleston WV  
25327-2067

THE ISSUES TO BE HEARD SHALL BE LIMITED TO THIS PROPOSED RULE.

*Eric Y. Koster*  
Authorized Signature

ATTACH A **BRIEF** SUMMARY OF YOUR PROPOSAL

**QUESTIONNAIRE**

*(Please include a copy of this form with each filing of your rule: Notice of Public Hearing or Comment Period; Proposed Rule, and if needed, Emergency and Modified Rule.)*

DATE: MAY 20, 2003

TO: LEGISLATIVE RULE-MAKING REVIEW COMMITTEE

FROM: *(Agency Name, Address & Phone No.)* STATE LOTTERY COMMISSION

312 MacCORKLE AVENUE 25314

CHARLESTON WV 25314

LEGISLATIVE RULE TITLE: 179-5 LIMITED VIDEO LOTTERY RULE

1. Authorizing statute(s) citation W.VA. CODE 29-22B-402

2. a. Date filed in State Register with Notice of Hearing or Public Comment Period:

b. What other notice, including advertising, did you give of the hearing?

NEWSLETTER TO LICENSEES

c. Date of Public Hearing(s) *or* Public Comment Period ended:

JUNE 30, 2003

d. Attach list of persons who appeared at hearing, comments received, amendments, reasons for amendments.

Attached \_\_\_\_\_ No comments received \_\_\_\_\_

e. Date you filed in State Register the agency approved proposed Legislative Rule following public hearing: (be exact)

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f. **Name, title, address and phone/fax/e-mail numbers** of agency person(s) to receive all *written correspondence* regarding this rule: (Please type)

JOHN C. MUSGRAVE, DIRECTOR OF THE STATE LOTTERY OFFICE

314 MacCORKLE AV., CHARLESTON WV 25314

558-0500 fax 558-3321 jmusgrave@wvlottery.com

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g. **IF DIFFERENT FROM ITEM 'f'**, please give **Name, title, address and phone number(s)** of agency person(s) who wrote and/or has responsibility for the contents of this rule: (Please type)

JOHN MELTON, IN-HOUSE ATTORNEY

314 MacCORKLE AVENUE, CHARLESTON WV 35314

558-1845 fax 558-3321 jmelton@wvlottery.com

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3. If the statute under which you promulgated the submitted rules requires certain findings and determinations to be made as a condition precedent to their promulgation:

a. Give the date upon which you filed in the State Register a notice of the time and place of a hearing for the taking of evidence and a general description of the issues to be decided.

N/A

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b. Date of hearing or comment period:

N / A

c. On what date did you file in the State Register the findings and determinations required together with the reasons therefor?

N / A

d. Attach findings and determinations and reasons:

Attached N / A

**Proposed Amended  
WEST VIRGINIA  
LEGISLATIVE RULE  
WEST VIRGINIA LOTTERY  
TITLE 179  
SERIES 5  
2004**

**LIMITED VIDEO LOTTERY RULE**

**A BRIEF SUMMARY of the PROPOSED RULE AS AMENDED:**

The first Extraordinary Session of the 2001 West Virginia Legislature enacted new article 29-22B to restrict, reduce and regulate the illegal use of video poker machines in the state. The Limited Video Lottery Rule is proposed to regulate this issue. Rule 179-5 became effective initially on July 1, 2002. Early in 2003, the Commission adopted an emergency amendment to the rule and a companion legislative rule amendment; that change defining "petroleum products" is also included in this summary.

1. The Director proposes to add a definition for the term "petroleum products" as those words appear in §29-22B-328(b) of the West Virginia Code; this change is found in section 179-5-2.15.
2. The Director proposes to add a definition for the term "incomplete application" [ §179-5-2.9 ] as the term is used in W.Va. Code §29-22B-509. The additional definition will specify that incomplete applications are those that have not included one or more of the required elements for licensure:
  - a. Fingerprint information;
  - b. All lottery forms completely filled in;
  - c. Payment of the non-refundable fee for license; and
  - d. An ABCC private club liquor license number or class 'A' beer license number.
3. The Director proposes to add a definition for "resident of this state" [ §179-5-2.17 ] to reference the five statutory conditions and state that any person meeting at least four of these requirements shall be considered a resident for limited video lottery licensing purposes.
4. The Lottery has a problem with the so-called "grandfathering" of retailers under the 150-foot restriction in W.Va. Code §29-22B-1202. These places have begun to surrender their licenses so that nearby buildings, owned in some cases by the same operator, may be licensed. Then the surrendering licensee will reapply for a license under the 180-day provision of §179-5-20.2. The Director proposes to amend rule §179-5-20.2 to prevent any new bar closer than 151 feet to a "grandfathered" bar from being licensed until after the 180-day waiting period expires.
5. The Director proposes to define the terms "advertising and promotion" [ §§179-5-2.1 and 34 ] as they are used in §29-22B-702(13) and 706(12) and to ban the use of gambling terms and symbols in the business names of retail licensees.
6. The Director proposes to define the term "operating video lottery terminals" as the term is used in Rule §179-5-27.1.

7. The Director proposes to add a new rule §179-5-30 dealing with calculation of the municipal/state share of gross profit because the statute now talks about 2% of "net terminal income." The Director is giving the local governments 2% of "gross profits", and the new section would make that clear.
8. The Director proposes to amend §179-5-5 to make it clear that there is a blanket bond now in effect for all retailers, and individual bonds are no longer proper.
9. The Director proposes to "sunset" the "certificates of reservation" that were issued in the fall of 2001 but have never been converted to permits. About 200 video lottery terminals are involved. The Director's proposed sunset date would be December 31, 2004.
10. Now that the Lottery and the State Police have agreed to institute electronic fingerprinting and review, the requirement for all-new fingerprint cards as a condition of annual license renewal is not necessary. The Director proposes the Commission will say so in new §179-5-4.3.
11. The Director proposes to establish a grace period for permit holders that have more machines than permits because one or more certificate-of-reservation permits were lost when the certificate's retailer went out of business. They should not be subject to any penalty until after the next permit bid event or 100 days, whichever first occurs.

**WEST VIRGINIA  
LEGISLATIVE RULE  
PROPOSED AMENDMENT  
WEST VIRGINIA LOTTERY  
TITLE 179  
SERIES 5  
2004**

**LIMITED VIDEO LOTTERY RULE**

A STATEMENT of CIRCUMSTANCES WHICH REQUIRE THIS RULE TO BE AMENDED:

The Commission was granted the following powers in W.Va. Code §29-22B-402(6 and (7):

*(6) To conduct a continuous study and investigation of limited video lottery throughout the state (A) to ascertain any defects in this article or in legislative rules that may conflict with the purposes of this article, (B) to discover any abuses in the administration, control and oversight of limited video lottery or (C) to discover any violation of this article or applicable legislative rules;*

*(7) To formulate and recommend proposed legislation amending this article or any applicable legislative rule so as to increase the efficiency and effectiveness of this article;*

The changes outlined in the companion document titled *A BRIEF SUMMARY OF THE PROPOSED RULE AS AMENDED* resulted from the Commission's observance of the system as set in place and its desire to correct observed defects in the system.

□  
APPENDIX B

FISCAL NOTE FOR PROPOSED RULES

Rule Title: 179 CSR 5 -- LIMITED VIDEO LOTTERY RULE

Type of Rule:  Legislative     Interpretive     Procedural

Agency: THE WEST VIRGINIA STATE LOTTERY COMMISSION

Address: P.O. BOX 2067

CHARLESTON WV 25327-2067

1. Effect of Proposed rule:

	ANNUAL FISCAL YEAR				
	INCREASE	DECREASE	CURRENT	NEXT	THEREAFTER
ESTIMATED TOTAL COST	\$2,911,164		-- 0 --	\$2,911,164	\$2,475,472
PERSONAL SERVICES	1,698,164			1,698,164	1,698,164
CURRENT EXPENSE	542,400			542,400	542,400
REPAIRS & ALTERATIONS					
EQUIPMENT	520,600			520,600	
OTHER	150,000			150,000	150,000

2. Explanation of Above Estimates:

47 new employees: 1 new program manager, 24 investigators II, 2 licensing clerks, 2 accountant II's, 6 auditors II, 2 information services coordinators II 6 computer operators II, 1 attorney II, 1 payroll assistant, 1 internal auditor III and 1 marketing program specialist. "Other" is for the mandatory contribution to a compulsive gambling program.

3. Objectives of These Rules:

To regulate and collect state revenue from the 9,000 limited video lottery terminals in adult environments.

Rule Title: Limited Video Lottery

4. Explanation of Overall Economic Impact of Proposed Rule:

A. Economic Impact on State Government:

The State of West Virginia will gain \$31 million from limited video lottery in fiscal year 2002, and \$121 million in fiscal year 2003.

B. Economic Impact on Political Subdivisions; Specific Industries; Specific Groups of Citizens:

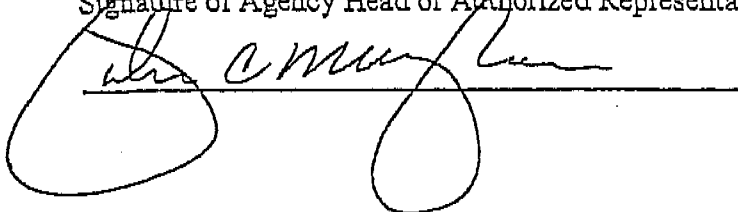
Cities and counties will share \$900,000 in fiscal year 2002, and thereafter \$5.6 million per year. Persons licensed as limited video lottery operators and limited video lottery retailers will share \$32.6 million in fiscal year 2002 and thereafter, \$163 million per year.

C. Economic Impact on Citizens/Public at Large.

Citizens will benefit from government programs funded by this new revenue source.

Date: June 12, 2001

Signature of Agency Head or Authorized Representative:

  
\_\_\_\_\_

TITLE 179  
AMENDMENT TO A  
LEGISLATIVE RULE

FILED

2003 MAY 29 A 10: 25

WEST VIRGINIA LOTTERY  
SERIES 5  
LIMITED VIDEO LOTTERY RULE

OFFICE WEST VIRGINIA  
SECRETARY OF STATE

**§179-5-1. General.**

1.1. Scope and Purpose. - The purpose of this legislative rule is to implement, clarify and explain provisions of the Limited Video Lottery Act codified in W. Va. Code § 29-22B-101.

1.2. Authority. - W. Va. Code - §29-22B-402

1.3. Filing Date. -

1.4. Effective Date. -

**§179-5-2 Definitions of terms and words.**

2.1. "Advertising" as used in West Virginia Code §29-22B-702(13) and §29-22B-706(12) means a media advertisement, an outdoor sign, or a sign inside the licensee's premises that may be seen from the outside of the premises, that conveys to the average reader or hearer that limited video lottery gaming is available at the retail establishment or from the licensed operator.

2.2. "ABCC" means the office and agency known as the alcohol beverage control commissioner created in W. Va. Code § 60-2-1.

2.3. "Act" and "the act" mean the Limited Video Lottery Act codified in W. Va. Code § 29-22B-1 *et seq.*

2.4. "Central computer", "central control computer" or "central site system" means any central site computer provided to and controlled by the commission to which video lottery terminals communicate for purposes of information retrieval and terminal activation and to disable programs. "Central computer" includes the computer at the commission's hot backup site when it is functioning as the central control computer.

2.5. "Control" means the authority to direct the management and policies of an applicant for a license or a holder of a license. The following persons are considered to have control of an applicant:

2.5.a. Each person associated with a corporate applicant, including any corporate holding company, parent company or subsidiary company of the applicant, except that:

2.5.a.1 A bank or other licensed lending institution that holds a mortgage or other lien acquired in the ordinary course of business does not have control of the applicant;

2.5.a.2 An investment advisor who is registered with the United States Securities and Exchange Commission and whose beneficial interest in the applicant is held strictly for investment purposes, who has the ability to control the activities of the corporate applicant or to elect a majority of the board of directors of that corporation does not have control of the applicant; and

2.5.a.3 An institutional investor who is registered with the United States

Securities and Exchange Commission and whose beneficial interest in the applicant is held strictly for investment purposes, who has the ability to control the activities of the corporate applicant or to elect a majority of the board of directors of that corporation. The applicant or licensee has the burden of proving that the interest is held for investment and not for direct or indirect control of the applicant or licensee; and

2.45.b. Each person associated with a noncorporate applicant who directly or indirectly holds any beneficial or proprietary interest in the applicant or who the commission determines to have the ability to control the applicant; and

2.45.c. Key personnel of an applicant, including any executive, employee or agent, having the power to exercise significant influence over decisions concerning any part of the applicant's business operation.

2.56. "Filed timely personal income tax returns," only for the purpose of determining whether a person is a resident of the state of West Virginia for purposes of licensing under the Limited Video Lottery Act and for no other purpose whatsoever, means the West Virginia personal income tax return of a person who is required by subdivision 2.4 of this rule to qualify as a four year resident of West Virginia was either filed or not filed under one of the following circumstances:

2.56.a The returns were filed for each of the four years preceding the filing of the application for licensure and for each year subsequent to licensure by the last day of the calendar or fiscal year in which the return or returns were due including any authorized extension of time;

2.56.b The person was not required to file a West Virginia personal income tax return because the low-income earned income exclusion applies (federal adjusted gross income is \$10,000 or less and earned income is \$10,000 or less). In this case, no West Virginia personal income tax return is required unless the difference between federal adjusted gross income and the amount of earned income excluded exceeds the amount of the allowable personal exemptions;

2.56.c The person was required to file a federal income tax return for the taxable year, but the person was not required to file a West Virginia personal income tax return for the same taxable year because the person was claimed as a deduction on his or her parent's income tax return for the taxable year;

2.56.c.1 In this case, the personal exemption available to the child is \$500 and not \$2,000; and

2.56.c.2 A child with West Virginia adjusted gross income in excess of \$500 is required to file a West Virginia personal income tax annual return except when the low-income earned income exclusion reduces West Virginia adjusted gross income to \$500 or less; or

2.56.d The person was not able to comply with subdivision 'a' of subsection 2.5 of this rule due to circumstances beyond the control of the person, and the inability to comply was not, in the determination of the commission, the result of a willful act or neglect by the person;

2.56.d.1 If the commission determines that the applicant relied on a paid tax preparer, the return will be considered timely filed when filed within six months beyond the limit set forth in subdivision 2.56.a if the paid preparer submits an affidavit to the commission, on a form acceptable to the commission, stating the applicant's return was not filed within twelve months of the end of the taxable year due to an error or omission on the part of the paid preparer; or

2.56.d.2 If the commission determines that the applicant's financial records were destroyed by fire, flood or other natural or man-made disaster, the return will be considered timely filed when filed.

2.67. "Gross profits" means the portion of gross terminal income collected by the commission from the permittee that remains after the commission deducts two percent of gross terminal income for administrative expenses.

2.78. "Gross terminal income" means the total amount of cash inserted into video lottery terminals operated by a licensee, minus the total value of game credits which are cleared from the video lottery terminals in exchange for winning redemption tickets printed by the video lottery terminals. Gross terminal income may also be determined by subtracting total credits won from total credits played. Either method will yield the same gross terminal income for the period.

2.9. "Incomplete applications" as used in W.Va. Code §29-22B-509(b) means applications that have not included one or more of the required elements for licensure:

2.9.a. Fingerprint information;

2.9.b. All lottery forms completely filled in;

2.9.c. Payment of the non-refundable fee for license; and

2.9.d. An ABCC private club liquor license number or class 'A' nonintoxicating beer license number.

2.810. "Indirect ownership" means an interest a person owns in an entity or in property solely as a result of application of constructive ownership rules without regard to any direct ownership interest (or other beneficial interest) in the entity or property. "Indirect ownership" shall be determined under the rules applicable to determining whether a gain or loss between related parties is recognized for federal income tax purposes provided in section 267 of the Internal Revenue Code and regulations of the Secretary of the United States Treasury.

2.911 "License" or "video lottery license" means the written authorization granted by the commission pursuant to the Act and this rule that permits the person named in the license to engage in the activity for which the license was issued during the period of time for which the license was issued, unless the license is surrendered by the licensee, or is cancelled or revoked by the director or the commission, before its expiration date. The activity for which the license was issued may not be engaged in during any period of time for which the license has been suspended by the director or the commission. The commission issues four types of licenses: (A) a limited video lottery retailer's license, (B) a manufacturer's license, (C) an operator's license and (D) a service technician's license.

2.1012. "Modified terminal not approved by the commission" as used in subsection 15.1 of this rule, means a video lottery terminal whose assembly or operational functions are not identical to the video lottery terminal that was tested by the commission's independent testing laboratory and approved by the commission for sale or lease to a permittee in West Virginia

2.13. "Operating video lottery terminals" as the term is used in section 27.1 of this rule means terminals that are accepting and processing limited video lottery wagers in a day. A video lottery terminal that does not accept and process any limited video lottery wagers during a day will not be counted as operating on day.

2.114. "Other act beyond the control of the permittee," as used in W.Va. Code §29-22B-1113(b), means a natural or man-made occurrence that was not caused by any person having direct or indirect ownership or control of the permittee. These occurrences include, but are not limited to, the following:

2.114.1. Failure of the electric power utility, the telephone utility, the water utility or the natural gas utility to provide electric power, telephone service, water or (if needed) natural gas to the restricted access adult-only facility;

2.114.2. The rendering of the restricted access adult-only facility uninhabitable by reason of smoke or water damage from a fire in an adjacent location of the building or structure in which the restricted access adult-only facility is located;

2.114.3. A declaration of a civil emergency that closes the premises in which the restricted access adult-only facility is located; or

2.114.4. A hardware or software malfunction in a video lottery terminal that can be corrected only by the licensed manufacturer that built the video lottery terminal, if the malfunction is

registered by the manufacturer with the commission before the downtime limit expires.

2.15. "Petroleum products" as used in W.Va. Code §29-22B-328(b) and elsewhere in this rule means gasoline and special fuels as those terms are defined by W.Va. Code §11-14-2.

~~2.1216.~~ "Pin ball machine" as it appears in W.Va. Code §29-22B-331 means an electro-mechanical amusement device in which a solid metal ball propelled by a plunger scores points as it rolls down a slanting surface among pins and targets. Flippers located on each side of the slanted surface allow the person playing the machine to keep the ball in play thereby scoring more points. "Pinball machine" does not include any electronic simulation that does not use a mechanical plunger, mechanical flippers or a physical solid metal ball to operate the game.

2.17. "Resident of this state" as used in W.Va. Code §29-22B-327 means an individual who qualifies as a resident of West Virginia under at least four of the five tests listed in W.Va. Code §29-22B-327.

~~2.1418.~~ "Restricted access adult-only facility" means and is limited to:

~~2.1418.a.~~ A private club licensed by the alcohol beverage control commissioner under W. Va. Code § 60-7-1 *et seq.* that is also licensed by the commission as a limited video lottery retailer to allow members and their guests to play video lottery games, subject to the following restrictions:

~~2.1418.a.1.~~ When a private club is frequented by minors and their parents, the private club is not a restricted access adult-only facility unless all of its video lottery terminals are located in a separate room suitable for the location of video lottery terminals with adult-only restricted access, the interior of which is not visible to persons outside the room. The commission shall determine whether the separate room is suitable for the location of video lottery terminals.

~~2.1418.a.2.~~ When a place of business includes a private club licensed under W. Va. Code § 60-7-1 *et seq.* and the place of business sells petroleum products, the private club may not have a limited video lottery retailer's license. This restriction applies even though the video lottery terminals would be located in a separate room, or in a building that is part of, contiguous to or adjoining a place of business that sells petroleum products. This restriction applies even though the private club or the business that sells petroleum products, or both businesses, are located in owned or leased space and even though the private club and the business that sells petroleum products are owned or operated by unrelated parties for purposes of application of section 267 of the Internal Revenue Code.

~~2.1418.b.~~ A place of business that (A) does not sell petroleum products, (B) has a Class "A" nonintoxicating beer license issued by the alcohol beverage control commissioner under W. Va. Code § 11-16-1 *et seq.* allowing the holder to sell nonintoxicating beer for consumption on the premises, and (C) meets all of the following:

~~2.1418.b.1.~~ The business derives at least 40% of its annual gross receipts at that location from sales of nonintoxicating beer to consumers and of the gross receipts from sales of nonintoxicating beer, at least 80% are from sales of nonintoxicating beer for consumption on the premises.

~~2.1418.b.1.A.~~ Example 1. ZXY pizza shop has a Class "A" nonintoxicating beer license. Annual gross receipts at that location from all sources is \$2 million. Of this amount, \$750,000 is from sales of nonintoxicating beer. Because gross receipts from sales of nonintoxicating beer is less than 40 percent of gross receipts from all sales of goods and services, the pizza shop is not eligible for a limited video lottery license.

~~2.1418.b.1.B.~~ Example 2. ZXY pizza shop has a Class "A" nonintoxicating beer license. Annual gross receipts at that location from all sources is \$2 million. Of this amount, \$850,000 is from sales of nonintoxicating beer. Annual gross receipts from sales of nonintoxicating beer for consumption on the premises is \$637,500 while annual gross receipts from sales of nonintoxicating beer for

off-premises consumption is \$212,500. In this example, more than 40 percent of annual gross receipts are from sales of nonintoxicating beer. However, because annual gross receipts from sales of nonintoxicating beer for consumption on the premises is less than 80 percent of gross receipts from all sales of nonintoxicating beer, the pizza shop is not eligible for a limited video lottery license.

2.†418.b.1.C. A business that has a Class “A” nonintoxicating beer license and wants to obtain or retain a limited video lottery license shall make and retain adequate records of its sales of goods and services. At a minimum, the records shall show, for each business location, total annual gross receipts, total annual gross receipts from all sales of nonintoxicating beer and total annual gross receipts from sales of nonintoxicating beer for consumption on the premises. When the business location has a Class “A” nonintoxicating beer license, the records separately shall show for each business day gross receipts derived from sales of nonintoxicating beer for consumption on the premises and gross receipts derived from sales of nonintoxicating beer for consumption off the premises. Whether nonintoxicating beer is sold for consumption on or off the premises is determined at the time nonintoxicating beer is sold to the customer. If nonintoxicating beer is sold for consumption off the premises, the sale is to be recorded as a sale for off-premises consumption even though the customer, after receiving the nonintoxicating beer in a sealed container, opens the container and consumes the product in whole or in part on the premises.

2.†418.b.1.D. In the absence of adequate records, the commission shall presume that annual gross receipts from sales of nonintoxicating beer is less than 40 percent of total annual gross receipts from all sales of goods and services at the business location.

2.†418.b.1.E. When the business does not keep adequate books and records of gross receipts from sales on nonintoxicating beer for consumption on the premises and of gross receipts from sales of nonintoxicating beer for consumption off the premises, the commission shall presume that gross receipts from sales of nonintoxicating beer for consumption on the premises is less than 80 percent of all sales on nonintoxicating beer.

2.†418.b.2. The business maintains a suitable kitchen and dining facility and related equipment for serving meals for on-premises consumption;

2.†418.b.3. The business regularly prepares and sells meals for consumption on the premises;

2.†418.b.4. The business has a separate room suitable for the location of video lottery terminals with adult-only restricted access, the interior of which is not visible to persons outside the room. The commission shall determine whether the separate room is suitable for the location of video lottery terminals; and

2.†418.b.5. The business meets any additional requirement(s) or standard developed by the commission for a Class “A” beer licensee.

2.†519. “Ten days after the date the ticket is printed,” as that phrase is used in subsection 8.1 of this rule, is calculated by excluding the day the ticket was printed and including the tenth subsequent day until the close of video lottery gaming that began on the tenth subsequent day.

### **§179-5-3. Review of continuing eligibility for license.**

3.1. The commission shall determine on a continuing basis the eligibility of licensees to hold a license by one or more of the following means:

3.1.a. The commission shall review the qualifications of each licensee on at least an annual basis;

3.1.b. The commission shall perform spot audits at retailer locations and at operator locations; and

3.1.c. The commission shall review reports of violations discovered by lottery investigators and ABCC inspectors during site visits to locations of operators, limited video lottery retailers and service

technicians.

3.2. Each operator and each limited video lottery retailer shall continue to meet the residency requirements during the period for which the license is issued. If the licensee is a corporation, association, partnership, limited liability company or other legal entity, the chief executive officer and the majority of the officers, directors, partners or members of the entity, both in number and percentage of ownership interest, shall satisfy the residency requirements during the period for which the license is issued

3.3. Each limited video lottery retailer shall continue to hold either a private club license or a class A nonintoxicating beer license issued by the West Virginia alcohol beverage control commissioner;

3.3.a. If the alcohol beverage control commissioner ~~suspends~~ cancels the retailer's private club license or class A nonintoxicating beer license, the director shall disable and cause not to operate the retailer's video lottery terminals at the location where the ABCC license is suspended and shall re-enable the video lottery terminals only when the suspension or cancellation is lifted by the alcohol beverage control commissioner; and

3.3.b. If the alcohol beverage control commissioner revokes the retailer's private club license or class A nonintoxicating beer license, the director shall disable and cause not to operate the retailer's video lottery terminals at the licensed location and shall recommend to the commission that the limited video lottery retailer's license for that location be revoked.

3.4. If any condition that a licensee must meet for licensure changes after a license is granted, other than conditions in subsection 4.3 of this rule, the director shall suspend the license until the condition is corrected, and shall disable and cause not to operate during the period of suspension the licensee's video lottery terminals.

3.5. Renewal of a suspended license and the collection of the annual license fee will be held in abeyance until the reason for the underlying suspension is remedied whenever the limited video lottery license is suspended during the time when limited video licenses are renewed.

3.6. The commission may proceed to revoke the limited video lottery license whenever a suspension lasts longer than 30 days, whether the suspension is by the alcohol beverage control commissioner or by the commission.

#### **§179-5-4. Application forms and other documents.**

4.1. The commission shall approve the forms of application to be used, including, but not limited to:

- 4.1.a. An application form;
- 4.1.b. A personal data form;
- 4.1.c. FBI fingerprint cards; and
- 4.1.d. IRS form 8821 to disclose income tax filings, when necessary.

4.2. All application, registration and disclosure forms and other documents submitted to the lottery commission, by or on behalf of an applicant for purposes of determining qualification for a limited video lottery license, shall be sworn to or affirmed before an officer qualified to administer oaths.

4.3. If the commission and the State Police implement an electronic fingerprint capturing technology, the requirement for submission of fingerprint cards for initial application and license renewal is waived as redundant for persons whose fingerprints are on file with the commission in electronic form.

#### **§179-5-5. Bonding requirements for operators and limited video lottery retailers who are permittees**

5.1. Before any operator or limited video lottery retailer is issued a permit to own or lease video lottery terminals from a licensed manufacturer, the permittee shall post a bond executed by a surety company authorized to transact surety business in West Virginia, or an irrevocable "letter of credit," as defined in W. Va. Code §46-5-103, issued by a national or state bank or other financial institution acceptable to the commission to ensure the performance of the permittee's duties and responsibilities under the Act and this rule and indemnification of the commission.

5.1.a. For the license year beginning the October 1, 2001, the annual bond or irrevocable letter of credit posted shall be in an amount equal to \$1,500 multiplied by the number of video lottery terminal stated in the permit. When an amended permit is issued for additional video lottery terminals, the permittee shall post a supplemental bond or irrevocable letter of credit for the additional lottery terminals or, in the permittee's discretion, a replacement bond or irrevocable letter credit for the number of video lottery terminals stated in the amended permit;

5.1.b. For license years beginning after September 30, 2002, the commission shall obtain a single financial guarantee bond covering all permittees as provided in W. Va. Code §29-22B-515;

5.1.b.1. The commission shall obtain a blanket bond covering all permittees by competitive bidding procedures through the purchasing division of the department of administration and shall apportion the cost of the bond premium among all participating permittees on a per-terminal basis;

5.1.b.2. Each permittee shall participate in the financial guarantee blanket bond program provided by the commission in the amount of at least \$2,000 for each terminal owned or leased by the permittee. The commission shall renew the blanket bond on an annual continuing basis. Bonding premium payments shall be made by electronic funds transfer from the permittee's bank accounts to the commission's revenues and transfers account each year; and

5.1.b.3. If it is determined by the director that one or more permittees should be bonded for an amount and in a form and manner different from the financial guarantee bond of at least \$2,000, or if other security should be provided by the permittee to ensure the performance of the permittee's duties and responsibilities or the indemnification of the commission, the director shall determine and impose the amount, form and manner of the coverage, and shall also report his or her determination to the commission.

5.2. The bond specified in subdivision 5.1.a be issued by a surety company authorized to transact surety business in West Virginia and the company must be approved by the West Virginia insurance commissioner as to solvency and responsibility.

5.3. A permittee who is a video lottery retailer that has permits for two or more restricted access adult-only facilities may post a ~~blanket~~ bond or irrevocable letter of credit until October 1, 2002 for the number of video lottery terminals stated in all permits held by the permittee.

5.4. Whenever a permittee has no valid bond or irrevocable letter of credit or blanket bond under this section, for the amount determined by this section, the commission shall disable and cause not to operate every video lottery terminal of the permittee that is placed in a licensed retail location until the appropriate bond or irrevocable letter of credit is received by the commission and becomes effective.

#### **§179-5-6. Additional duties of limited video lottery retailers.**

6.1. In addition to the additional duties as listed in W. Va. Code §29-22B-702, a limited video lottery retailer shall:

6.1.a. Ensure that the computer controller/validator unit is at all times turned on, supplied with electric power, supplied with paper tape and connected to each limited video lottery terminal and to the telephone connection to the commission's central computer;

6.1.b. Acquire and install one or more security cameras, at least one video cassette recorder,

memory disk or other device that will record the video feed from the security cameras, and the necessary cabling to connect the cameras to the video cassette recorder or other device in the restricted access adult-only facility on the premises of a licensed limited video lottery retailer;

6.1.c. Ensure that security cameras are placed and remain placed in the specific locations that have been approved by the commission, and are not relocated within the facility without the prior written approval of the director;

6.1.d. Ensure that security cameras are correctly aimed at the video lottery terminals and are always operating 24 hours a day;

6.1.e. Ensure that video recorders tied to the security cameras are operating 24 hours a day;

6.1.f. Ensure that videotapes or other storage media are changed when they are completely recorded, and that no tape or other storage media are reused more than the tape or media manufacturer's recommended number of times;

6.1.g. Ensure that videotapes or other storage media are retained for at least 60 days after they are recorded;

6.1.h. Pay for all credits won upon presentment of a valid winning video lottery ticket from a video lottery terminal located on the premises where it is presented for payment;

6.1.i. Clear printer paper jams and bill acceptor jams and replace paper rolls in the printer unit in a competent and timely manner based on training received from a licensed service technician;

**§179-5-7. Additional duties of limited video lottery retailer regarding payment of credits.**

7.1. A limited video lottery ticket must be presented for payment no later than ten days after the date the ticket is printed.

7.1.a. This ten-day calculation will not be extended regardless of whether the tenth day falls on a Saturday, Sunday or legal holiday; and

7.1.b. When an act of God such as a flood renders the video lottery gaming system at a retail location inoperative in the opinion of the West Virginia State Lottery Commission, the ten-day time period will be deemed to be interrupted until such time as the video lottery gaming system is restored to operation.

**§179-5-8. Supplemental duties of manufacturers.**

8.1. In addition to the additional duties imposed on all licensees by W.Va. Code §29-22B-705, a manufacturer shall:

8.1.a. Pay no compensation or inducement of any kind to any operator or retailer, or give or transfer anything of value to any operator or retailer, beyond a nominal consideration of one dollar per year. "Anything of value" does not include the following transactions:

8.1.a.1. A lease agreement for video lottery terminals with the option to purchase the video lottery terminals at the end of the lease term, so long as the terms are reasonable and customary as determined by the commission; and

8.1.a.2. A loan for the purchase of video lottery terminals so long as the terms are reasonable and customary as determined by the commission; and

8.1.b. Prepare training courses for applicants seeking to be licensed as service technicians and prepare and administer course proficiency tests approved by the commission at the conclusion of each course;

**§179-5-9. Supplemental duties of service technicians.**

9.1. In addition to the additional duties imposed on all licensees by W.Va. Code §29-22B-707, a manufacturer shall train retailers and their employees how to clear printer paper jams and bill acceptor jams and replace paper rolls in the printer unit in a competent and timely manner; and

**§179-5-10. Additional requirements for testing of video lottery terminals and associated equipment.**

10.1. The commission shall review and approve one or more independent testing laboratories for the purpose of inspecting and testing video lottery terminals, associated equipment and software to be operated or used in West Virginia under this rule;

10.1.a. Any testing laboratory appointed by the commission for these functions shall, at the time of appointment, have a minimum of 5 years of experience testing video gaming equipment on behalf of government regulators of video gaming devices such as the video lottery terminals regulated by this rule;

10.1.b. The testing laboratories shall report all testing results to the commission, both video lottery terminals, associated equipment and software that comply with the Act and this rule, as well as video lottery terminals, associated equipment and software that do not comply; and

10.1.c. The testing laboratories shall test to assure the commission in writing that the video lottery terminals, associated equipment and software tested comply with all requirements and specifications set forth in the Act and this rule.

10.2. The commission shall require that hardware modifications and modifications of software be submitted to a designated testing laboratory by the commission. Modified hardware and software must be approved by the commission before it may be used in limited video lottery in West Virginia.

10.3. The commission may also require that the manufacturer transport two working models of a video lottery terminal with all components as it will be set up in retail locations, including any associated equipment that may be used, to the designated testing laboratory for testing, examination and analysis. When this is required, the manufacturer shall pay the cost of transportation of one video lottery terminal to lottery headquarters and a second video lottery terminal to the commission's hot backup computer site.

**§179-5-11. Additional video lottery hardware and software specifications not found in W.Va. Code §§29-22B-901 through 912.**

11.1. A video lottery terminal shall not allow more than two dollars to be wagered on a single game; however, the following game options do not violate the two dollar wager limit on a single game because none require the insertion of more than \$2.00 to play the game:

11.1.a. The double-up option in poker games;

11.1.b. The splitting option in blackjack games;

11.1.c. The insurance option in blackjack games; and

11.1.d. The let-it-ride option in blackjack games.

11.2. A video lottery terminal may not be designed or configured to allow more than one individual to use video lottery terminal at the same time.

11.3. Each video lottery terminal must contain a single printing mechanism capable of printing an original ticket and retaining an exact legible copy within the video lottery terminal, or other means of capturing and retaining an electronic copy of the ticket data as approved by the commission for at least eleven days after the ticket is printed;

11.3.a If an impact printer is used by the video lottery terminal, the retained audit tape must be a different color paper from the ticket paper received by the player;

11.3.b If a thermal printer is used and the duplicate information is stored electronically in the video lottery terminal, any duplicate ticket printed by the terminal must have the prominent word "DUPLICATE" printed on the face of the ticket; and

11.3.c In addition to the information required to be printed on the ticket by W.Va. Code §29-22B-905, the unique terminal identification number shall be recorded on the ticket when credits accrued on a video lottery terminal are redeemed for cash.

11.4. The commission shall provide a label for each video lottery prominently displaying information on how to locate and contact persons or organizations available for help, assistance or treatment for persons who may have a gambling addiction, together with the telephone number "1-800-GAMBLER" or another help line telephone number that the commission may later choose.

11.4.a. Each limited video lottery retailer shall conspicuously post the following printed statement provided by the commission in at least 24-pitch type size: "CAUTION - Gambling and playing this machine can be hazardous to your health, your finances, and your future."

**§179-5-12. Only licensed manufacturers may sell or lease video lottery terminals to permittees.**

12.1. Only a licensed manufacturer of video lottery terminals may sell, lease or otherwise transfer ownership or possession of video lottery terminals for use in this state to a person who possesses at the time of delivery a valid permit to own or lease one or more video lottery terminals and a valid operator's license or a valid limited video lottery retailer's license issued by the commission.

12.2. One permittee may not sell, lease or otherwise transfer ownership or possession of a video lottery terminal to another permittee.

12.3. With the prior written approval of the commission, a licensed manufacturer may broker the sale of video lottery terminals it has manufactured from one permittee to another permittee provided the acquiring permittee is authorized by the commission to acquire the video lottery terminals.

**§179-5-13. Modifications to previously approved video lottery terminals.**

13.1. Changes to previously-approved EPROMs, the motherboard or any other hardware within the logic area of the video lottery terminal, as well as coin acceptors, bill acceptors and printers shall be approved in writing by the commission before live wagering at retail locations may occur using any modified hardware or software.

13.2. Changes to previously approved software that affects in any way the operation or payout of a video lottery terminal must be approved in writing by the commission before live wagering at retail locations may occur using any payout.

13.3. Changes to the video lottery terminal cabinet, including all printed material that appears on the cabinet or its clear glass or plastic front must be approved in writing by the director prior to use with the modification;

**§179-5-14. Unapproved video lottery terminals; action on licenses; civil penalty.**

14.1. A video lottery terminal is deemed *prima facie* to be contraband if a manufacturer or other person supplies the video lottery terminal or a video lottery terminal modification to a licensed permittee or license limited video lottery retailer and the new or modified terminal has not been approved by the commission.

14.2. When video lottery terminals have been seized and destroyed as provided in W.Va. Code §29-

22B-1204, the commission shall suspend the licenses of the permittee and the licensed manufacturer for not less than one week or more than five weeks;

14.2.a. When the license of an operator is suspended, the commission shall disable and cause not to operate all video lottery terminals owned or leased by the operator in the state of West Virginia;

14.2.b. When the license of a limited video lottery retailer who is a permittee is suspended, the commission shall disable and cause not to operate all video lottery terminals owned or leased by the licensee at the retail location for which the license was suspended; and

14.2.c. When the license of a manufacturer is suspended, the commission shall disable and cause not to operate all video lottery terminals manufactured by the manufacturer and operating in the state of West Virginia.

14.3. In addition to suspension of licenses, the commission may impose a civil money penalty as provided in W. Va. Code §29-22B-1601.

**§179-5-15. Initial permit fee payment.**

15.1. For persons authorized to own or lease video lottery terminals without going through the bid process, the fee shall initially be paid at the time the permit is issued for the number of video lottery terminals stated on the permit.

15.2. For persons authorized to own or lease video lottery terminals as a result of a bidding process, the amount bid per terminal shall be paid in lieu of the initial \$1,000 per terminal fee.

**§179-5-16. Reservation of authority to have video lottery terminals on or before August 1, 2001 by persons who held a private club license or Class "A" nonintoxicating beer license on January 1, 2001.**

16.1. On or before August 1, 2001, every person who on the January 1, 2001 held a private club license issued as provided W. Va. Code §60-7-1 *et seq.*, or a Class "A" nonintoxicating beer license issued as provided in W. Va. Code §11-16-1 *et seq.*, and who wants to offer video lottery terminals, as defined in this rule, for the enjoyment of the licensee's customers may file an application to be licensed as a limited video lottery retailer under this rule.

16.2. The applications shall be submitted on forms supplied by the director. Each application shall:

16.2.a. Be signed by the applicant or a person authorized to sign the application filed for a person who is not an individual; and

16.2.b. Provide all of the information requested by the commission.

16.3. The commission shall return to the applicant, for completion and re-filing an application that is incomplete in any material respect.

16.4. An application filed on or before August 1, 2001 for a limited video lottery retailer's license shall state the number of video lottery terminals to be located on the premise of the applicant. This number may not exceed 5 video lottery terminals, except that eligible fraternal societies and veterans' organizations may have up to 10 video lottery terminals on the premises for which the limited video lottery license is issued.

16.5. The application shall also elect and state whether the applicant intends to own or lease up to 2 video lottery terminals (up to 7 in the case of eligible fraternal and veterans' organizations) from a licensed manufacturer or obtain them from a licensed operator.

16.6. A licensee who elects to own 2 video lottery terminals (or 7 in the case of certain fraternal and veteran organizations) may obtain additional video lottery terminals from an operator or by being a

successful bidder under W.Va. Code §29-22B-1107 provided the total number of video lottery terminals on the licensee's premises does not exceed the number specified in subsection 16.4 of this section.

16.7. An applicant, upon payment of \$1,000 per video lottery terminal the applicant intends to own or lease, shall be issued a permit to purchase or lease from a licensed manufacturer the number of video lottery terminals stated in the permit if the applicant held a private club license on January 1, 2001, and the applicant elects to own or lease up to 2 video lottery terminals from a licensed manufacturer (or up to 7 video lottery terminals in the case of an eligible fraternal or veterans' organization), and the applicant qualifies as a private club for a limited video lottery license.

16.8. An applicant who intends to own or lease video lottery terminals, upon payment of \$1,000 per video lottery terminal, shall be issued a permit to purchase or lease from a licensed manufacturer the number of video lottery terminals stated in the permit if the applicant held a Class "A" nonintoxicating beer license on January 1, 2001, but did not also hold a private club license on that date for the location for which the application for a limited video lottery retailer's license is submitted.

16.9. The commission, when issuing a limited video lottery retailer's license to an applicant who qualifies as a private club for a limited video lottery license, shall also issue the applicant a certificate reserving up to 2 video lottery terminal authorizations (or up to 7 video lottery terminals authorizations in the case of an eligible fraternal or veterans' organization) as requested in the application filed on or before August 1, 2001 if the applicant held a private club license on January 1, 2001, and the applicant does not elect to own or lease up to 2 video lottery terminals from a licensed manufacturer (or up to 7 video lottery terminal authorizations in the case of an eligible fraternal or veterans' organization);

16.9.a. The applicant may then contract with an operator for video lottery terminals and give the certificate of reservation to the operator; and.

16.9.b. The operator, upon submitting to the commission a true copy of its contract with the licensed video lottery retailer along with the certificate of reservation issued to the retailer by the commission and payment of \$1,000 per video lottery terminal stated in the certificate of reservation shall be issued a permit or an amended permit.

16.9.c. When a retailer that received a certificate of reservation, and has transferred that certificate of reservation to an operator, loses its limited video lottery retailer license, the underlying permit received in exchange for the retailer's certificate of reservation is void after the passage of 100 days for the number of terminals represented by the certificate of reservation.

16.10. When the commission issues a limited video lottery retailer's license to an applicant who held a Class "A" nonintoxicating beer license on January 1, 2001, but did not also hold a private club license on that date for the location for which the application for a limited video lottery retailer's license is submitted, and the applicant does not elect to own or lease up to 2 video lottery terminals from a licensed manufacturer (or up to 7 video lottery terminal authorizations in the case of an eligible fraternal or veterans' organization), the commission shall also issue the applicant a certificate reserving up to 2 video lottery terminal authorizations (or up to 7 video lottery terminals authorizations in the case of an eligible fraternal or veterans' organization) as requested in the application if it was filed on or before August 1, 2001;

16.10.a. The licensee may then contract with an operator for video lottery terminals and may give the certificate of reservation to the operator; and

16.10.b. The operator, upon submitting to the commission a true copy of its contract with the licensed video lottery retailer along with the certificate of reservation issued to the retailer by the commission and payment of \$1,000 per video lottery terminal stated in the certificate of reservation shall be issued a permit or an amended permit.

16.11. An applicant shall not be issued a permit to purchase or lease video lottery terminals from a licensed manufacturer or a certificate of reservation if the applicant held a private club license or Class "A" nonintoxicating beer license on January 1, 2001, and if on August 1, 2001, the person does not qualify for

issuance of a limited video lottery license. The person shall be required to obtain all video lottery terminals from a licensed operator or be a successful bidder under W.Va. Code §29-22B-1107 if the person qualify in the future for a limited video lottery retailer's license.

16.12. An applicant shall not be issued a permit to purchase or lease video lottery terminals from a licensed manufacturer or a certificate of reservation if the applicant held a Class "A" nonintoxicating beer license on January 1, 2001 but not a private club license as of that date, and if on August 1, 2001, the person does not qualify for issuance of a limited video lottery license as a holder of a Class "A" nonintoxicating beer license. The person shall obtain all video lottery terminals from a licensed operator or be a successful bidder under W.Va. Code §29-22B-1107 for authorization to purchase or lease video lottery terminals from a licensed manufacturer if the person is issued a private club license after December 31, 2000, and qualifies for a limited video lottery retailer's license.

16.13. A certificate of reservation issued by the commission that is not converted to a permit by December 31, 2004 shall be void and of no further use.

~~16.14.~~ 14. The commission shall issue an amended permit which shall expire at 12:00 a.m. in this state on July 1, 2011 when the number of video lottery terminals a permittee is allowed to own or lease increases or decreases.

~~16.15.~~ 15. A permit to own or lease video lottery terminals issued after July 1, 2011 for the 10-year period that ends June 30, 2021, expires at 12:00 a.m. in this state on July 1, 2021, unless it is surrendered or revoked before that time. When the number of video lottery terminals a permittee is allowed to own or lease increases or decreases, the commission shall issue an amended permit which shall expire at 12:00 a.m. in this state on July 1, 2021.

~~16.16.~~ 16. A person licensed as a limited video lottery retail shall continuously meet the qualifications for issuance of that license. If the limited video lottery license is surrendered or revoked by the commission, the licensee's permit to own or lease video lottery terminals shall also be surrendered or revoked.

~~16.17.~~ 17. A licensee's permit expires at 12:00 a.m. on the 3<sup>rd</sup> day if the person's license as a limited video lottery retailer expires and the license is not renewed within 30 days after the expiration date. The person shall then obtain all video lottery terminals on the premises for which the license is issued from a licensed operator or as a result of a successful under W.Va. Code §29-22B-1107 if the person subsequently reapplies for a limited video lottery retailer's license and the license is issued.

~~16.18.~~ 18. A permit to own or lease video lottery terminals is a revocable privilege granted pursuant to the provision of the Act and this rule. Issuance of a permit or a license under the Act does not create (A) any property in the permit or the license, (B) any right to transfer or encumber the permit or license, (C) any vested right in the permit or license, or (D) the accrual of any value to the privilege of participating in any limited video lottery activity.

~~16.19.~~ 19. An application for a limited video lottery retailer's license may not include more than one physical location. A separate application shall be submitted for each location at which the applicant wants to offer video lottery terminals if a person owns or operates two or more physical locations licensed by the alcohol beverage control commissioner.

#### **§179-5-17. The bidding process.**

17.1. Mailed and courier-delivered bids shall be addressed as follows:

<p>Submit one (1) original bid to:</p> <p>State of West Virginia  Department of Administration  Purchasing Division  2019 Washington Street, East  P.O. Box 50130  Charleston, WV 25305-0130</p>	<p>Submit one (1) copy of the bid to:</p> <p>State Auditor's Office  Bid Observer  State of West Virginia  1900 Kanawha Blvd., East  Bldg. 1, Room W116  Charleston, WV 25305-0230</p>
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17.2. The outside envelope/package(s) should be clearly marked:

17.2.a. Buyer: \_\_\_\_\_, Director;

17.2.b. Req.: Video Lottery Permit Bids;

17.2.c. Date: (opening) \_\_\_\_\_; and

17.2.d. Time: (opening) \_\_\_\_\_.

17.3. Bids submitted to either office by facsimile shall be rejected.

17.4. Failure of the United States Postal Service or a courier service to make timely delivery of any bid shall not act to validate any bid not in the hands of the Purchasing Division or the State Auditor's Bid Observer's Office by the time and date specified in the class II-O advertisement.

17.5. Each bid shall indicate both the number of video lottery terminals for which the permit is sought and the per-terminal bid for which the permit is sought.

17.6. No bid may be altered or withdrawn after the appointed hour for the opening of the bids.

17.7. The Auditor's representatives and Purchasing Division officials will open all received bids in the same room and will match bids to each duplicate;

17.7.a. The Lottery's representatives shall reject any bid for which there is no duplicate, or where the original and copy differ in amount or in any other material way;

17.7.b. The Lottery's representatives will next determine whether the original bid sent to the Purchasing Division contains a bid bond equal to 100 percent of the per-terminal bid amount multiplied by the number of video lottery terminal authorizations requested by the bid;

17.7.b.1. If no bond or State Treasurer's receipt is found, the bid shall be rejected; or

17.7.b.2. If the amount of the bond is less than 100 percent of the per-terminal bid amount multiplied by the number of video lottery terminal authorizations requested, the bid shall be rejected; and

17.7.c. The Lottery's representatives shall next reject any bid as non-responsive if the per terminal bid amount is less than the minimum per-terminal bid amount established by the West Virginia State Lottery Commission prior to the first publication and included in the published notice;

17.7.d. The Lottery's representatives shall reduce the number of terminal authorizations requested in the bid if a successful bid would grant to the bidder a total number of video lottery terminals greater than 7½% of the total available terminals authorized by the Act if the bidder is an operator, 10 if the bidder is a retailer that is a fraternal or veterans organization, or 5 if the bidder is a retailer who is not a fraternal or veterans organization with a single licensed retail location. When the bidder is a video lottery retailer who has more than one licensed retail location, the number of video lottery terminal

authorizations may not exceed 5 multiplied by the number of retail locations for which the bidder holds a limited video lottery retail license;

17.7.e. Whenever there are two or more bids of the same dollar amount and the number of authorizations for which the bids were submitted exceeds the number of authorizations still available to fill the bids, the commission shall award the permit based upon the drawing of lots among the bidders; and

17.7.f. Once all bids are opened, those bids that have passed all qualitative checks will be arranged in per-terminal amount from highest bid to lowest bid and the results posted by representatives of the Lottery in a spreadsheet or on a marker board. Each listing shall show the following information:

17.7.f.1. Name of the Bidder;

17.7.f.2. Per terminal amount bid in US dollars;

17.7.f.3. Number of terminal authorizations requested; and

17.7.f.4. Number of terminal authorizations remaining after this bid opening is completed.

17.8. All permits shall be signed by the director of the lottery in the name of the state of West Virginia and shall state number of video lottery terminals the permit authorizes the holder to own or lease from licensed manufacturers.

#### **§179-5-18. Examples of the preference for current permit holders in year 2011.**

18.1. The preference for current permit holders allowed by W.Va. Code §29-22B-1108 shall be computed by adding 5 percent of the bid price submitted by the current permit holder to the amount of the bid submitted by that holder;

18.1.a. Example for year 2011. Operator "A" holds a current permit to own or lease 500 video lottery terminals. Operator "A" submits a bid of \$3,000 per terminal for authorization to own or lease 500 terminals during the 10-year period that begins July 1, 2011. The minimum bid amount set by the commission is \$3,000 per terminal authorization. When the bids are opened and the amounts of the per terminal bids are arrayed from highest to lowest, it is apparent that operator "A" is not a successful bidder for some or all of the sought operator "A." Before the permits are awarded, the commission will apply the 5 percent preference to bids submitted by a current permittee whose bids equal or exceed the minimum per terminal bid authorization amount set by the commission. With this preference added, operator "A's" bid of \$3,000 per terminal authorization is effectively \$3,150 per terminal authorization. Because of this preference, operator "A" is a successful bidder for 500 video lottery terminal authorizations. The amount due from operator "A" will be \$1.5 million plus applicable license fees. The amount due shall be paid to the commission on or before the date set by the commission; and

18.1.b. Example for year 2021. Operator "A" holds a current permit to own or lease 500 video lottery terminals. Operator "A" submits a bid of \$4,000 per terminal for authorization to own or lease 500 terminals during the 10-year period that begins July 1, 2021. The minimum bid amount set by the commission is \$4,000 per terminal authorization. When the bids are opened and the amounts of the per terminal bids are arrayed from highest to lowest, it is apparent that operator "A" is not a successful bidder for some or all of the sought operator "A." Before the permits are awarded, the commission will apply the 5 percent preference to bids submitted by current permittee whose bids equal or exceed the minimum per terminal bid authorization amount set by the commission. With this preference added, operator "A's" bid of \$4,000 per terminal authorization is effectively \$4,200 per terminal authorization. Because of this preference, operator "A" is a successful bidder for 500 video lottery terminal authorizations. The amount due from operator "A" will be \$2 million plus applicable license fees. The amount due shall be paid to the commission on or before the date set by the commission.

18.2. The preference may not be calculated on any bid that is for less than the minimum per terminal authorization bid price set by the commission.

**§179-5-19. Operator –retailer contracts.**

19.1. A true copy of all contracts the applicant has entered into with persons who hold a limited video lottery retailer's license issued under the Act for placement of video lottery terminals in the premises of the limited video lottery retailer for whom authorizations were reserved shall be attached to the application along with a true copy of the certificate of reservation issued by the commission to that video lottery retailer.

19.2. The contract between the operator and the limited video lottery retailer shall be in writing and be signed by the parties, or their duly authorized representative when the party is a person who is not an individual;

19.2.a. The commission shall supply a contract elements form to provide quick and easy review of the important terms and elements of each contract;

19.2.b. The operator submitting each contract shall list the required information and contract terms from the signed contract onto the commission-supplied form and shall staple the form onto the appropriate contract prior to filing the contract with the commission; and

19.2.c. The operator shall provide to the commission an affidavit stapled to each contract, which is signed and attested to by the operator's chief executive stating that this contract is the only contract, agreement or understanding, written or oral, between the operator and the licensed video lottery retailer concerning the placement and operation of limited video lottery terminals, and that the operator will execute no further limited video lottery agreements with the retailer so long as this attached agreement is in force for video lottery terminals on the premise of the retailer stated in the contract. Any other agreements between the operator and the limited video lottery retailer shall be identified by the operator and are subject to review by the commission. Those agreements shall be arms length and for fair market consideration, and shall not be for excess or unreasonable consideration designed to circumvent the requirement of this subdivision 19.2.c of this subsection.

**§179-5-20. Additional requirements regarding the 150-foot requirement for location of a limited video lottery retailer license.**

20.1. A retailer license will not be denied based solely on the proposed establishment being closer than 150 feet to an existing limited video lottery retail licensee or in a structure where another limited video lottery licensee was already licensed to conduct video lottery games so long as the initial application for a limited video lottery retailer license for the premises was applied for on or before July 1, 2002 if an applicant applies for a limited video lottery license for a specific premise which was a licensed ABCC location under a valid and continuing private club liquor license or a Class "A" nonintoxicating beer license on or before January 1, 2001, and if an ABCC license for that premises is still in effect at the time of the filing of the application for a limited video lottery license for the same premise.

20.2 After July 1, 2002, the initial exemption from the 150-foot restriction and the single structure under one roof restriction as stated in subsection 20.1 of this rule shall be considered waived for the premises whenever a premises that has initially been licensed by the commission as a limited video lottery retail location ceases to offer limited video lottery gaming for at least 180 consecutive days. Until the 180-day period has passed, no new limited video lottery retailer license shall be granted for a premises closer than 150 feet to the previously-licensed premises.

20.3. The award of the license shall be determined based on the date the applications were received in the state lottery office when two or more applications for a limited video lottery retailer's license are pending at the same time, if the proposed premise of each applicant would be in the same structure under one roof, and each applicant meets all other requirements for a retailer license;

20.3.a. The license shall be awarded to the applicant who first filed a complete application;  
and

20.3.b. The license shall be issued by the commission by lots when the applications were received on the same day.

20.4. The award of a retailer license shall be determined based on the date the applications were received in the state lottery office when two applications for limited video lottery retailer's licenses are pending at the same time for premises that are within 150 feet of each other, and neither premise is within 150 feet of an existing licensee;

20.4.a. The license shall be awarded to the applicant who first filed a complete application;  
and

20.4.b. The license shall be issued by the commission by lots when the applications were received on the same day.

20.5. The award of a retailer license shall be determined based on the date the applications were received in the state lottery office when more than two applicants for limited video lottery retailer's license are pending at the same time for premises that are within 150 feet of one or more other applicants;

20.5.a. The license shall be awarded to the applicant who first filed a complete application if complete applications were received on the same day, the commission shall first eliminate one or more applicants if by doing so, the remaining applicants would comply with the 150-foot restriction; and

20.5.b. The award of the license shall be determined by the commission by lots when elimination of one or more applicants will not make other applicants eligible.

#### **§179-5-21. Testing and installation of approved lottery terminals.**

21.1. The request for original approval or subsequent modification shall be made directly to one of the commission's designated independent testing laboratories.

21.2. The request for modification shall contain a detailed description of the type of change, the reasons for the change and technical documentation of the change.

21.3. Each video lottery terminal approved for placement at a licensed location shall conform to the exact specifications of the video lottery terminal prototype tested and approved by the independent testing laboratory, and approved by the commission.

21.4. The director shall disable and cause not to operate during the suspension period every video lottery terminal supplied by the operator to all licensed video lottery retailers when an operator's license is suspended.

21.5. The director shall disable and cause not to operate during a license suspension period every video lottery terminal owned or leased by the permittee when a the license of a video lottery retailer who is also a permittee is suspended.

21.6. The director shall disable and cause not to operate during the suspension period every video lottery terminal supplied by the manufacturer to permittees that are placed in licensed video lottery retailer locations when a manufacturer's license is suspended.

#### **§179-5-22. Transportation from manufacturer and registration of video lottery terminals.**

22.1. A manufacturer transporting or arranging for the transportation of one or more video lottery terminals into this state shall, prior to shipment, provide the commission with the number or other identification mark that identifies the security seal on the container within the cargo compartment of the

carrier delivering one or more video lottery terminals to a permittee.

22.2. Notices required by this section twenty-three and W.Va. Code §29-22B-1205 shall be either by United States mail, by courier service, by facsimile or by Internet electronic mail using the format prescribed by the commission.

22.3. No operator or limited video lottery retailer who holds a permit to own or lease a video lottery terminal may transport, or arrange for the transportation of, a video lottery terminal to a non-licensed retail location, or to a licensed limited access adult-only location if the transported terminal or terminals will result in more video lottery terminals in the new location than has been authorized by the commission.

**§179-5-23. Training for service technician licensees and license applicants.**

23.1. Instructors for service technician training classes shall be employed by the manufacturer or be retained by the manufacturer under contract.

23.2. No individual may act as an instructor who is an officer, principal or employee of a person that holds a limited video lottery license as an operator, retailer or service technician.

**§179-5-24. Master keys.**

24.1. Each licensed manufacturer shall provide the commission with 40 copies of the master key for access into the logic area door of the manufacturer's video lottery terminals placed in operation.

24.2. No manufacturer may provide any copies of the logic area access key to any operator, retailer, service technician or to any other person other than the commission.

24.3. The object of subsections 24.1 and 24.2 of this section is that one master key shall be capable of opening all video lottery terminals the manufacturer sells or leases to permittees for use in locations governed by the Act and this rule.

**§179-5-25. Sealing the logic area of the video lottery terminal and the controller unit.**

25.1. The commission shall provide logic box and controller unit security seals for each video lottery terminal and controller unit in operation.

25.2. The seal shall be affixed by commission personnel to prevent unauthorized access to the video lottery terminal logic unit or tampering with the controller unit.

25.3. Any licensee that discovers a broken or torn seal shall immediately report the incident to the lottery commission by telephone and shall also report to the commission in writing within thirty-six hours by facsimile or Internet electronic mail;

25.3.a. The reporting licensee shall identify himself or herself by name and by license number;

25.3.b. The reporting licensee shall identify the video lottery terminal by location, license number and decal number;

25.3.c. The reporting licensee shall report the date and time when the broken or torn seal was discovered; and

25.3.d. The reporting licensee shall state the hard meter reading of the video lottery terminal at the time the broken or torn seal was discovered.

25.4. Upon receipt of a report that a seal has been broken or torn, the commission shall disable the video lottery terminal.

25.5. The video lottery terminal shall remain disabled until completion by the commission of an investigation of the seal damage.

**§179-5-26. Repairs to logic board or circuitry.**

26.1. Reports required by W.Va. Code §29-22B-1304 may be delivered by United States mail, by courier service, by facsimile or by Internet electronic mail using the format prescribed by the commission.

**§179-5-27. Accounting for the state's share of gross terminal income.**

27.1. The gross terminal income from all operating video lottery terminals of a permittee shall be calculated monthly by the commission based on the calendar month.

27.2. The commission shall send a statement to each permittee of the following information for each machine covered by the permittee's permit that was in service for any portion of the calendar month covered by the calculations:

27.2.a. Credits played;

27.2.b. Credits won;

27.2.c. Gross terminal income;

27.2.d. Two percent of gross terminal income for the commission's administrative expenses;

27.2.e. Gross profits;

27.2.f. The commission's share rate applicable to gross profits for the current quarter; and

27.2.g. The commission's two percent of gross terminal income plus the commission's net terminal income to be swept from the permittee's account by electronic fund transfer.

27.3. Each licensed permittee shall maintain in its bank account an amount equal to or greater than the commission's two percent of gross terminal income plus the commission's net terminal income from its operation of video lottery machines, to be electronically transferred by the lottery commission on the tenth day of the month that follows the month for which the report is made. If the tenth day of the month falls on a Saturday, Sunday or legal holiday, as that term is defined in W. Va. Code §2-2-1, the due date shall be the next day that is not a Saturday, Sunday or legal holiday.

27.4. If a permittee fails to maintain the bank account balance required in W.Va. Code §29-22B-1401(b), the commission may disable all of a permittee's video lottery terminals until full payment of all amounts due is made;

27.4.a. If the commission receives a non-sufficient funds message from the permittee's depository bank:

27.4.a.1. The director shall suspend the permittee's license until the permittee has paid the full amount owed to the Lottery by cashier's check, or certified check, or money order, or cash, and also has paid the one hundred percent civil penalty provided for in W.Va. Code §29-22B-1407(a); and

27.4.a.2. The director shall issue a warning letter containing an explanation the consequences of a future non-sufficient funds message; and

27.4.b. If the permittee does not settle for all moneys and penalties due to the commission within thirty days after the commission's demand for payment of non-sufficient funds amounts, the director shall recommend to the commission that the permittee's license and ten-year permit be revoked; and

27.4.c. If the commission receives three non-sufficient funds messages within any twelve consecutive month period, the director shall recommend to the commission that the permittee's license and ten-year permit be revoked.

27.5. Interest shall accrue on any unpaid balance due the commission at the rates charged for state tax delinquency under W.Va. Code §11-10-17a;

27.5.a. The interest shall begin to accrue on the date payment is due to the commission and shall continue to accrue until the amount due, including applicable interest, is paid; and

27.5.b. Payments shall be applied first to interest and then to the balance of the amount due the commission.

27.6. The statement required in this section may be transmitted to the permittee by United States mail, facsimile or Internet e-mail.

**§179-5-28. Resolution of discrepancies.**

28.1. The commission will not withhold from money it owes to an operator and pay that money to a retailer unless directed to do so by a state court of record.

**§179-5-29. Pay over of state's share of gross terminal income when electronic funds transfer is inoperative.**

29.1. The commission shall monthly transfer from each permittee's bank account the state's share of gross terminal income as calculated under subdivision 63.2.g of this rule.

29.2. The permittee shall remit payment by mail if the electronic transfer of funds is not operational or the commission notifies the permittee that remittance by this method is required.

29.3. Using the commission's statement under W.Va. Code §29-22B-1408, the permittee shall report, for each video lottery terminal operated by a licensee, the following information on forms prepared and supplied by the commission:

29.3.a. Credits played;

29.3.b. Credits won;

29.3.c. Gross terminal income;

29.3.d. Two percent of gross terminal income for the commission's administrative expenses;

29.3.e. Gross profits;

29.3.f. The commission's share rate applicable to gross profits for the current quarter; and

29.3.g. The lottery commission's two percent of gross terminal income plus the commission's net terminal income to be swept from the permittee's account by electronic fund transfer.

29.4. The permittee shall remit to the commission the amount calculated in subdivision 29.3.g of this rule;

29.4.a. The remittance shall be sealed in a properly addressed and stamped envelope and deposited in the United States mail no later than noon on the tenth day of the month that follows the month for which the report is made; and

29.4.b. If the tenth day of the month falls on a Saturday, Sunday or legal holiday, the due date shall be the next day that is not a Saturday, Sunday or legal holiday.

29.5. The rule regarding non-sufficient funds messages from the permittee's depository bank contained in subsection 27.4 and subdivisions 27.4.a through 27.4.c of this rule also apply to payments made by check to the commission under provisions of this section.

**§179-5-30. Distribution of shares of gross profits.**

30.1 Gross profit shall be distributed by the commission as follows:

30.1.a Beginning the first day of July, 2002, a county and the incorporated municipalities within that county shall receive two percent of the gross profits generated by limited video lottery terminals located within the county; and

30.1.b From this two percent of gross profits, each municipality shall receive a share that bears the same proportion to the total two percent of gross profits as the population of the municipality bears to the total population of the county as determined by the most recent decennial United States census of population, and the county shall receive the remaining portion of the two percent of gross profits.

30.2 Any remaining funds shall be deposited into the state excess lottery revenue fund established in section eighteen-a, article twenty-two of this chapter.

30.3 The licensed operators and limited video lottery retailers shall receive the balance of gross terminal income remaining after deduction of the state's share as calculated pursuant to this section.

**§179-5-~~30~~31. Examination of permittee and retailer books and records.**

~~30~~31.1. The commission has the right to examine all accounts, bank accounts, financial statements and records in a retailer licensee's possession, under its control or in which it has an interest, when the retailer is not also a permittee, and the licensed retailer shall authorize all third parties in possession or in control of the accounts or records to allow examination of any of those accounts or records by the commission.

**§179-5-~~31~~32. Additional requirements concerning appeal of an order.**

~~31~~32.1. A petition for hearing shall be served on the commission by delivery in one of the following ways:

~~31~~32.1.a. Personal delivery to the West Virginia lottery's central office at the address stated in the order, during regular business hours and excluding Saturdays, Sundays and legal holidays;

~~31~~32.1.b. United States mail, postage prepaid, addressed to the post office box stated in the order;

~~31~~32.1.c. Delivery to the West Virginia lottery's central office by private companies such as Airborne, DHL, Federal Express and United Parcel Service; or

~~31~~32.1.d. Facsimile transmission to telephone number stated in the order. When the petition is delivered by facsimile transmission, the original of the petition and required security shall immediately be delivered to the commission using one of the delivery methods set forth in subdivisions ~~31~~32.1.a, ~~31~~32.1.b or ~~31~~32.1.c.

~~31~~32.2. Filing of the petition and subsequent documents is in each case effective upon delivery to the West Virginia lottery's central office and is not effective upon mailing or pickup by a private delivery company.

~~31~~32.3. Copies of all documents filed in an appeal under this section must be served upon all other parties.

**§179-5-~~32~~33. Judicial review.**

3233.1. The petition for appeal shall be filed in conformity with the requirements of W. Va. Code §29A-5-4.

3233.2. Any party to the proceeding in circuit court may appeal an adverse decision of the circuit court to the West Virginia supreme court of appeals as provided in W. Va. Code §29A-5-4(h).

3233.3. The application for appeal to the supreme court of appeals shall be filed within the time provided by law for civil appeals generally in W. Va. Rules of Appellate Procedure, West Virginia Supreme Court of Appeals.

**§179-5-34. Prohibition on retailer and operator advertising and promotion activities; restriction on retailer corporation and doing-business-as names of retail license locations.**

34.1. A limited video lottery licensed operator shall conduct no video lottery advertising.

34.2. A limited video lottery licensed retailer shall conduct no video lottery advertising or promotional activities.

34.3. A limited video lottery licensed retailer shall not use the words "video lottery in the name of the approved location, or in any directions or advertising visible from outside the licensed retailer's establishment.

34.4. A limited video lottery licensed retailer shall not use words commonly associated with gambling either in its corporation name or in its doing-business-as name.

34.3. A limited video lottery licensed retailer shall not use gambling symbols including but not limited to playing card, roulette wheels, slot machines or dice on any sign or in any directions or advertising visible from outside the licensed retailer's establishment.

**§179-5-35. Prohibition against a business selling petroleum products establishing a separate room or building which is a part of, contiguous to, or adjoining the place of business as a restricted access adult-only facility.**

35.1. The commission may grant a license to and renew the license of an applicant for a limited video lottery retailer license for a restricted access adult-only facility that is contiguous to or adjoining a business that sells petroleum products so long as all of the following requirements are met:

35.1.a. The restricted access adult-only facility is not owned or operated either directly or indirectly by a direct or indirect owner of the business selling petroleum product or products (hereinafter "petroleum products"); and

35.1.b. If the facility is leased, directly or indirectly, from the business selling petroleum products or from the direct or indirect owner of that business, the lease must be for a fixed monthly fair market rent and may not be based, in whole or in part, on the gross or net income of the video lottery terminals or on the video lottery income of the tenant licensee; or

35.1.c. If the facility is leased, directly or indirectly, from the landlord who directly or indirectly also leases space to the business selling petroleum product, the lease must be for a fixed monthly fair market rent and may not be based, in whole or in part, on the gross or net income of the video lottery terminals or on the video lottery income of the tenant licensee.

35.2. The commission shall not grant a license to an applicant for a restricted access adult-only facility that fits within one or more of the following situations:

35.2.a. A business that sells petroleum products has subdivided its building or space within a building in order to create a restricted access adult-only facility to be owned or operated either directly or indirectly by a direct or indirect owner of the business that sells petroleum products;

35.2.b. The owner of a commercial business facility leased to a business that sells petroleum products has subdivided the facility on or after April 21, 2001, in order to create a restricted access adult-only facility to be owned or operated either directly or indirectly by a direct or indirect owner of the lessor;

35.2.c. A business that sells petroleum products has subdivided its parcel of land in order to create a restricted access adult-only facility to be owned or operated either directly or indirectly by a direct or indirect owner of the business selling petroleum products;

35.2.d. The owner of a commercial business facility leased to a business that sells petroleum products has subdivided the parcel of land on which the business selling petroleum products operates in order to create a restricted access adult-only facility on a separate parcel to be owned or operated either directly or indirectly by a direct or indirect owner of the lessor or the business selling petroleum products ;

35.2.e. The restricted access adult-only facility is in a facility that is contiguous to, adjoining, or on a parcel of real property adjoining a business that sells petroleum products and is owned or operated either directly or indirectly by a direct or indirect owner of the business selling petroleum products ;

35.2.e. The restricted access adult-only facility is leased from an adjoining or contiguously located business selling petroleum products, and the consideration for the lease is based in whole or in part on the gross or net income of the video lottery terminals or on the video lottery income of the tenant; or

35.2.f. The restricted access adult-only facility is leased from the same landlord who also leases space to an adjoining or contiguously located business selling petroleum products, and the consideration for the lease is based in whole or in part on the gross or net income of the video lottery terminals or on the video lottery income of the tenant.

35.3. For purposes of determining whether property is "directly or indirectly" owned or leased by or from a related person, the related party rules set forth in 26 U.S.C. §§267 and 707, as amended, shall apply, including any regulations for that section issued by the United States Secretary of the Treasury, which are hereby incorporated by reference.

## APPENDIX A

### 26 U.S.C. § 267. Losses, expenses, and interest with respect to transactions between related taxpayers.

#### (a) In general.

(1) **Deduction for losses disallowed.** No deduction shall be allowed in respect of any loss from the sale or exchange of property, directly or indirectly, between persons specified in any of the paragraphs of subsection (b). The preceding sentence shall not apply to any loss of the distributing corporation (or the distributee) in the case of a distribution in complete liquidation.

#### (2) Matching of deduction and payee income item in the case of expenses and interest.

If--

(A) by reason of the method of accounting of the person to whom the payment is to be made, the amount thereof is not (unless paid) includible in the gross income of such person, and

(B) at the close of the taxable year of the taxpayer for which (but for this paragraph) the amount would be deductible under this chapter, both the taxpayer and the person to whom the payment is to be made are persons specified in any of the paragraphs of subsection (b),

then any deduction allowable under this chapter in respect of such amount shall be allowable as of the day as of which such amount is includible in the gross income of the person to whom the payment is made (or, if later, as of the day on which it would be so allowable but for this paragraph). For purposes of this paragraph, in the case of a personal service corporation (within the meaning of section 441(i)(2)), such corporation and any employee-owner (within the meaning of section 269A(b)(2), as modified by section 441(i)(2)) shall be treated as persons specified in subsection (b).

(3) **Payments to foreign persons.** The Secretary shall by regulations apply the matching principle of paragraph (2) in cases in which the person to whom the payment is to be made is not a United States person.

#### (b) Relationships. The persons referred to in subsection (a) are:

(1) Members of a family, as defined in subsection (c)(4);

(2) An individual and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for such individual;

(3) Two corporations which are members of the same controlled group (as defined in subsection (f));

(4) A grantor and a fiduciary of any trust;

(5) A fiduciary of a trust and a fiduciary of another trust, if the same person is a grantor of both trusts;

(6) A fiduciary of a trust and a beneficiary of such trust;

(7) A fiduciary of a trust and a beneficiary of another trust, if the same person is a grantor of both trusts;

(8) A fiduciary of a trust and a corporation more than 50 percent in value of the outstanding stock of which is owned, directly or indirectly, by or for the trust or by or for a person who is a grantor of the trust;

(9) A person and an organization to which section 501 (relating to certain educational and charitable organizations which are exempt from tax) applies and which is controlled directly or indirectly by such person or (if such person is an individual) by members of the family of such individual;

(10) A corporation and a partnership if the same persons own--

(A) more than 50 percent in value of the outstanding stock of the corporation, and

(B) more than 50 percent of the capital interest, or the profits interest, in the partnership;

(11) An S corporation and another S corporation if the same persons own more than 50 percent in value of the outstanding stock of each corporation;

(12) An S corporation and a C corporation, if the same persons own more than 50 percent in value of the outstanding stock of each corporation; or

(13) Except in the case of a sale or exchange in satisfaction of a pecuniary bequest, an executor of an estate and a beneficiary of such estate.

**(c) Constructive ownership of stock.** For purposes of determining, in applying subsection (b), the ownership of stock--

(1) Stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust shall be considered as being owned proportionately by or for its shareholders, partners, or beneficiaries;

(2) An individual shall be considered as owning the stock owned, directly or indirectly, by or for his family;

(3) An individual owning (otherwise than by the application of paragraph (2)) any stock in a corporation shall be considered as owning the stock owned, directly or indirectly, by or for his partner;

(4) The family of an individual shall include only his brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants; and

(5) Stock constructively owned by a person by reason of the application of paragraph (1) shall, for the purpose of applying paragraph (1), (2), or (3), be treated as actually owned by such person, but stock constructively owned by an individual by reason of the application of paragraph (2) or (3) shall not be treated as owned by him for the purpose of again applying either of such paragraphs in order to make another the constructive owner of such stock.

**(d) Amount of gain where loss previously disallowed. If--**

(1) in the case of a sale or exchange of property to the taxpayer a loss sustained by the transferor is not allowable to the transferor as a deduction by reason of subsection (a)(1) (or by reason of section 24(b) of the Internal Revenue Code of 1939); and

(2) after December 31, 1953, the taxpayer sells or otherwise disposes of such property (or of other property the basis of which in his hands is determined directly or indirectly by reference to such property) at a gain,

then such gain shall be recognized only to the extent that it exceeds so much of such loss as is properly allocable to the property sold or otherwise disposed of by the taxpayer. This subsection applies with respect to taxable years ending after December 31, 1953. This subsection shall not apply if the loss sustained by the transferor is not allowable to the transferor as a deduction by reason of section 1091 (relating to wash sales) or by reason of section 118 of the Internal Revenue Code of 1939.

**(e) Special rules for pass-thru entities.**

(1) **In general.** In the case of any amount paid or incurred by, to, or on behalf of, a pass-thru entity, for purposes of applying subsection (a)(2)--

(A) such entity,

(B) in the case of--

(i) a partnership, any person who owns (directly or indirectly) any capital interest or profits interest of such partnership, or

(ii) an S corporation, any person who owns (directly or indirectly) any of the stock of such corporation,

(C) any person who owns (directly or indirectly) any capital interest or profits interest of a partnership in which such entity owns (directly or indirectly) any capital interest or profits interest, and

(D) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to a person described in subparagraph (B) or (C), shall be treated as persons specified in a paragraph of subsection (b). Subparagraph (C) shall apply to a transaction only if such transaction is related either to the operations of the partnership described in such

subparagraph or to an interest in such partnership.

(2) **Pass-thru entity.** For purposes of this section, the term "pass-thru entity" means--

- (A) a partnership, and
- (B) an S corporation.

(3) **Constructive ownership in the case of partnerships.** For purposes of determining ownership of a capital interest or profits interest of a partnership, the principles of subsection (c) shall apply, except that--

(A) paragraph (3) of subsection (c) shall not apply, and

(B) interests owned (directly or indirectly) by or for a C corporation shall be considered as owned by or for any shareholder only if such shareholder owns (directly or indirectly) 5 percent or more in value of the stock of such corporation.

(4) Subsection (a)(2) not to apply to certain guaranteed payments of partnerships

In the case of any amount paid or incurred by a partnership, subsection (a)(2) shall not apply to the extent that section 707(c) applies to such amount.

(5) **Exception for certain expenses and interest of partnerships owning low-income housing.**

(A) **In general.** This subsection shall not apply with respect to qualified expenses and interest paid or incurred by a partnership owning low-income housing to--

(i) any qualified 5-percent or less partner of such partnership, or

(ii) any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to any qualified 5-percent or less partner of such partnership.

(B) **Qualified 5-percent or less partner.** For purposes of this paragraph, the term "qualified 5-percent or less partner" means any partner who has (directly or indirectly) an interest of 5 percent or less in the aggregate capital and profits interests of the partnership but only if--

(i) such partner owned the low-income housing at all times during the 2-year period ending on the date such housing was transferred to the partnership, or

(ii) such partnership acquired the low-income housing pursuant to a purchase, assignment, or other transfer from the Department of Housing and Urban Development or any State or local housing authority.

For purposes of the preceding sentence, a partner shall be treated as holding any interest in the partnership which is held (directly or indirectly) by any person related (within the meaning of subsection (b) of this section or section 707(b)(1)) to such partner.

(C) **Qualified expenses and interest.** For purpose of this paragraph, the term "qualified expenses and interest" means any expense or interest incurred by the partnership with respect to low-income housing held by the partnership but--

(i) only if the amount of such expense or interest (as the case may be) is unconditionally required to be paid by the partnership not later than 10 years after the date such amount was incurred, and

(ii) in the case of such interest, only if such interest is incurred at an annual rate not in excess of 12 percent.

(D) **Low-income housing.** For purposes of this paragraph, the term "low-income housing" means--

(i) any interest in property described in clause (i), (ii), (iii), or (iv) of section 1250(a)(1)(B), and

(ii) any interest in a partnership owning such property.

(6) **Cross reference.** For additional rules relating to partnerships, see section 707(b).

(f) **Controlled group defined; special rules applicable to controlled groups.**

(1) **Controlled group defined.** For purposes of this section, the term "controlled group" has the meaning given to such term by section 1563(a), except that--

(A) "more than 50 percent" shall be substituted for "at least 80 percent" each place it appears in section 1563(a), and

(B) the determination shall be made without regard to subsections (a)(4) and (e)(3)(C) of section 1563.

(2) **Deferral (rather than denial) of loss from sale or exchange between members.** In the case of any loss from the sale or exchange of property which is between members of the same controlled group and to which subsection (a)(1) applies (determined without regard to this paragraph but with regard to paragraph (3))--

(A) subsections (a)(1) and (d) shall not apply to such loss, but

(B) such loss shall be deferred until the property is transferred outside such controlled group and there would be recognition of loss under consolidated return principles or until such other time as may be prescribed in regulations.

(3) **Loss deferral rules not to apply in certain cases.**

(A) **Transfer to DISC.** For purposes of applying subsection (a)(1), the term "controlled group" shall not include a DISC.

(B) **Certain sales of inventory.** Except to the extent provided in regulations prescribed by the Secretary, subsection (a)(1) shall not apply to the sale or exchange of property between members of the same controlled group (or persons described in subsection (b)(10)) if--

(i) such property in the hands of the transferor is property described in section 1221(a)(1),

(ii) such sale or exchange is in the ordinary course of the transferor's trade or business,

(iii) such property in the hands of the transferee is property described in section 1221(a)(1), and

(iv) the transferee or the transferor is a foreign corporation.

(C) **Certain foreign currency losses.** To the extent provided in regulations, subsection (a)(1) shall not apply to any loss sustained by a member of a controlled group on the repayment of a loan made to another member of such group if such loan is payable in a foreign currency or is denominated in such a currency and such loss is attributable to a reduction in value of such foreign currency.

(4) **Determination of relationship resulting in disallowance of loss, for purposes of other provisions.** For purposes of any other section of this title which refers to a relationship which would result in a disallowance of losses under this section, deferral under paragraph (2) shall be treated as disallowance.

(g) **Coordination with section 1041.** Subsection (a)(1) shall not apply to any transfer described in section 1041(a) (relating to transfers of property between spouses or incident to divorce).

## **26 U.S.C. § 707. Transactions between partner and partnership.**

(a) **Partner not acting in capacity as partner.**

(1) **In general.** If a partner engages in a transaction with a partnership other than in his capacity as a member of such partnership, the transaction shall, except as otherwise provided in this section, be considered as occurring between the partnership and one who is not a partner.

(2) **Treatment of payments to partners for property or services.** Under regulations prescribed by the Secretary--

(A) **Treatment of certain services and transfers of property.** If--

(i) a partner performs services for a partnership or transfers property to a partnership,

(ii) there is a related direct or indirect allocation and distribution to such partner, and

(iii) the performance of such services (or such transfer) and the allocation and distribution, when viewed together, are properly characterized as a transaction occurring between the partnership and a partner acting other than in his capacity as a member of the partnership, such allocation and distribution shall be treated as a transaction described in paragraph (1).

**(B) Treatment of certain property transfers. If--**

(i) there is a direct or indirect transfer of money or other property by a partner to a partnership,

(ii) there is a related direct or indirect transfer of money or other property by the partnership to such partner (or another partner), and

(iii) the transfers described in clauses (i) and (ii), when viewed together, are properly characterized as a sale or exchange of property, such transfers shall be treated either as a transaction described in paragraph (1) or as a transaction between 2 or more partners acting other than in their capacity as members of the partnership.

**(b) Certain sales or exchanges of property with respect to controlled partnerships.**

(1) **Losses disallowed.** No deduction shall be allowed in respect of losses from sales or exchanges of property (other than an interest in the partnership), directly or indirectly, between--

(A) a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or the profits interest, in such partnership, or

(B) two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests.

In the case of a subsequent sale or exchange by a transferee described in this paragraph, section 267(d) shall be applicable as if the loss were disallowed under section 267(a)(1). For purposes of section 267(a)(2), partnerships described in subparagraph (B) of this paragraph shall be treated as persons specified in section 267(b).

(2) **Gains treated as ordinary income.** In the case of a sale or exchange, directly or indirectly, of property, which in the hands of the transferee, is property other than a capital asset as defined in section 1221--

(A) between a partnership and a person owning, directly or indirectly, more than 50 percent of the capital interest, or profits interest, in such partnership, or

(B) between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interests or profits interests, any gain recognized shall be considered as ordinary income.

(3) **Ownership of a capital or profits interest.** For purposes of paragraphs (1) and (2) of this subsection, the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) other than paragraph (3) of such section.

(c) **Guaranteed payments.** To the extent determined without regard to the income of the partnership, payments to a partner for services or the use of capital shall be considered as made to one who is not a member of the partnership, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, for purposes of section 162(a) (relating to trade or business expenses).

## APPENDIX B

### Treasury Regulation § 1.267(b)-1 Relationships.

#### (a) In general.

(1) The persons referred to in section 267(a) and section 1.267 (a)-1 are specified in section 267(b).

(2) Under section 267(b)(3), it is not necessary that either of the two corporations be a personal holding company or a foreign personal holding company for the taxable year in which the sale or exchange occurs or in which the expenses or interest are properly accruable, but either one of them must be such a company for the taxable year next preceding the taxable year in which the sale or exchange occurs or in which the expenses or interest are accrued.

(3) Under section 267(b)(9), the control of certain educational and charitable organizations exempt from tax under section 501 includes any kind of control, direct or indirect, by means of which a person in fact controls such an organization, whether or not the control is legally enforceable and regardless of the method by which the control is exercised or exercisable. In the case of an individual, control possessed by the individual's family, as defined in section 267(c)(4) and paragraph (a)(4) of section 1.267 (c)-1, shall be taken into account.

#### (b) Partnerships.

(1) Since section 267 does not include members of a partnership and the partnership as related persons, transactions between partners and partnerships do not come within the scope of section 267. Such transactions are governed by section 707 for the purposes of which the partnership is considered to be an entity separate from the partners. See section 707 and section 1.707-1. Any transaction described in section 267(a) between a partnership and a person other than a partner shall be considered as occurring between the other person and the members of the partnership separately. Therefore, if the other person and a partner are within any one of the relationships specified in section 267(b), no deductions with respect to such transactions between the other person and the partnership shall be allowed:

(i) To the related partner to the extent of his distributive share of partnership deductions for losses or unpaid expenses or interest resulting from such transactions, and

(ii) To the other person to the extent the related partner acquires an interest in any property sold to or exchanged with the partnership by such other person at a loss, or to the extent of the related partner's distributive share of the unpaid expenses or interest payable to the partnership by the other person as a result of such transaction.

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

**Example 1.** A, an equal partner in the ABC partnership, personally owns all the stock of M Corporation. B and C are not related to A. The partnership and all the partners use an accrual method of accounting, and are on a calendar year. M Corporation uses the cash receipts and disbursements method of accounting and is also on a calendar year. During 1956 the partnership borrowed money from M Corporation and also sold property to M Corporation, sustaining a loss on the sale. On December 31, 1956, the partnership accrued its interest liability to the M Corporation and on April 1, 1957 (more than 2 1/2 months after the close of its taxable year), it paid the M Corporation the amount of such accrued interest. Applying the rules of this paragraph, the transactions are considered as occurring between M Corporation and the partners separately. The sale and interest transactions considered as occurring between A and the M Corporation fall within the scope of section 267 (a) and (b), but the transactions considered as occurring between partners B and C and the M Corporation do not. The latter two partners may, therefore, deduct their distributive shares of partnership deductions for the loss and the accrued interest. However, no deduction shall be allowed to A for his distributive shares of these partnership deductions. Furthermore, A's adjusted basis for his partnership interest must be decreased by the amount of his distributive share of such

deductions. See section 705(a)(2).

**Example 2.** Assume the same facts as in example (1) of this subparagraph except that the partnership and all the partners use the cash receipts and disbursements method of accounting, and that M Corporation uses an accrual method. Assume further, that during 1956 M Corporation borrowed money from the partnership and that on a sale of property to the partnership during that year M Corporation sustained a loss. On December 31, 1956, the M Corporation accrued its interest liability on the borrowed money and on April 1, 1957 (more than 2 1/2 months after the close of its taxable year) it paid the accrued interest to the partnership. The corporation's deduction for the accrued interest is not allowed to the extent of A's distributive share (one-third) of such interest income. M Corporation's deduction for the loss on the sale of the property to the partnership is not allowed to the extent of A's one-third interest in the purchased property.

### **Sec. 1.267(c)-1 Constructive ownership of stock.**

#### **(a) In general.**

(1) The determination of stock ownership for purposes of section 267(b) shall be in accordance with the rules in section 267(c).

(2) For an individual to be considered under section 267(c)(2) as constructively owning the stock of a corporation which is owned, directly or indirectly, by or for members of his family it is not necessary that he own stock in the corporation either directly or indirectly. On the other hand, for an individual to be considered under section 267(c)(3) as owning the stock of a corporation owned either actually, or constructively under section 267(c)(1), by or for his partner, such individual must himself actually own, or constructively own under section 267(c)(1), stock of such corporation.

(3) An individual's constructive ownership, under section 267(c) (2) or (3), of stock owned directly or indirectly by or for a member of his family, or by or for his partner, is not to be considered as actual ownership of such stock, and the individual's constructive ownership of the stock is not to be attributed to another member of his family or to another partner. However, an individual's constructive ownership, under section 267(c)(1), of stock owned directly or indirectly by or for a corporation, partnership, estate, or trust shall be considered as actual ownership of the stock, and the individual's ownership may be attributed to a member of his family or to his partner.

(4) The family of an individual shall include only his brothers and sisters, spouse, ancestors, and lineal descendants. In determining whether any of these relationships exist, full effect shall be given to a legal adoption. The term "ancestors" includes parents and grandparents, and the term "lineal descendants" includes children and grandchildren.

(b) **Examples.** The application of section 267(c) may be illustrated by the following examples:

**Example 1.** On July 1, 1957, A owned 75 percent, and AW, his wife, owned 25 percent, of the outstanding stock of the M Corporation. The M Corporation in turn owned 80 percent of the outstanding stock of the O Corporation. Under section 267(c)(1), A and AW are each considered as owning an amount of the O Corporation stock actually owned by M Corporation in proportion to their respective ownership of M Corporation stock. Therefore, A constructively owns 60 percent (75 percent of 80 percent) of the O Corporation stock and AW constructively owns 20 percent (25 percent of 80 percent) of such stock. Under the family ownership rule of section 267(c)(2), an individual is considered as constructively owning the stock actually owned by his spouse. A and AW, therefore, are each considered as constructively owning the M Corporation stock actually owned by the other. For the purpose of applying this family ownership rule, A's and AW's constructive ownership of O Corporation stock is considered as actual ownership under section 267(c)(5). Thus, A constructively owns the 20 percent of the O Corporation stock constructively owned by AW, and AW constructively owns the 60 percent of the O Corporation stock constructively owned by A. In addition, the family ownership rule may be applied to make AWF, AW's father, the constructive owner of

the 25 percent of the M Corporation stock actually owned by AW. As noted above, AW's constructive ownership of 20 percent of the O Corporation stock is considered as actual ownership for purposes of applying the family ownership rule, and AWF is thereby considered the constructive owner of this stock also. However, AW's constructive ownership of the stock constructively and actually owned by A may not be considered as actual ownership for the purpose of again applying the family ownership rule to make AWF the constructive owner of these shares. The ownership of the stock in the M and O Corporations may be tabulated as follows:

Person	Stock ownership in M Corporation		Total under Section 257 (Percent)
	Actual (Percent)	Constructive (Percent)	
A	75	25	100
A W (A's wife)	25	75	100
A W F (AW's father)	None	25	25
M Corporation	----	----	----
O Corporation	None	None	None

Person	Stock ownership in O Corporation		Total under Section 257 (Percent)
	Actual (Percent)	Constructive (Percent)	
A	None	60	80
A W (A's wife)	None	20	80
A W F (AW's father)	None	20	20
M Corporation	80	None	80
O Corporation	-----	-----	-----

Assuming that the M Corporation and the O Corporation make their income tax returns for calendar years, and that there was no distribution in liquidation of the M or O Corporation, and further assuming that other corporation was a personal holding company under section 542 for the calendar year 1956, no deduction is allowable with respect to losses from sales or exchanges of property made on July 1, 1957, between the two corporations. Moreover, whether or not either corporation was a personal holding company, no loss would be allowable on a sale or exchange between A or AW and either corporation. A deduction would be allowed, however, for a loss sustained in an arm's length sale or exchange between A and AWF, and between AWF and the M or O Corporation.

**Example 2.** On June 15, 1957, all of the stock of the N Corporation was owned in equal proportions by A and his partner, AP. Except in the case of distributions in liquidation by the N Corporation, no deduction is allowable with respect to losses from sales or exchanges of property made on June 15, 1957, between A and the N Corporation or AP and the N Corporation since each partner is considered as owning the stock owned by the other; therefore, each is considered as owning more than 50 percent in value of the outstanding stock of the N Corporation.

**Example 3.** On June 7, 1957, A owned no stock in X Corporation, but his wife, AW, owned 20 percent in value of the outstanding stock of X, and A's partner, AP, owned 60 percent in value of the outstanding stock of X. The partnership firm of A and AP owned no stock in X Corporation. The ownership of AW's stock is attributed to A, but not that of AP since A does not own any X Corporation stock either actually, or constructively under section 267(c)(1). A's constructive ownership of AW's stock is not the ownership required for the attribution of AP's stock. Therefore, deductions for losses from sales or exchanges of property made on June 7, 1957, between X Corporation and A or AW are allowable since neither person owned more than 50 percent in value of the outstanding stock of X, but deductions for losses from sales or exchanges between X Corporation and AP would not be allowable by section 267(a) (except for distributions in liquidation of X Corporation).

## **Sec. 1.267(f)-1 Controlled Groups.**

### **(a) In general --**

(1) **Purpose.** This section provides rules under section 267(f) to defer losses and deductions from certain transactions between members of a controlled group (intercompany sales). The purpose of this section is to prevent members of a controlled group from taking into account a loss or deduction solely as the result of a transfer of property between a selling member (S) and a buying member (B).

(2) **Application of consolidated return principles.** Under this section, S's loss or deduction from an intercompany sale is taken into account under the TIMING principles of section 1.1502-13 (intercompany transactions between members of a consolidated group), treating the intercompany sale as an intercompany transaction. For this purpose:

(i) The matching and acceleration rules of section 1.1502-13(c) and (d), the definitions and operating rules of section 1.1502-13(b) and (j), and the simplifying rules of section 1.1502-13(e)(1) apply with the adjustments in paragraphs (b) and (c) of this section to reflect that this section

--

(A) Applies on a controlled group basis rather than consolidated group basis;  
and

(B) Generally affects only the TIMING of a loss or deduction, and not its ATTRIBUTES (e.g., its SOURCE and CHARACTER) or the holding period of property.

(ii) The special rules under section 1.1502-13(f) (stock of members) and (g) (obligations of members) apply under this section only to the extent the transaction is also an intercompany transaction to which section 1.1502-13 applies.

(iii) Any election under section 1.1502-13 to take items into account on a separate

entity basis does not apply under this section. See section 1.1502-13(e)(3).

(3) **Other law.** The rules of this section apply in addition to other applicable law (including nonstatutory authorities). For example, to the extent a loss or deduction deferred under this section is from a transaction that is also an intercompany transaction under section 1.1502-13(b)(1), attributes of the loss or deduction are also subject to recharacterization under section 1.1502-13. See also, sections 269 (acquisitions to evade or avoid income tax) and 482 (allocations among commonly controlled taxpayers). Any loss or deduction taken into account under this section can be deferred, disallowed, or eliminated under other applicable law. See, for example, section 1091 (loss eliminated on wash sale).

(b) **Definitions and operating rules.** The definitions in section 1.1502-13(b) and the operating rules of section 1.1502-13(j) apply under this section with appropriate adjustments, including the following:

(1) **Intercompany sale.** An intercompany sale is a sale, exchange, or other transfer of property between members of a controlled group, if it would be an intercompany transaction under the principles of section 1.1502-13, determined by treating the references to a consolidated group as references to a controlled group and by disregarding whether any of the members join in filing consolidated returns.

(2) **S's losses or deductions.** Except to the extent the intercompany sale is also an intercompany transaction to which section 1.1502-13 applies, S's losses or deductions subject to this section are determined on a separate entity basis. For example, the principles of section 1.1502-13(b)(2)(iii) (treating certain amounts not yet recognized as items to be taken into account) do not apply. A loss or deduction is from an intercompany sale whether it is directly or indirectly from the intercompany sale.

(3) **Controlled group; member.** For purposes of this section, a controlled group is defined in section 267(f). Thus, a controlled group includes a FSC (as defined in section 922) and excluded members under section 1563 (b)(2), but does not include a DISC (as defined in section 992). Corporations remain members of a controlled group as long as they remain in a controlled group relationship with each other. For example, corporations become nonmembers with respect to each other when they cease to be in a controlled group relationship with each other, rather than by having a separate return year (described in section 1.1502-13(j)(7)). Further, the principles of section 1.1502-13(j)(6) (former common parent treated as continuation of group) apply to any corporation if, immediately before it becomes a nonmember, it is both the selling member and the owner of property with respect to which a loss or deduction is deferred (whether or not it becomes a member of a different controlled group filing consolidated or separate returns). Thus, for example, if S and B merge together in a transaction described in section 368(a)(1)(A), the surviving corporation is treated as the successor to the other corporation, and the controlled group relationship is treated as continuing.

(4) **Consolidated taxable income.** References to consolidated taxable income (and consolidated tax liability) include references to the combined taxable income of the members (and their combined tax liability). For corporations filing separate returns, it ordinarily will not be necessary to actually combine their taxable incomes (and tax liabilities) because the taxable income (and tax liability) of one corporation does not affect the taxable income (or tax liability) of another corporation.

(c) **Matching and acceleration principles of section 1.1502-13 --**

(1) **Adjustments to the timing rules.** Under this section, S's losses and deductions are deferred until they are taken into account under the timing principles of the matching and acceleration rules of section 1.1502-13(c) and (d) with appropriate adjustments. For example, if S sells depreciable property to B at a loss, S's loss is deferred and taken into account under the principles of the matching rule of section 1.1502-13(c) to reflect the difference between B's depreciation taken into account with respect to the property and the depreciation that B would take into account if S and B were divisions of a single corporation; if S and B subsequently cease to be in a controlled group relationship with each other, S's remaining loss is taken into account under the principles of the acceleration rule of section 1.1502-13(d). For purposes of this section, the adjustments to section 1.1502-13(c) and (d) include the following:

(i) **Application on controlled group basis.** The matching and acceleration rules apply on a controlled group basis, rather than a consolidated group basis. Thus if S and B are wholly-owned members of a consolidated group and 21% of the stock of S is sold to an unrelated person, S's loss continues to be deferred under this section because S and B continue to be members of a controlled group even though S is no longer a member of the consolidated group. Similarly, S's loss would continue to be deferred if S and B remain in a controlled group relationship after both corporations become nonmembers of their former consolidated group.

(ii) **Different taxable years.** If S and B have different taxable years, the taxable years that include a December 31 are treated as the same taxable years. If S or B has a short taxable year that does not include a December 31, the short year is treated as part of the succeeding taxable year that does include a December 31.

(iii) **Transfer to a section 267(b) or 707(b) related person.** To the extent S's loss or deduction from an intercompany sale of property is taken into account under this section as a result of B's transfer of the property to a nonmember that is a person related to any member, immediately after the transfer, under sections 267(b) or 707(b), or as a result of S or B becoming a nonmember that is related to any member under section 267(b), the loss or deduction is taken into account but allowed only to the extent of any income or gain taken into account as a result of the transfer. The balance not allowed is treated as a loss referred to in section 267(d) if it is from a sale or exchange by B (rather than from a distribution).

(iv) **B's item is excluded from gross income or noncapital and nondeductible.** To the extent S's loss would be redetermined to be a noncapital, nondeductible amount under the principles of section 1.1502-13 but is not redetermined because of paragraph (c)(2) of this section, then, if paragraph (c)(1)(iii) of this section does not apply, S's loss continues to be deferred and is not taken into account until S and B are no longer in a controlled group relationship. For example, if S sells all of the stock of corporation T to B at a loss and T subsequently liquidates into B in a transaction qualifying under section 332, S's loss is deferred until S and B (including their successors) are no longer in a controlled group relationship. See section 1.1502-13(c)(6)(ii).

(v) **Circularity of references.** References to deferral or elimination under the Internal Revenue Code or regulations do not include references to section 267(f) or this section. See, e.g., section 1.1502-13(a)(4) (applicability of other law).

(2) **Attributes generally not affected.** The matching and acceleration rules are not applied under this section to affect the attributes of S's intercompany item, or cause it to be taken into account before it is taken into account under S's separate entity method of accounting. However, the attributes of S's intercompany item may be redetermined, or an item may be taken into account earlier than under S's separate entity method of accounting, to the extent the transaction is also an intercompany transaction to which section 1.1502-13 applies. Similarly, except to the extent the transaction is also an intercompany transaction to which section 1.1502-13 applies, the matching and acceleration rules do not apply to affect the timing or attributes of B's corresponding items.

**(d) Intercompany sales of inventory involving foreign persons --**

(1) **General rule.** Section 267(a)(1) and this section do not apply to an intercompany sale of property that is inventory (within the meaning of section 1221(1)) in the hands of both S and B, if --

(i) The intercompany sale is in the ordinary course of S's trade or business;

(ii) S or B is a foreign corporation; and

(iii) Any income or loss realized on the intercompany sale by S or B is not income or loss that is recognized as effectively connected with the conduct of a trade or business within the United States within the meaning of section 864 (unless the income is exempt from taxation pursuant to a treaty obligation of the United States).

(2) **Intercompany sales involving related partnerships.** For purposes of paragraph (d)(1)

of this section, a partnership and a foreign corporation described in section 267(b)(10) are treated as members, provided that the income or loss of the foreign corporation is described in paragraph (d)(1)(iii) of this section.

(3) **Intercompany sales in ordinary course.** For purposes of this paragraph (d), whether an intercompany sale is in the ordinary course of business is determined under all the facts and circumstances.

(e) **Treatment of a creditor with respect to a loan in nonfunctional currency.** Sections 267(a)(1) and this section do not apply to an exchange loss realized with respect to a loan of nonfunctional currency if --

(1) The loss is realized by a member with respect to nonfunctional currency loaned to another member;

(2) The loan is described in section 1.988-1(a)(2)(i);

(3) The loan is not in a hyperinflationary currency as defined in section 1.988-1(f); and

(4) The transaction does not have as a significant purpose the avoidance of Federal income tax.

(f) **Receivables.** If S acquires a receivable from the sale of goods or services to a nonmember at a gain, and S sells the receivable at fair market value to B, any loss or deduction of S from its sale to B is not deferred under this section to the extent it does not exceed S's income or gain from the sale to the nonmember that has been taken into account at the time the receivable is sold to B.

(g) **Earnings and profits.** A loss or deduction deferred under this section is not reflected in S's earnings and profits before it is taken into account under this section. See, e.g., sections 1.312-6(a), 1.312-7, and 1.1502-33(c)(2).

(h) **Anti-avoidance rule.** If a transaction is engaged in or structured with a principal purpose to avoid the purposes of this section (including, for example, by avoiding treatment as an intercompany sale or by distorting the timing of losses or deductions), adjustments must be made to carry out the purposes of this section.

(i) [Reserved]

(j) **Examples.** For purposes of the examples in this paragraph (j), unless otherwise stated, corporation P owns 75% of the only class of stock of subsidiaries S and B, X is a person unrelated to any member of the P controlled group, the taxable year of all persons is the calendar year, all persons use the accrual method of accounting, tax liabilities are disregarded, the facts set forth the only activity, and no member has a special status. If a member acts as both a selling member and a buying member (e.g., with respect to different aspects of a single transaction, or with respect to related transactions), the member is referred as to M (rather than as S or B). This section is illustrated by the following examples.

**Example 1. Matching and acceleration rules.**

(a) **Facts.** S holds land for investment with a basis of \$130. On January 1 of Year 1, S sells the land to B for \$100. On a separate entity basis, S's loss is long-term capital loss. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, B sells the land to X for \$110.

(b) **Matching rule.** Under paragraph (b)(1) of this section, S's sale of land to B is an intercompany sale. Under paragraph (c)(1) of this section, S's \$30 loss is taken into account under the timing principles of the matching rule of section 1.1502-13(c) to reflect the difference for the year between B's corresponding items taken into account and the recomputed corresponding items. If S and B were divisions of a single corporation and the intercompany sale were a transfer between the divisions, B would succeed to S's \$130 basis in the land and would have a \$20 loss from the sale to X in Year 3. Consequently, S takes no loss into account in Years 1 and 2, and takes the entire \$30 loss into account in Year 3 to reflect the \$30 difference in that year between the \$10 gain B takes into account and its \$20 recomputed loss. The attributes of S's intercompany items and B's corresponding items are determined on a separate entity basis.

Thus, S's \$30 loss is long-term capital loss and B's \$10 gain is ordinary income.

(c) **Acceleration resulting from sale of B stock.** The facts are the same as in paragraph (a) of this EXAMPLE 1, except that on July 1 of Year 3 P sells all of its B stock to X (rather than B's selling the land to X). Under paragraph (c)(1) of this section, S's \$30 loss is taken into account under the timing principles of the acceleration rule of section 1.1502-13(d) immediately before the effect of treating S and B as divisions of a single corporation cannot be produced. Because the effect cannot be produced once B becomes a nonmember, S takes its \$30 loss into account in Year 3 immediately before B becomes a nonmember. S's loss is long-term capital loss.

(d) **Subgroup principles applicable to sale of S and B stock.** The facts are the same as in paragraph (a) of this EXAMPLE 1, except that on July 1 of Year 3 P sells all of its S and B stock to X (rather than B's selling the land to X). Under paragraph (b)(3) of this section, S and B are considered to remain members of a controlled group as long as they remain in a controlled group relationship with each other (whether or not in the original controlled group). P's sale of their stock does not affect the controlled group relationship of S and B with each other. Thus, S's loss is not taken into account as a result of P's sale of the stock. Instead, S's loss is taken into account based on subsequent events (e.g., B's sale of the land to a nonmember).

**Example 2.** Distribution of loss property.

(a) **Facts.** S holds land with a basis of \$130 and value of \$100. On January 1 of Year 1, S distributes the land to P in a transaction to which section 311 applies. On July 1 of Year 3, P sells the land to X for \$110.

(b) **No loss taken into account.** Under paragraph (b)(2) of this section, because P and S are not members of a consolidated group, section 1.1502-13(f)(2)(iii) does not apply to cause S to recognize a \$30 loss under the principles of section 311(b). Thus, S has no loss to be taken into account under this section. (If P and S were members of a consolidated group, section 1.1502-13(f)(2)(iii) would apply to S's loss in addition to the rules of this section, and the loss would be taken into account in Year 3 as a result of P's sale to X.)

**Example 3.** Loss not yet taken into account under separate entity accounting method.

(a) **Facts.** S holds land with a basis of \$130. On January 1 of Year 1, S sells the land to B at a \$30 loss but does not take into account the loss under its separate entity method of accounting until Year 4. On July 1 of Year 3, B sells the land to X for \$110.

(b) **Timing.**

Under paragraph (b)(2) of this section, S's loss is determined on a separate entity basis. Under paragraph (c)(1) of this section, S's loss is not taken into account before it is taken into account under S's separate entity method of accounting. Thus, although B takes its corresponding gain into account in Year 3, S has no loss to take into account until Year 4. Once S's loss is taken into account in Year 4, it is not deferred under this section because B's corresponding gain has already been taken into account. (If S and B were members of a consolidated group, S would be treated under section 1.1502-13(b)(2)(iii) as taking the loss into account in Year 3.)

**Example 4.** Consolidated groups.

(a) **Facts.** P owns all of the stock of S and B, and the P group is a consolidated group. S holds land for investment with a basis of \$130. On January 1 of Year 1, S sells the land to B for \$100. B holds the land for sale to customers in the ordinary course of business. On July 1 of Year 3, P sells 25% of B's stock to X. As a result of P's sale, B becomes a nonmember of the P consolidated group but S and B remain in a controlled group relationship with each other for purposes of section 267(f). Assume that if S and B were divisions of a single corporation, the items of S and B from the land would be ordinary by reason of B's activities.

(b) **Timing and attributes.** Under paragraph (a)(3) of this section, S's sale to B is

subject to both section 1.1502-13 and this section. Under section 1.1502-13, S's loss is redetermined to be an ordinary loss by reason of B's activities. Under paragraph (b)(3) of this section, because S and B remain in a controlled group relationship with each other, the loss is not taken into account under the acceleration rule of section 1.1502-13(d) as modified by paragraph (c) of this section. See section 1.1502-13(a)(4). Nevertheless, S's loss is redetermined by section 1.1502-13 to be an ordinary loss, and the character of the loss is not further redetermined under this section. Thus, the loss continues to be deferred under this section, and will be taken into account as ordinary loss based on subsequent events (e.g., B's sale of the land to a nonmember).

(c) **Resale to controlled group member.** The facts are the same as in paragraph (a) of this EXAMPLE 4, except that P owns 75% of X's stock, and B resells the land to X (rather than P's selling any B stock). The results for S's loss are the same as in paragraph (b) of this EXAMPLE 4. Under paragraph (b) of this section, X is also in a controlled group relationship, and B's sale to X is a second intercompany sale. Thus, S's loss continues to be deferred and is taken into account under this section as ordinary loss based on subsequent events (e.g., X's sale of the land to a nonmember).

**Example 5.** Intercompany sale followed by installment sale.

(a) **Facts.** S holds land for investment with a basis of \$130x. On January 1 of Year 1, S sells the land to B for \$100x. B holds the land for investment. On July 1 of Year 3, B sells the land to X in exchange for X's \$110x note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for principal payments of \$55x in Year 4 and \$55x in Year 5. Section 453A applies to X's note.

(b) **Timing and attributes.** Under paragraph (c) of this section, S's \$30x loss is taken into account under the timing principles of the matching rule of section 1.1502-13(c) to reflect the difference in each year between B's gain taken into account and its recomputed loss. Under section 453, B takes into account \$5x of gain in Year 4 and in Year 5. Therefore, S takes \$20x of its loss into account in Year 3 to reflect the \$20x difference in that year between B's \$0 loss taken into account and its \$20x recomputed loss. In addition, S takes \$5x of its loss into account in Year 4 and in Year 5 to reflect the \$5x difference in each year between B's \$5x gain taken into account and its \$0 recomputed gain. Although S takes into account a loss and B takes into accounts gain, the attributes of B's \$10x gain are determined on a separate entity basis, and therefore the interest charge under section 453A(c) applies to B's \$10x gain on the installment sale beginning in Year 3.

**Example 6.** Section 721 Transfer to a related nonmember.

(a) **Facts.** S owns land with a basis of \$130. On January 1 of Year 1, S sells the land to B for \$100. On July 1 of Year 3, B transfers the land to a partnership in exchange for a 40% interest in capital and profits in a transaction to which section 721 applies. P also owns a 25% interest in the capital and profits of the partnership.

(b) **Timing.** Under paragraph (c)(1)(iii) of this section, because the partnership is a nonmember that is a related person under sections 267(b) and 707(b), S's \$30 loss is taken into account in Year 3, but only to the extent of any income or gain taken into account as a result of the transfer. Under section 721, no gain or loss is taken into account as a result of the transfer to the partnership, and thus none of S's loss is taken into account. Any subsequent gain recognized by the partnership with respect to the property is limited under section 267(d). (The results would be the same if the P group were a consolidated group, and S's sale to B were also subject to section 1.1502-13.)

**Example 7.** Receivables.

(a) **Controlled group.** S owns goods with a \$60 basis. In Year 1, S sells the goods to X for X's \$100 note. The note bears a market rate of interest in excess of the applicable Federal rate, and provides for payment of principal in Year 5. S takes into account \$40 of income in Year 1 under its method of accounting. In Year 2, the fair market value of X's note falls to \$90 due to an increase in prevailing market

interest rates, and S sells the note to B for its \$90 fair market value.

(b) **Loss not deferred.** Under paragraph (f) of this section, S takes its \$10 loss into account in Year 2. (If the sale were not at fair market value, paragraph (f) of this section would not apply and none of S's \$10 loss would be taken into account in Year 2.)

(c) **Consolidated group.** Assume instead that P owns all of the stock of S and B, and the P group is a consolidated group. In Year 1, S sells to X goods having a basis of \$90 for X's \$100 note (bearing a market rate of interest in excess of the applicable Federal rate, and providing for payment of principal in Year 5), and S takes into account \$10 of income in Year 1. In Year 2, S sells the receivable to B for its \$85 fair market value. In Year 3, P sells 25% of B's stock to X. Although paragraph (f) of this section provides that \$10 of S's loss (i.e., the extent to which S's \$15 loss does not exceed its \$10 of income) is not deferred under this section, S's entire \$15 loss is subject to section 1.1502-13 and none of the loss is taken into account in Year 2 under the matching rule of section 1.1502-13(c). See paragraph (a)(3) of this section (continued deferral under section 1.1502-13). P's sale of B stock results in B becoming a nonmember of the P consolidated group in Year 3. Thus, S's \$15 loss is taken into account in Year 3 under the acceleration rule of section 1.1502-13(d). Nevertheless, B remains in a controlled group relationship with S and paragraph (f) of this section permits only \$10 of S's loss to be taken into account in Year 3. See section 1.1502-13(a)(4) (continued deferral under section 267). The remaining \$5 of S's loss continues to be deferred under this section and taken into account under this section based on subsequent events (e.g., B's collection of the note or P's sale of the remaining B stock to a nonmember).

**Example 8. Selling member ceases to be a member.**

(a) **Facts.** P owns all of the stock of S and B, and the P group is a consolidated group. S has several historic assets, including land with a basis of \$130 and value of \$100. The land is not essential to the operation of S's business. On January 1 of Year 1, S sells the land to B for \$100. On July 1 of Year 3, P transfers all of S's stock to newly formed X in exchange for a 20% interest in X stock as part of a transaction to which section 351 applies. Although X holds many other assets, a principal purpose for P's transfer is to accelerate taking S's \$30 loss into account. P has no plan or intention to dispose of the X stock..

(b) **Timing.** Under paragraph (c) of this section, S's \$30 loss ordinarily is taken into account immediately before P's transfer of the S stock, under the timing principles of the acceleration rule of section 1.1502-13(d). Although taking S's loss into account results in a \$30 negative stock basis adjustment under section 1.1502-32, because P has no plan or intention to dispose of its X stock, the negative adjustment will not immediately affect taxable income. P's transfer accelerates a loss that otherwise would be deferred, and an adjustment under paragraph (h) of this section is required. Thus, S's loss is never taken into account, and S's stock basis and earnings and profits are reduced by \$30 under sections 1.1502-32 and 1.1502-33 immediately before P's transfer of the S stock.

(c) **Nonhistoric assets.** Assume instead that, with a principal purpose to accelerate taking into account any further loss that may accrue in the value of the land without disposing of the land outside of the controlled group, P forms M with a \$100 contribution on January 1 of Year 1 and S sells the land to M for \$100. On December 1 of Year 1, when the value of the land has decreased to \$90, M sells the land to B for \$90. On July 1 of Year 3, while B still owns the land, P sells all of M's stock to X and M becomes a nonmember. Under paragraph (c) of this section, M's \$10 loss ordinarily is taken into account under the timing principles of the acceleration rule of section 1.1502-13(d) immediately before M becomes a nonmember. (S's \$30 loss is not taken into account under the timing principles of section 1.1502-13(c) or section 1.1502-13(d) as a result of M becoming a nonmember, but is taken into account based on subsequent events such as B's sale of the land to a nonmember or P's sale of the stock of S or B to a nonmember.) The land is not an historic asset of M and, although taking M's loss into account reduces P's basis in the M stock under section 1.1502-32, the negative adjustment only eliminates the \$10 duplicate stock loss. Under

paragraph (h) of this section, M's loss is never taken into account. M's stock basis, and the earnings and profits of M and P, are reduced by \$10 under sections 1.1502-32 and 1.1502-33 immediately before P's sale of the M stock.

(k) **Cross-reference.** For additional rules applicable to the disposition or deconsolidation of the stock of members of consolidated groups, see sections 1.337(d)-2T, 1.1502-13(f)(6), and 1.1502-35T.

(l) **Effective dates --**

(1) **In general.** This section applies with respect to transactions occurring in S's years beginning on or after July 12, 1995. If both this section and prior law apply to a transaction, or neither applies, with the result that items are duplicated, omitted, or eliminated in determining taxable income (or tax liability), or items are treated inconsistently, prior law (and not this section) applies to the transaction.

(2) **Avoidance transactions.** This paragraph (l)(2) applies if a transaction is engaged in or structured on or after April 8, 1994, with a principal purpose to avoid the rules of this section (and instead to apply prior law). If this paragraph (l)(2) applies, appropriate adjustments must be made in years beginning on or after July 12, 1995, to prevent the avoidance, duplication, omission, or elimination of any item (or tax liability), or any other inconsistency with the rules of this section.

(3) **Prior law.** For transactions occurring in S's years beginning before July 12, 1995 see the applicable regulations issued under sections 267 and 1502. See, e.g., sections 1.267(f)-1, 1.267(f)-1T, 1.267(f)-2T, 1.267(f)-3, 1.1502-13, 1.1502-13T, 1.1502-14, 1.1502-14T, and 1.1502-31 (as contained in the 26 CFR part 1 edition revised as of April 1, 1995).

**Treasury Regulation § 1.707-1 Transactions between partner and partnership.**

(a) **Partner not acting in capacity as partner.** A partner who engages in a transaction with a partnership other than in his capacity as a partner shall be treated as if he were not a member of the partnership with respect to such transaction. Such transactions include, for example, loans of money or property by the partnership to the partner or by the partner to the partnership, the sale of property by the partner to the partnership, the purchase of property by the partner from the partnership, and the rendering of services by the partnership to the partner or by the partner to the partnership. Where a partner retains the ownership of property but allows the partnership to use such separately owned property for partnership purposes (for example, to obtain credit or to secure firm creditors by guaranty, pledge, or other agreement) the transaction is treated as one between a partnership and a partner not acting in his capacity as a partner. However, transfers of money or property by a partner to a partnership as contributions, or transfers of money or property by a partnership to a partner as distributions, are not transactions included within the provisions of this section. In all cases, the substance of the transaction will govern rather than its form. See paragraph(c)(3) of section 1.731-1.

(b) **Certain sales or exchanges of property with respect to controlled partnerships.**

(1) **Losses disallowed.**

(i) No deduction shall be allowed for a loss on a sale or exchange of property (other than an interest in the partnership), directly or indirectly, between a partnership and a partner who owns, directly or indirectly, more than 50 percent of the capital interest or profits interest in such partnership. A loss on a sale or exchange of property, directly or indirectly, between two partnerships in which the same persons own, directly or indirectly, more than 50 percent of the capital interest or profits interest in each partnership shall not be allowed.

(ii) If a gain is realized upon the subsequent sale or exchange by a transferee of property with respect to which a loss was disallowed under the provisions of subdivision (i) of this subparagraph, section 267(d) (relating to amount of gain where loss previously disallowed) shall apply as though the loss were disallowed under section 267(a)(1).

(2) **Gains treated as ordinary income.**

Any gain recognized upon the sale or exchange, directly or indirectly, of property which, in the hands of the transferee immediately after the transfer, is property other than a capital asset, as defined in section 1221, shall be ordinary income if the transaction is between a partnership and a partner who owns, directly or indirectly, more than 80 percent of the capital interest or profits interest in the partnership. This rule also applies where such a transaction is between partnerships in which the same persons own, directly or indirectly, more than 80 percent of the capital interest or profits interest in each partnership. The term "property other than a capital asset" includes (but is not limited to) trade accounts receivable, inventory, stock in trade, and depreciable or real property used in the trade or business.

(3) **Ownership of a capital or profits interest.** In determining the extent of the ownership by a partner, as defined in section 761(b), of his capital interest or profits interest in a partnership, the rules for constructive ownership of stock provided in section 267(c) (1), (2), (4), and (5) shall be applied for the purpose of section 707(b) and this paragraph. Under these rules, ownership of a capital or profits interest in a partnership may be attributed to a person who is not a partner as defined in section 761(b) in order that another partner may be considered the constructive owner of such interest under section 267(c). However, section 707(b)(1)(A) does not apply to a constructive owner of a partnership interest since he is not a partner as defined in section 761(b). For example, where trust T is a partner in the partnership ABT, and AW, A's wife, is the sole beneficiary of the trust, the ownership of a capital and profits interest in the partnership by T will be attributed to AW only for the purpose of further attributing the ownership of such interest to A. See section 267(c) (1) and (5). If A, B, and T are equal partners, then A will be considered as owning more than 50 percent of the capital and profits interest in the partnership, and losses on transactions between him and the partnership will be disallowed by section 707(b)(1)(A). However, a loss sustained by AW on a sale or exchange of property with the partnership would not be disallowed by section 707, but will be disallowed to the extent provided in paragraph (b) of section 1.267(b)-1. See section 267 (a) and (b), and the regulations thereunder.

(c) **Guaranteed payments.** Payments made by a partnership to a partner for services or for the use of capital are considered as made to a person who is not a partner, to the extent such payments are determined without regard to the income of the partnership. However, a partner must include such payments as ordinary income for his taxable year within or with which ends the partnership taxable year in which the partnership deducted such payments as paid or accrued under its method of accounting. See section 706(a) and paragraph (a) of section 1.706-1. Guaranteed payments are considered as made to one who is not a member of the partnership only for the purposes of section 61(a) (relating to gross income) and section 162(a) (relating to trade or business expenses). For a guaranteed payment to be a partnership deduction, it must meet the same tests under section 162(a) as it would if the payment had been made to a person who is not a member of the partnership, and the rules of section 263 (relating to capital expenditures) must be taken into account. This rule does not affect the deductibility to the partnership of a payment described in section 736(a)(2) to a retiring partner or to a deceased partner's successor in interest. Guaranteed payments do not constitute an interest in partnership profits for purposes of sections 706(b)(3), 707(b), and 708(b). For the purposes of other provisions of the internal revenue laws, guaranteed payments are regarded as a partner's distributive share of ordinary income. Thus, a partner who receives guaranteed payments for a period during which he is absent from work because of personal injuries or sickness is not entitled to exclude such payments from his gross income under section 105(d). Similarly, a partner who receives guaranteed payments is not regarded as an employee of the partnership for the purposes of withholding of tax at source, deferred compensation plans, etc. The provisions of this paragraph may be illustrated by the following examples:

**Example (1).** Under the ABC partnership agreement, partner A is entitled to a fixed annual payment of \$10,000 for services, without regard to the income of the partnership. His distributive share is 10 percent. After deducting the guaranteed payment, the partnership has \$50,000 ordinary income. A must include \$15,000 as ordinary income for his taxable year within or with which the partnership taxable year

ends (\$10,000 guaranteed payment plus \$5,000 distributive share).

**Example (2).** Partner C in the CD partnership is to receive 30 percent of partnership income as determined before taking into account any guaranteed payments, but not less than \$10,000. The income of the partnership is \$60,000, and C is entitled to \$18,000 (30 percent of \$60,000) as his distributive share. No part of this amount is a guaranteed payment. However, if the partnership had income of \$20,000 instead of \$60,000, \$6,000 (30 percent of \$20,000) would be partner C's distributive share, and the remaining \$4,000 payable to C would be a guaranteed payment.

**Example (3).** Partner X in the XY partnership is to receive a payment of \$10,000 for services, plus 30 percent of the taxable income or loss of the partnership. After deducting the payment of \$10,000 to partner X, the XY partnership has a loss of \$9,000. Of this amount, \$2,700 (30 percent of the loss) is X's distributive share of partnership loss and, subject to section 704(d), is to be taken into account by him in his return. In addition, he must report as ordinary income the guaranteed payment of \$10,000 made to him by the partnership.

**Example (4).** Assume the same facts as in example (3) of this paragraph, except that, instead of a \$9,000 loss, the partnership has \$30,000 in capital gains and no other items of income or deduction except the \$10,000 paid X as a guaranteed payment. Since the items of partnership income or loss must be segregated under section 702(a), the partnership has a \$10,000 ordinary loss and \$30,000 in capital gains. X's 30 percent distributive shares of these amounts are \$3,000 ordinary loss and \$9,000 capital gain. In addition, X has received a \$10,000 guaranteed payment which is ordinary income to him.

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